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Trusts: Managing Property with Income and Estate Planning

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Trusts: Managing Property with Income and Estate Planning
Gerald A. Harrison, Extension Economist and Legal Affairs Specialist

This information is a teaching and decision-making aid and is not intended to supply definitive answers to your estate planning and settlement questions. Legal counsel is advised for questions concerning the maintenance and transfer of your estate.

Introduction
This presentation is intended as a brief overview of some of the popular trusts.

Many people miss opportunities to use trusts in the development, management and transfer of their estate. Trusts may be provided for the benefit of the original property owner as well as for the benefit of a spouse, children, grandchildren, other dependents, and for charitable purposes. While the predominant use of a trust is to hold and manage property with the income and principal to benefit designated individuals, tax avoidance may often be the greater motivation.

Establishing a trust requires that a property owner, who is the “trustmaker,” (and is referred to as the settlor or grantor) transfers property by deed or other transfer device to a trustee for the beneficiaries. The property (cash, stock, real estate, or other assets) is managed for the beneficiaries according to a set of rules in the trust instrument or agreement (i.e., the trust). In modern planning, a trust would be defined by a written document even though a court of law can, if an argument arises, declare a trust to be present by intent or implication in order to be fair to parties who should benefit from certain property. Management rules, transfer arrangements, and tax planning in a trust are very important. Trusts should be established only after study of needs and alternatives with appropriate family communication, professional analysis, and legal counsel for guidance and drafting. Trusts may be drafted in great detail to cover all the practical aspects of the management of trust property (referred to as principal or corpus) and its income. Alternatively, trusts may be brief leaving trustee conduct to be governed by extensive state law concerning trusts. To provide certainty of rules, flexibility, and to avoid limitations in state law, it is advisable to have the settlor’s and beneficiaries’ needs and limitations spelled out in the trust. The settlor, trustee, and beneficiaries should know their goals, rights, duties, and expectations.

The general and specific names applied to trusts are numerous but usually indicate something about the purpose, time of formation, tax characteristics, income distribution rules or corpus of the trust. For example, “simple” trusts are those for which the trustee must distribute all the trust income annually or more frequently which is an income tax law designation. All other trusts, for income tax purposes, could be referred to as “complex” trusts. Inter vivos or lifetime trusts are those which are established while the settlor is living even though the trust may be inactive until the settlor dies. The inter vivos trust may receive assets from an estate of the decedent-settlor or his or her decedent spouse’s estate. Testamentary trusts are established after death of the “settlor” by provision for a trust in his or her will. Lifetime trusts may be revocable or irrevocable. Many of the uses of trusts have resulted in popular names such as “land,” “minor’s,” and “short term,” but all of these are lifetime trusts. A marital deduction trust may be prepared during the lifetime of the settlor in a document outside the will.

Living Trusts: Revocable or Irrevocable
A popular book, How to Avoid Probate! by Norman Dacey in 1966 (and a 1980 version How to Avoid Probate—Updated!), stresses the possibility of using living trusts for the primary purposes of avoiding attorneys’ fees for probate or estate administration. It is a popular notion that fees charged by personal representatives and their legal counsel are excessive. The fee for the attorney may be 1% to 5% of the assets handled in the estate and a one-half or equal sum for the personal representative. However, some lawyers will provide probate counsel on an hourly fee basis. While the use of Dacey’s “declaration of trust” forms without the assistance of estate and tax planning legal counsel is not advised, transferring assets into a lifetime trust for continued use by the settlor or dependents and other heirs or beneficiaries and for ultimate distribution to beneficiaries rather than transfer by will is a sound strategy for many situations.

Placing property into revocable or irrevocable living trusts will avoid the need for transfers after death and thus avoid the portion of the probate fees associated with postmortem property transfers. The personal representative and legal counsel will still be entitled to a fee (albeit smaller) for determining death tax liability for interests of a decedent that are represented by rights in one or more trusts. Mr. Dacey's idea of virtually all conceivable assets into lifetime trusts complete with distribution provisions to beneficiaries upon termination of the trust may be impractical in many situations from a legal and asset management point of view and misleading in regard to actual estate administration costs since the decedent-settlor's retained interest will be subject to federal estate and inheritance taxes. To illustrate how a misunderstanding may arise, the IRS has ruled that even though the settlor has established an irrevocable trust, with gifts of assets into the trust, merely retaining the right to change the trustee is sufficient to require the full value of the assets held in the trust on the date of the settlor's death to be included in the settlor's gross estate for federal estate tax purposes.

