Trusts: Uses and Considerations

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Trusts are a form of property ownership in which the persons who hold legal title to the property manage it for the benefit of someone else. Trusts have many potential uses, including avoidance of probate, minimization of income taxes, minimization of estate taxes, and management of assets for minors and others incapable of managing their business affairs. The appropriate structure for a particular trust is determined by the objectives of the individual establishing the trust.

Establishing the Trust

Establishment of a trust involves transferring assets to an individual or individuals who will manage those assets for the benefit of designated beneficiaries. The person creating the trust is sometimes called a trustor or grantor. The individual or individuals who manage the assets are called trustees. The grantor may serve as trustee or he may designate one or more individuals or a business, such as a bank, to serve as trustee. The appropriate choice of trustee will vary, depending upon the purpose of the trust and the goals, interests and management skills of the grantor.

Trusts may be established either by a written document or oral statement establishing the trust during the grantor's lifetime or by a will. If the trust property includes real estate, the trust must be created by a written document. Trusts that take effect during the grantor's lifetime are called intervivos trusts. Trusts which are created by will are called testamentary trusts. If the grantor's goal is avoidance of probate or minimization of his own estate or income taxes, an intervivos trust may be required. A disadvantage of intervivos trusts arises from the fact that, depending upon how they are structured, the grantor may lose control over the property which is transferred to the trust.

The amount of control which a grantor will retain over the assets after a trust is created is determined by how the trust is structured. A revocable trust is one which may be terminated at any time by the grantor. An irrevocable trust is one which may not be terminated by the grantor once it is created until the end of the time period specified in the trust terms. The maximum length of time for which a trust may be created is 21 years if a fixed time period is specified or, alternatively, 21 years plus the life or lives of designated beneficiaries who are alive when the trust is created. In Oklahoma, trusts are deemed to be revocable unless the document creating the trust specifically says the trust is irrevocable. An irrevocable trust will generally be required to achieve minimization of estate or income taxes.

Even if the trust is irrevocable, the grantor may still be able to retain some control over asset management. One method of retaining control is for the grantor to serve as trustee. In such a case, the grantor would not have complete control since he or she would have to manage the assets within the constraints of the trust framework and in such manner as to promote the interests of the beneficiaries. A second form of control results from the grantor retaining the right to designate the beneficiaries who will receive the benefits of the trust. This right is called a power of appointment and may be exercised after the trust is created. Retention of a power of appointment provides flexibility by permitting the grantor to postpone decisions regarding distribution until some point in the future when he may have more information about the needs of potential beneficiaries. If the grantor does not wish to retain the power, it may be granted to another individual, such as the grantor's spouse. If a power of appointment is retained or granted to someone else, the trust should specify what will happen if the power has not been exercised prior to the death of the holder or in the holder's will. A general power of appointment allows the person holding the power freedom to name anyone as beneficiary, including himself. A special power of appointment limits the choice of beneficiaries to certain designated individuals, excluding the individual holding the power. In some cases, retention of a power of appointment may prevent the trust from achieving some tax avoidance goals. For example, if the grantor retains the right to name himself as a beneficiary, he essentially still has complete control of the property and no tax benefits would result from creation of such a trust.

Trustees

Either an individual or a business entity may serve as trustee. There may be one or more trustees. Both the grantor and the beneficiary are eligible to serve as trustee, but it may be desirable for tax and other reasons to name an independent trustee. If an individual is named as trustee, a secondary trustee should be named to take charge in case of the death of the primary trustee. It may also be desirable to name a secondary trustee if an institutional trustee is named since the bank or other institutional trustee may eventually cease to exist. Many banks and other financial institutions have trust departments and offer trust management services. A fee is generally charged for those services. One advantage of using a corporate trustee, such as a bank, is that the bank probably employs individuals who are experienced in trust management. A disadvantage of using a corporate trustee is that the trustee fees may significantly diminish trust income or principal.