Irrevocable trusts are often established which explicitly retain the income from or use of assets held in trust such as a rental property or a residence. Federal estate and state inheritance tax laws require the fair market value as of date of settlor's death to be subject to death taxes just as would be true if the assets were held in a revocable trust. Revocable or irrevocable trusts may be advisable regardless of the failure to avoid consideration for death taxes because of: (1) trusts providing the desired transfer arrangements which may be comforting to both the beneficiaries (heirs) and settlor to have this done prior to death; (2) little or no concern about death taxes because of the relatively low value of the assets and because of the exemptions, deductions, and credits provided in the estate and inheritance tax law; (3) savings in legal and other fees from trust transfers rather than transferring under a will or by the laws of descent; (4) management services obtained from the trustee; (5) income tax savings in the case of irrevocable trusts which shift income from the settlor to the trust and/or beneficiaries; and (6) privacy of transfer arrangements which may be obtained with a trust rather than transfers by a will which become a public record once the will is submitted for probate. In short, many property owners may gain substantial benefits with lifetime trusts even though they cannot afford to fully give up ownership of assets to the extent necessary to avoid income or death taxes.

Further, it is important to emphasize that a trust can and should include desired transfer restrictions between family members especially where real estate or closely-held business interests (stock, partnership interests or other trust beneficial interests) exist. Transfer restrictions such as preferential buy-sell rules should be provided for at all times whether in: a will, bylaws of a corporation, a partnership agreement, deed or binding contract. The basic idea is to set binding rules for those who wish to or must sell what they have acquired along with other family members. Such provisions are important for husband and wife situations as well as parent-child, brother-sister and family-in-law co-ownership arrangements. Property owners may want to set up rules that may (or must) be used to block transfers to "outsiders" and, in some cases, give preferred treatment to certain family members.

Following is a brief presentation of a few lifetime type trusts. Those presented are intended as a teaching illustration and are not necessarily the application of a trust that is useful for your purposes.

**Land Trust**

The land trust is a variation from the normal arrangement for operating a trust. It is peculiar because the routine management rights are usually held by the beneficiaries rather than the trustee. Since in England and by our common law tradition, the placing of "trustee powers" in the beneficiaries voided a trust, the land trust was added to the Indiana trust statutes in 1971 as a permissible trust and a later amendment permits personal property as well as real estate to be held by a land trust.

Management of the trust assets by the beneficiaries (business partners or family members) departments and other trust companies will readily provide information on how fees are set for trust services. Also, if assets are held in a trust, the annual tax preparation and counseling fees may be increased significantly over what was experienced prior to trust formation. However, it should be emphasized that some trust arrangements might not require either professional trustee services or complicated tax filings.

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2 Revocable trusts are those which the settlor has retained the power to terminate the trust and receive back the remaining principal and accumulation of income.

3 Attorney's fees for drafting a trust range from a few to several hundred dollars depending upon the complexity of the document and related counseling. Professional trustee fees are on an annual basis and will depend upon the nature of the management involved, a fraction of a percent of the trust principal for funds held in a "common pool" to several percent for management of real estate. Bank trust

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4 Kess and Westlin list eleven advantages of revocable trusts on page 204 of the CCH Estate Planning Guide.
makes the land trust attractive. Usually the land trust instrument (beneficiary agreement) provides that a majority of the beneficiaries may make most decisions. This may be the rental or sale of farmland or other property as well as routine management responsibilities (taxes, insurance and minor improvements). Trustees for land trusts are usually limited to maintaining the official records of beneficial ownership and in some cases to performing accounting and tax preparation services. The land trust permits conversion of real estate interest to personal property as beneficial interest. Land trust beneficiary agreements need not be recorded which allows for privacy. Beneficial interest is handled on a pro rata basis for sharing expenses and income. IRS accepts the land trust as a nontaxpayer with net incomes taxed to the beneficiaries similar to a partnership or a simple trust (where all income must be distributed at least annually).

Land trusts are viewed as a relatively simple arrangement particularly for managing real estate interests. Beneficiary agreements usually include transfer restrictions (buy-sell arrangements) and provide for termination of the trust after 20 to 40 years unless the beneficiaries elect to continue. If the land trust is terminated, the beneficiaries usually become tenants-in-common. Even though Indiana law provides for the land trust, they have not been widely used in Indiana. A limited partnership or corporation is often selected in lieu of the land trust. Many CPA's and tax planning lawyers may counsel businesses and property owners into partnerships and corporations because of their greater flexibility for tax and financial structure planning.

Minor’s Trust

A minor’s trust serves the primary purpose of holding assets for a minor. Minors are deemed incapable of managing property because of legal disability. The federal tax law has requirements to be satisfied if the trust with a minor as beneficiary is to achieve certain objectives. The usual tax objectives are: (1) gifts into the trust will be deemed to be of a present interest (rather than a future interest even though the use and enjoyment may be withheld from the minor for many years) which allows the gift to be eligible for the $10,000 annual gift tax exclusion, (2) income which arises from the assets each year will be viewed as taxable to the minor-beneficiary or to the trust if accumulated and not to the grantor-donor or trustee-parent, and (3) assets in the trust will not be part of a donor-parent’s federal estate tax estate should he or she predecease the minor-beneficiary who has not yet had the right to withdraw the assets in the trust.

To achieve the above objectives, the minor’s trust instrument must include certain provisions. First, the minor must have the right to a distribution of the trust assets and accumulations of income at age 21 (even though age of majority is 18 in Indiana). Parents or other donees can use the minor’s trust as a holding device achieving desirable income tax results, yet the consumption of income and/or principal may be withheld until age 21. This trust may provide income and principal to the minor at the trustee’s discretion. The college age beneficiary could receive needed funds from his or her minor’s trust. However, if a parent is the trustee for their child’s minor’s trust and allocates trust income for expenses of the child which are a legal obligation of the parent, the income will be taxable to the parent. This is the federal tax law even though the parent is not the donor of the trust assets. If a parent is the donor of the principal in the trust, then the parent may not serve as the trustee if the parent wishes to avoid having the minor’s trust assets subject to federal estate tax in the parent’s estate should the parent die before the child reaches 21. Lastly, the minor’s trust must provide, in the event of the death of the minor beneficiary, principal and income accumulations available to the minor’s estate or subject to the minor’s testamentary general power of appointment.

Short Term Trusts

Just as is true for the minor’s trust and other uses of trusts, the short term or Clifford trust is motivated by income tax avoidance. Often circumstances develop where a taxpayer in a relatively high tax bracket desires to provide long term support for another person in a lower tax bracket. The shorter term trust permits the support donor (grantor) to place assets in a special purpose trust with income rights for the support recipient as the beneficiary. A short term trust permits an exception to a fundamental rule of income tax law that “income is taxable to the person who ‘owns’ the source of the income.” To benefit from this exception, the law requires transfer of the settlor’s assets irrevocably into a trust for at least 10 years or for the life of the beneficiary if the latter should be shorter. After a full 10 years pass (or after the beneficiary’s death), the assets may revert to the settlor. The 10-year “lock up” of trust corpus and the provision of the income from the trust assets to the “short term” beneficiary shift the income tax liability to the beneficiary.

The table below illustrates how much a settlor’s annual federal income tax might be reduced by shifting assets and income into a

\footnote{Clifford was a taxpayer whose short term trust was reviewed before the U.S. Supreme Court in 1939. The Internal Revenue Code includes specific rules to permit, but limit, this use of a trust.}
short term trust. The table is based upon three beginning levels of taxable income and shifts of $1,000, $3,000, and $10,000 of income.

<table>
<thead>
<tr>
<th>Settlor's Taxable Income (Before Shift)</th>
<th>Annual Decrease in Settlor's Income Tax by Shifting</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$1,000 of Income</td>
</tr>
<tr>
<td>$30,000</td>
<td>$253</td>
</tr>
<tr>
<td>$60,000</td>
<td>340</td>
</tr>
<tr>
<td>$90,000</td>
<td>450</td>
</tr>
</tbody>
</table>

The grantor is assumed to be married filing jointly for the tax year 1984. For the 1984 Tax Rate Schedules, the additional tax on a given increment of income increases until $162,400 of income is reached after which the marginal tax rate levels at 50%. A beneficiary must include the annual net income from the trust in his or her taxable income unless it is accumulated and taxed in the trust. The beneficiary who is relying upon income from the settlor presumably has less taxable income.