Trustees are held to the same standard of care in investing trust assets as a prudent, intelligent person would use in managing his or her own affairs. They must consider both the probable safety and the probable income of the investments they make. They are not permitted to speculate with trust assets. Unless the trust instrument permits it, the trustee may not buy trust property or sell property to the trust or lend trust funds to himself or commingle trust funds with his own individual funds. However, banks acting as trustees may obtain approval to maintain common trust fund accounts in which funds from several trusts are combined and used by the bank in the same manner as deposits in other accounts. This permits the bank to minimize the costs of managing small trust accounts. In such cases, the bank still has a duty to keep records of the status of each trust and to account for the administration of each trust to the beneficiaries.

The grantor of the trust may specify in the document creating the trust that the trustee will not be held to some or all of the duties, restrictions and liabilities which would otherwise be imposed or may designate additional restrictions and liabilities. If too many restrictions are placed upon the trustee, it may be difficult to find someone who is willing to serve as trustee. On the other hand, the duties and restrictions normally imposed by statute are designed to protect the interests of the beneficiary and insure that the grantor's objectives are achieved.

Uses of Trusts

Transferring Income

Each trust is generally treated as a separate income tax entity. However, multiple trusts with the same grantor and same beneficiary may be treated as one trust for income tax purposes if the I.R.S. can show that the principal purpose of the multiple trust arrangement is tax avoidance. Trusts are allowed a deduction for payments to beneficiaries and beneficiaries report that amount as income. The 1986 Tax Reform Act reduced the ability to lower marginal tax rates by splitting income between trusts.

One potential use of trusts is transfer of income from parents to minor children. Such transfers can result in lower income taxes if the children are in lower marginal tax brackets than their parents. Care should be taken in structuring trusts to achieve such an objective since the income will be taxed to the parents if they continue to exercise control over the property and the income it generates. However, the grantor parents may act as trustees without adverse income tax consequences as long as the trustees are not given excessive control powers. Grantors will be treated as owners of trust property (and taxed on its income) if they 1) retain a right to have the trust principal returned within ten years after the trust is established, 2) have discretion to distribute income, principal or both as they please, 3) have extensive administrative controls under which they can benefit, 4) have the power to revoke the trust, or 5) have the power to distribute income to themselves or their spouses. A trustee other than the grantor will be treated as owner of the trust property to the extent he or she has the power, acting alone, to transfer trust principal or income to himself or herself.

In determining whether income will be taxable to the minor or to his parents, the I.R.S. will look at the economic realities of the arrangement. If the income is used to satisfy the parents' legal obligation to support their child (to provide food, clothing, shelter, and other necessities) or if the income is used by the parents for their personal benefit, the income will be taxable to the parents.

The types of income which may be transferred through trusts are investment income (by transferring the income producing assets to the trust) or business income (by transferring partial or total ownership of the business to the trust). Salaries and personal service income may not be transferred for income tax purposes.

Parents sometimes attempt to transfer income by opening a bank account with one parent named as trustee for the benefit of their child. This is sometimes called a tentative or Totten trust but is not a satisfactory method of transferring income. This type of arrangement is completely revocable and, consequently, there are no income, gift, or estate tax benefits. Income from the account is still taxable to the parents.

One type of trust which previously was frequently used to transfer income to children is called a Clifford trust. Clifford trusts were frequently used to create an educational fund to pay college expenses. In establishing a Clifford trust, the parent transferred property to the trust for a period of at least 10 years. The trust held the property for the designated time period and accumulated the income for the benefit of the child beneficiary. At the end of the specified time period, the property originally transferred to the trust was returned to the parent. The income went to the child. Previously, if such a procedure was followed, the income was taxable to the child rather than the parent while the trust was in effect. If the parent was in a higher income tax bracket than the child, total income taxes declined.

The important requirements were: 1) the property was transferred to the trust for at least 10 years, 2) the trust was irrevocable during that time period, 3) the grantor could not borrow from the trust without adequate income and security and 4) the income accrued for the benefit of the child rather than the parent. The popularity of the Clifford trust resulted from its relatively short duration and the fact that the principal eventually reverted to the grantor.