How the income is taxed in the return of the beneficiary depends upon the type of income received from the trust, e.g., ordinary income or long term capital gain. A beneficiary who is a child of the settlor has no zero bracket amount available against unearned income (e.g., trust distributions, interest, dividends, and capital gains). If the beneficiary is an elderly relative of the grantor, gross income of $1,000 or more per year would exclude the beneficiary from being included as an income tax dependent of the grantor. A beneficiary age 65 or older would have two $1,000 exemptions plus a $2,300 zero bracket amount if unmarried, permitting up to $4,300 of net income without tax liability. If the beneficiaries are a couple age 65 or older, the exemptions total $4,000 and the zero bracket amount is $3,400; $7,400 in total may be included in income before a tax would arise. With $10,000 of trust income the single elderly beneficiary without other taxable income would have $8,000 subject to a tax of $760 in 1984. The married, elderly couple would have only $6,000 taxable income (if there were no other taxable income) and a tax of $291. Costs of establishing the trust and managing the trust on an annual basis including extra tax preparation and legal services should be considered to calculate the savings from the settlor’s avoidance of income tax. Also, for sizable income streams placed in a short term trust there may be a gift tax cost.

When the short term trust is established, the settlor is making a gift for gift tax purposes which is the present value of the income as determined from federal income tax regulation tables. Assets transferred to the trust for just 10 years and a day would have a gift tax value of about 61% of the fair market value of the assets on the date of the transfer of the assets to the trust. If the trust provides that the income must be distributed to a beneficiary currently (at least annually) rather than accumulated, the income stream is viewed as a present interest (rather than a future interest) allowing up to the $10,000 annual exclusion per donee per year ($20,000 if the settlor’s spouse splits the gift between their two gift tax returns).

The fair market value of assets that would yield a $3,000 annual return if earning at an 8% rate would be $37,500. The 61% factor times $37,500 would be a gift of $22,875. If gift splitting with the settlor’s spouse takes place per or if there were two settlors, the $22,875 would exceed an available $20,000 total annual exclusion by $2,875. If there were only one settlor or no gift splitting, the settlor would have an adjusted taxable gift of $12,875. Depending upon past gift-making and accumulated taxable and adjusted taxable gifts, there might be no gift tax liability since the unified credit to apply against a calculated gift tax is $96,300 in 1984 (a taxable gift equivalency of $325,000, rising to $600,000 in 1987 and after.) If the annual income is $10,000 from assets with an 8% yield, the value of the assets in the trust would need to be $125,000, and the 61% present value gift would be $76,250. The adjusted taxable gift would be $66,250 with only one $10,000 amount to exclude. Such adjusted taxable gifts must be added to the settlor-donor’s estate tax base following death for the calculation of the federal estate tax and before the subtraction of the unified credit.

Furthermore, the full or part value of the settlor’s trust assets will also be included in the gross estate tax estate of the settlor in the event of death, if the trust instrument provides for the assets to revert to the grantor. The greater the number of years to run of the 10-year trust, the less the reversionary interest would be, and the less to be included in the decedent-grantor’s estate tax calculation. If the settlor died on the day following the first day of the 10-year-and-a-day trust, the reversionary interest would be about 39% of the fair market value of the trust.

6 This “table percentage factor” is based upon proposed Treasury regulations for “10% tables” effective December 1, 1983. The 10% tables replace the 6% tables (and a factor here of 44%) raising the “percentage factors” and the value of the gift. The 10% is the assumed annual internal rate of return. If the assets are placed in the trust for 10 years and a day or the life of the beneficiary (rather than for a full 10 years and a day), then a different table and factor applies since the life expectancy (age) of the beneficiary becomes an element influencing the present value of the income gift. For example, if the life expectancy of a beneficiary aged 75 was involved, the factor is 46%.
assets. If the settlor dies with two years to go in the 10-year period, the reversionary interest would be about 83% of the fair market value of the trust assets subject to reversion on the date of death.

When farmland and business assets are considered for transfer to a short term trust, additional tax considerations arise. On assets that generated an investment tax credit, there is the potential for recapture. In the case of farmland, the settlor should examine the potential for special valuation of the farmland for estate tax purposes. The reversionary interest that may arise during the course of a short term trust is a future interest and may not be eligible for special valuation of farmland.

In addition, the IRS has ruled that assets transferred to a short term trust having a potential capital gain (i.e., value exceeds tax basis) gives rise to value that must be included as part of the gift unless the trust instrument precludes the sale of the asset by the trustee. To emphasize the importance of special provisions in the trust instrument, a trustee who holds farmland without specific instructions to do so may violate the prudent man rule, a conservative criterion that generally must guide trustees in their choice of investments.

Recently the practice of real estate and personal property gifts into a short term trust and the leaseback by the donor-grantor has come under attack by the IRS. But the gift-leaseback may still be a viable arrangement for tax purposes if rigid guidelines are followed: 1) an independent trustee, 2) leaseback in writing, 3) a meaningful business purpose, and 4) ideally the grantor-lessee should not hold a reversionary interest. As an alternative the property could be returned to a spouse or children.

Life Insurance Trusts

Trusts to manage life insurance proceeds for minors and other dependents may offer one of the most important uses of a trust. Parents who die prematurely may have a substantial influence over how insurance proceeds paid to a trust are used for children rather than risk misuse of funds by a guardian, surviving spouse, or other policy beneficiary. The trust may provide a superior investment vehicle before the funds are spent on surviving dependents or distributed when children reach an advanced age. Trusts for the purpose of receiving death benefits may be established during lifetime or drafted into a will (testamentary).

Those with substantial insurance coverage who expect to have modest or larger estates with potential estate tax liability may establish trusts to own life insurance policies for children. "Policy owning" trusts may require periodic gifts into the trusts so that funds may be available to pay premiums. The Crumey provisions usually allow the beneficiaries 30 to 60 days to withdraw the gifts from the trust. The withdrawal rights are essential for a present interest gift according to the federal tax law. If there are no withdrawal rights, the gift provides the donee a future interest, and the $10,000 annual gift tax exclusion cannot help avoid an adjusted taxable gift. Insurance trusts with Crumey provisions might present income tax concerns for the beneficiaries if the trust accumulates gifts subject to lapsed withdrawal rights.

If the insured-decedent does not own the life insurance policy, the insurance proceeds generally will not be part of the decedent's federal estate tax estate. Yet, the trust may include provisions that permits the trustee to make cash available to an estate through a loan or purchase of assets that may benefit the trust beneficiaries. Acquisition and control of certain assets by trust beneficiaries who may be children of a decedent may be an important estate planning objective. The life insurance trust can be a vital part of a plan to shift the family farm or a controlling interest in a closely-held business.

Testamentary Trusts

Wills and trusts should be carefully coordinated. Estate planning lawyers encourage individuals and married couples to establish one or more trusts during lifetime to provide for existing or potential lifetime needs as well as to satisfy postmortem objectives. In some cases there may be only minimal funding of a lifetime trust, which is primarily for the purpose of receiving assets transferred by a will provision.

Many individuals and couples accept the idea of a need for management assistance and control of their assets or insurance proceeds and tax planning after death but do not see a need for lifetime trusts. The testamentary (those provided for directly in the will) use of the trust is not a probate avoidance device for the person whose will includes such a trust(s). Assets controlled by the decedent, such that a will provision may direct them into a trust, are part of the probate estate for attorney and executor fee purposes and subject to federal and state death tax. The use of a testamentary trust may prevent assets from being part of the estate of trust beneficiaries such as a surviving spouse or children and may provide income and estate tax savings for the beneficiaries and their estates.

Testamentary trusts and disclaimers may be used together to provide flexibility in postmortem planning. If a surviving spouse or other devisee, after receiving legal and tax counsel, believes it would be best to not accept certain assets from a decedent's estate, he or she may disclaim (give-up the right to receive) assets and let them transfer to whomever would have received the assets had the disclaiming party predeceased the decedent. The one who dis-
claims properly under federal tax law and state law avoids having the disclaimed transfer considered as a gift for federal gift tax purposes, and the inheritance tax liability is shifted to the alternate recipient(s).

**Marital and Nonmarital Deduction Trusts**

Marital and nonmarital deduction trusts are typically a testamentary type although the trust instrument which provides for this one or two or more) trust arrangement could be established during the lifetime of the trust-provider. Most of the assets to be handled by these trusts, which are initially for the benefit of a surviving spouse, are allocated to one of the trusts according to a formula designed to utilize the federal estate tax features: marital deduction and unified credit. A major goal is to minimize the federal estate tax and to some extent state death tax imposed upon the estates of both the first spouse to die and the surviving spouse. Marital and nonmarital trust arrangements are known by several names depending upon the choice of jargon or the particular purpose. “A and B” are shorter and once popular designations for the general terms marital (A) and nonmarital (B). Under federal tax rules effective in 1982, a QTIP (qualified terminal interest property) trust is a variation of a marital trust. Nonmarital trusts may be referred to as: bypass, credit shelter, or residuary, depending upon the nature of the asset-transferring formula.