The 1986 Tax Reform Act greatly restricted the ability of parents to use trusts to reduce marginal tax rates by transferring income to minor children in lower tax brackets. First, the differential between minimum and maximum tax rates is much less than under the previous system so the maximum potential savings are less. Secondly, there are fewer brackets, so there is a greater likelihood that children and parents may already be in the same marginal rate bracket. Thirdly, the tax act specifically restricted the ability of parents to transfer income to minor children. Clifford trusts that were not established prior to 1986 may no longer be established to shift income for tax purposes. The Kiddie Tax Rules will apply in this situation. If the child's net unearned income exceeds the annual inflation adjusted exemption amount ($2,200 for 2019), this income is taxed at the parents highest marginal tax rate.

Avoiding Probate

Individuals frequently desire to avoid the costs and public records of a probate proceeding. If the grantor's goal is to avoid probate and the costs associated with probate, an intervivos (lifetime) trust must be created. If the trust is created by a will, the trust will not take effect until after the probate process is completed. Either a revocable or an irrevocable intervivos trust may be used to avoid probate as long as the trust does not specify that the assets are to be poured back into the estate for distribution according to the terms of the will. Assets not included in the trust will still be subject to probate.

Avoiding Estate and Gift Taxes

A transfer of property to a revocable trust is not normally considered to be a completed gift until the power to revoke the trust terminates. This has two effects. First, no gift tax results from the transfer of property to a revocable trust. Second, any property transferred to a revocable trust will still be included in the transferor's estate. Both of these results occur because the transferor has the power to revoke the trust and have the property returned at any time.

Irrevocable trusts pose fewer problems from an estate tax perspective. Since the grantor has permanently forfeited the property, the property is generally not included in his estate for estate tax purposes. However, care must be taken in creating the trust because if the grantor serves as trustee and has too much power, the trust assets may be included in his estate. Also, if the trust provides the beneficiary with the types of support that the grantor is legally obligated to provide, the trust property may be included in the grantor's estate.

Transfers of property to an irrevocable trust may be subject to gift tax if the amount of property transferred in a given year exceeds the annual gift tax exclusion. If spouses combine their gift tax exclusions, a maximum of $30,000 ($15,000 from each spouse) may be transferred to each recipient for 2019 without incurring gift taxes.

In order to qualify for the annual gift tax exclusion, the beneficiary must receive a present rather than a future interest in the trust property. In the case of trusts established for the benefit of children under the age of 21, this requires that either:

1a) the trustee must have discretion to distribute property and income before the beneficiary reaches age 21, and
   b) any remaining property must pass to the beneficiary at age 21, and
   c) if the beneficiary dies before reaching age 21, the trust assets must be payable to his/her estate or

2) the beneficiary must be given a Crummey power. A Crummey power is a power of the beneficiary to withdraw assets from the trust for a limited period of time (such as 30 days) after the assets are transferred to the trust.

Marital Deduction Trusts

It is sometimes desirable to establish a trust that will provide income for life to the surviving spouse, with the principal going to children or grandchildren upon the surviving spouse's death. From a tax perspective, it is desirable, if possible, to create the trust in such a way as to take advantage of the marital deduction. The marital deduction permits most transfers to spouses to escape estate and gift tax consequences. However, a problem sometimes arises in using trusts because the marital deduction is not allowed for most terminable interests and the interest which a surviving spouse receives in a life trust is a terminable interest. (For exception see section on QTIP trusts.)

A terminable interest is an interest which will terminate on the lapse of time or the occurrence or failure to occur of some contingency. Life estates, annuities and terms for years are all terminable interests. I.R.C. §2056(b) bars a marital deduction where:

1. the surviving spouse receives a terminable interest, and
2. the decedent also gave an interest to someone else who may possess or own the property after the surviving spouse's interest terminates (such as a remainder).

It doesn't matter whether the second interest was created at the same time as the spouse's interest or in a separate document. However, no problem exists if someone else is given a terminable interest and the surviving spouse receives the second interest.