Prior to 1977, the federal estate tax marital deduction was limited to one-half of the adjusted gross estate (gross estate minus allowable debts and expenses incurred by the estate). Under this deduction limitation, a “50-50” formula was typical to assign assets to the marital and nonmarital trusts. From 1977 through 1981, the marital deduction was the larger of $250,000 or one-half the adjusted gross estate. Because the law was again amended to now permit a 100% marital deduction, it is possible for decedent spouses after 1981 to devise all assets to the surviving spouse and possibly to a marital trust and completely avoid estate tax at the first spouse’s death. However, the assets qualified for the marital deduction are subject to gift and estate tax and inheritance tax in the estate of the surviving spouse.

Starting on January 1, 1977, a unified credit (replacing an exemption of $60,000) was added to subtract from a calculated federal estate tax. Generally, to avoid adding potentially taxable assets to the estate of the surviving spouse, a nonmarital (credit shelter or bypass) trust may be provided to receive assets with a value at least equal to the equivalent deduction value of the federal unified credit. The unified gift and estate tax credit is $96,300 for 1984 with an equivalency of $325,000 increasing each year to $192,800 in 1987—with an equivalent deduction value of $600,000. Decedents’ federal estate tax estates after subtracting allowable debts and expenses, which results in an estate tax base (without a marital deduction) of $600,000 or less, could go estate tax free into the credit shelter trust. If the transfer of assets into the “shelter” trust exceeds the equivalent deduction of the unified credit and other available federal estate tax credits, these transfers are subject to federal estate tax in the decedent’s estate. Since the marital deduction is 100% (since January 1, 1982) the married decedent may avoid estate tax in his or her estate by leaving the assets above the “credit shelter” to the surviving spouse with enough income rights and powers to qualify for the marital deduction. This would permit complete avoidance of federal estate tax in the estate of the first spouse to die. The sheltering result does not depend upon a trust being provided to hold the assets. Property interests could be devised directly to individuals other than the spouse to avoid additional value in the surviving spouse’s estate, and those assets qualified for the marital deduction could be transferred to the surviving spouse.

While assets transferred to the marital trust are potentially taxable in the estate of the surviving spouse, those assets in the credit shelter trust may provide limited rights and access to a surviving spouse and with proper trust drafting will not be included in the surviving spouse’s estate and thus avoid death taxes at his or her death. However, a surviving spouse also has his or her unified credit available with an equivalent deduction value of $600,000 by 1987. An estate planning spouse often makes lifetime transfers to his or her spouse or utilizes right of survivorship ownership so that the surviving spouse’s estate can utilize the unified credit without acquiring additional assets from the decedent spouse’s estate.

A credit shelter or bypass trust is not only a vehicle for avoiding estate tax on a surviving spouse’s estate, but it can be important in achieving a decedent spouse’s goals concerning ultimate control of assets and maintenance of assets for other heirs. There is considerable flexibility in the federal tax law concerning what the credit shelter trust may provide to the surviving spouse yet not have the trust assets included in the surviving spouse’s estate. The credit shelter or bypass trust may provide all of the annual income to the surviving spouse. Further, the surviving spouse could be provided the right to invade the principal limited by an ascertainable standard relating to support, maintenance, health, or education. In fact, a surviving spouse may serve as the sole trustee of this type of trust having income rights and limited invasion rights. As long as the invasion rights do not exceed on an annual basis the larger of $5,000 or 5% of the trust principal, no ascertainable standard need be utilized, and there will be nothing added to a surviving spouse’s estate that remains in the bypass trust.
except the value of the $5,000 or 5% right that was not exercised in the calendar year of the beneficiary spouse’s death. Failure to exercise the right in prior years does not cause the cumulative value of the lapsed rights to be added to the surviving spouse’s estate. Thus, it is possible to provide for a surviving spouse in a substantial way, yet avoid taxation of the supporting assets in a surviving spouse’s estate. While a surviving spouse may serve as a sole trustee, this may not be advisable where other family members (as trustee) or a corporate trustee may have the needed expertise. Letting someone besides the beneficiary spouse serve as trustee may avoid unnecessary depletion of assets and may accommodate income tax avoidance on the surviving spouse’s behalf through discretionary income distribution.

Prior to 1982, a transfer by a decedent to a surviving spouse would not qualify for the estate tax marital deduction unless the surviving spouse had at least the right to the income from the assets on an annual (or more often) basis and the right to give the remainder to whomever desired at his or her death. (This right is referred to as a general power of appointment as opposed to a terminal interest as in the case with only a life interest.) These minimum rights made the property part of the surviving spouse’s estate tax estate. If the property value in the decedent’s estate is to qualify for a marital deduction, it must be eligible for inclusion in a surviving spouse’s estate if the property is still available at the surviving spouse’s death.

Since 1981, a federal estate tax law permits a marital deduction for “qualified terminal interest property” (QTIP), which in its strictest form may be a legal life estate or life interest in a trust with the remainder interest going as designated by the donor-testator (decedent spouse). It is possible for a decedent property-owning spouse to have designated no more than the annual income (invasion of principal for the benefit of only the surviving spouse could be permitted if desired) from certain assets to a surviving spouse, yet a marital deduction is permitted for the decedent’s estate for the value of such assets. While a legal life estate can be QTIP, it is generally advisable to utilize the trust vehicle, referred to as the QTIP trust especially where a surviving spouse might need invasion rights (a lifetime power of appointment). Whether property restricted in this manner ought to be qualified for the marital deduction rather than assigned to a nonmarital or bypass trust may be elected by the personal representative after death of the provider. However, the individual spouses should plan property arrangements and trust vehicles in advance and possibly designate rules to guide and protect the interests of the personal representative. The new QTIP provision provides additional death tax planning flexibility.

Property owners need not utilize trusts and other restrictive arrangements to qualify property for the marital deduction. Transfers to the surviving spouse may be free of restrictions or limitations that trusts normally impose. On the other hand, life interest trusts or legal life estates, and whether they are to be qualified for the marital deduction and possibly with inflexible formula clauses to allocate property between marital deduction and bypass trusts, may be irrevocably set once death occurs. The advantages of leaving the QTIP election in the hands of the personal representative is usually one of adding flexibility to estate tax planning for both the decedent’s and the surviving spouse’s estates and income tax planning for the surviving spouse and other heirs.

Conclusion

Management of assets and tax planning with trusts is a standard in modern estate planning. However, many people are not familiar with how simple or complex trust arrangements may be. The discussion above demonstrates some of the aspects of trusts and their terminology. Various uses and tax implications are shown. Other uses of trusts, such as for charitable purposes, are available. Trusts may be established perpetually for qualified charitable beneficiaries. Of course, lifetime charitable transfers may provide income tax savings to the donor in addition to being free of gift tax.

Adequate communication, study, and analysis with the assistance and guidance of tax and legal counsel should precede the establishment or provision for trusts. How or whether the trust efficiently satisfies needs and objectives of the settlor and beneficiaries is what is most important. Wills, transfer restrictions, choice of business organization, and types or forms of assets held must be carefully coordinated with trust planning.

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References


Author's Note: Numerous other books and current articles in professional magazines are available. Bank trust departments have pamphlets available on various uses of trusts and information on fee schedules for trust services. The author may be contacted for additional papers and sources of information: Gerald A. Harrison, Agricultural Economics Department, 630 Krannert, Purdue University, West Lafayette, IN 47907. Phone (317) 494-4216.

Note to readers: Those not familiar with the federal income tax law for individuals, such as alternative filing statuses and exemptions and the zero bracket amounts, might want to review the IRS publication #17, Your Federal Income Tax, available from the IRS by calling 1-800-424-1040. Likewise, information on Federal gift and estate tax may be found in IRS publication 448. Other publications are available from the author, Gerald A. Harrison, Agricultural Economics Department, 630 Krannert, Purdue University, West Lafayette, IN 47907.

Other Publications*
Getting Started in Estate Planning. HE-517, 4 pgs., 2/82
Estate and Financial Record for Estate Planning. EC-521, 11 pgs., 4/81
Farm Estate and Transfer Planning: a Management Perspective. NCR-193, 1983, $2.00
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Keeping Your Important Papers. HE-564, 14 pgs., 11/82
Indiana Laws for Understanding Your Estate. EC-519, 22 pgs., 6/81, $1.00
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