QTIP Trusts

The 1981 Economic Recovery Tax Act provided a special exception which permits terminable interest property which satisfies certain requirements to qualify for the marital deduction. Such property is called Qualified Terminable Interest Property (QTIP) and trusts which satisfy the requirements are called QTIP trusts. This exception permits the marital deduction for transfers of terminable interests if the surviving spouse is entitled to all income for life, payable at least annually, and if no one (including the surviving spouse) has the power to appoint any of the property to someone other than the surviving spouse during his or her lifetime. Income interests for a term of years or until remarriage will not qualify for the exception. In order to qualify, the donor or the transferor's executor must make an election on the estate or gift tax return. Once the election is made, it is irrevocable. The election may be made for part or all of the property, so some planning flexibility is possible.

Spendthrift Trusts

Spendthrift trusts are trusts which are created to preserve assets which might otherwise be recklessly spent by beneficiaries. Such trusts limit the rights of the beneficiary's creditors to reach trust assets before they are distributed to the beneficiary and also limit the rights of the beneficiary to transfer his right to receive income from the trust. A grantor cannot create such a trust with himself named as beneficiary and thereby prevent his own creditors from reaching the trust assets. Oklahoma statutes also limit the amount of trust income that can be protected from creditors of non-grantor beneficiaries to $5000 income per beneficiary per year. If one individual is the beneficiary of multiple spendthrift trusts, only a total of $5000 income may be protected from creditors and assignees. All trust income, including the protected $5000, is still subject to enforceable claims for support of a spouse or child of the beneficiary and for necessary services or supplies. However, there is no limit to the amount of principal which may be protected from the creditors of beneficiaries other than the grantor.

Asset Management

Another potential use of trusts is asset management. If the beneficiaries are minors or lack the experience necessary to manage the assets, it may be desirable to employ a trustee with the necessary management skills. This can also be useful in the case where the grantor does not live where the assets are located. Older individuals may find it desirable to establish a trust to avoid the possibility of guardianship if they later become unable to manage their assets. By establishing a trust while they are still competent, they would be able to select the trustee who would manage their assets and have an opportunity to observe the trustee as manager.

Other Considerations

One disadvantage of an irrevocable trust is that the grantor cannot change his distribution plan during the term of the trust. Thus, it becomes especially important that care be taken in establishing an irrevocable trust. The problem is less severe in the case of a temporary trust such as a Clifford trust, in which the assets will eventually revert to the grantor, than in the case of a trust in which the trust principal will be transferred to the beneficiaries at the termination of the trust. Revocable trusts and trusts created in a will avoid this disadvantage.

Choosing Property to Transfer to Trust

Care should be taken in transferring appreciated property to a trust during the grantor's lifetime. If property with a fair market value in excess of its basis is transferred to a trust and the trust sells the property at a gain within two years after the trust receives it, the gain will be taxed as if the grantor had sold the property. This means that the characterization of the income as ordinary income or capital gain will depend on the status of the asset in the grantor's hands. Additionally, the tax rate applicable to the sale would be the rate applicable if the grantor had sold the property.

Problems may also arise if business or farm property is transferred to an intervivos trust. I.R.C. §2032A and §6166 permit certain estates to qualify for actual use valuation and deferral of estate taxes if a specified minimum percentage of the estate is composed of farm or business property. If too much farm or business property is removed from the estate, the estate may not qualify to take advantage of these provisions. This may not be a significant problem if estate taxes are not a concern.

Conclusions

This fact sheet is designed to provide a basic understanding of some of the fundamental concepts involved in the use of trusts in estate and tax planning. Many technical rules were not discussed. The importance of obtaining competent professional assistance in establishing and managing a trust cannot be overemphasized. Trusts can be highly useful planning tools if properly designed, but particularly in the area of tax management, they require very careful drafting to insure that all of the grantor's goals are achieved. Many of the trust income tax and accounting regulations are quite complex, and if you become trustee of a trust, you will probably find that an attorney or accountant familiar with the rules can provide valuable assistance in tax planning and in completing the necessary paperwork.

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