

# Chapter 10.

## Role of Trusts

### OVERVIEW

A trust is an arrangement by which a person or entity called a trustee holds legal title to designated property in trust. The property in the trust is called the corpus, and it is managed by the trustee for the benefit of one or more beneficiaries. The rules governing trust administration come from Federal law, State law, and the provisions of the trust instrument itself. Federal law primarily concerns the Federal tax treatment of income, estate, and gift transfers associated with trusts. State law generally governs the conduct and rights of the trustee, controls on trustee action, and State tax aspects. The trust instrument contains the rules of operation within the options permitted by State law.

A trust may be established to do almost anything the person creating it, called the grantor, might do for himself (herself) and some things that he (she) cannot do because of lack of skill, sickness, disability, distance from the timberland, or death. The ability of the trust to bridge the gap between life and death is one of its remarkable characteristics. A trust is recognized as a separate legal entity under both State and Federal law.

### BASIC CONSIDERATIONS

The discussion that follows concerns trusts generally; however, the principles are illustrated in several examples concerning timberland.

#### Trust Provisions

Trust law is complex and, as noted above, is based on both Federal and State law. Because the States do not have a uniform law of trusts, it is imperative to have the trust instrument drafted by an attorney who knows not only the Federal tax rules but also the applicable State law. The provisions generally included in a trust are as follows:

*Property.*--The property transferred to the trust to be managed--the corpus--is described. If timberland is being put in trust, the applicable deeds and legal descriptions should be included.

*Trustee.*--This is the person or entity who holds title to the property and signs the trust agreement. The trustee may be either an individual or an institution such as a bank and may include cotrustees as necessary or desired.

*Beneficiaries.*--Both primary and contingent beneficiaries may be named. The conditions under which income and principal will be distributed are spelled out. With respect to timber, it is particularly important to distinguish between the principal (timber merchantable volume and young growth present at creation of the trust) and the income (subsequent growth); and between the trustee's powers and the beneficiaries' rights with respect to both.

*Powers.*--The administrative powers and flexibility accorded the trustee are enumerated. Flexibility is especially important as concerns timberland because of sometimes rapid changes in markets, new technology, and environmental regulations.

*Spending Provision.*--This bars transfer of a beneficiary's interest and stipulates that it is not subject to a creditor's claims, subject to the provisions of State trust law.

*Term.*--The length of the trust is the term. If a shorter period is not specified, a saving clause against perpetuities can provide that the trust will end no later than the period allowed by State law. State law generally limits a trust term to no more than 21 years longer than the death of the last surviving beneficiary named in the trust.

*Bond.*--The trust may specify that the trustee post a bond, but most trusts normally exempt the trustee from this requirement and address the conditions for exemption of successor trustees.

*Successor.*--The trust instrument should provide for appointment of a successor trustee in the event the named trustee dies, becomes incapable, or declines to serve.

*Fees.*--Payment of reasonable fees to the trustee is provided for, or alternatively the trustee serves without a fee. Institutional trustees always serve for a fee because that is their business.

#### Nontax Benefits

Nontax benefits can include professional management of financial and real property assets, including timberland. A trust can be designed to

assure a timber owner or beneficiaries designated by the owner of both income and protection from creditors. Trusts are frequently designed to benefit family members--such as spouses, minor children and grandchildren, and aged parents--during either the life of the grantor (living trusts) or after the grantor's death (testamentary trusts). The trust supplies the missing management and experience elements for the beneficiaries, who may lack ability and training, be in poor health, be involved in school or a profession, or be incompetent. It can provide the opportunity to travel by insuring professional management of timberland and other assets and by freeing the grantor and/or beneficiaries from management details. A trust assures continuity of management, provides privacy, and can save probate expenses. In fact, trust creativity is limited only by the grantor's imagination and the applicable law.

## TAX TREATMENT OF TRUSTS

Trusts can provide savings in three major tax areas: income, estate, and gift. These are discussed here, in general terms. Specific tax considerations associated with particular types of trusts are addressed later.

### Income Taxes

A trust can either be a separate taxable entity or a conduit for passing income to beneficiaries, who then report the income on their own returns, or both. Moreover, a trust can be set up to accumulate income, distribute income, or a combination of both. Thus, the trust income can be split in one more way than there are beneficiaries. The grantor is taxed on trust income only to the extent of income actually received, or income actually used for the support of someone that the grantor is legally obligated to support.

The Federal income tax saving benefits associated with trusts have been severely limited by recent tax reform changes. The rules with respect to short-term, income-splitting trusts--such as Clifford and spousal remainder trusts (see chapter 8)--have been changed so that the income from such trusts is now taxable to the grantor, thus removing them as an effective income-splitting device between grantor and beneficiary. Income from other types of trusts received by children under age 14 who are eligible to be claimed as dependents on their parents' returns is taxed at the parents' rate on income in excess of

\$1,100 per year. Both trust and estate Federal income tax rate schedules have been revised to lower the bracket thresholds far below those of other non-corporate taxpayers. Trusts must also now make estimated payments on income. The current income tax rules regarding estimated payments and distributions to beneficiaries may serve to increase the cost of trust administration. Generally, trusts must use a calendar year as their tax year. There still remain a number of ways for the grantor to retain favorable income tax treatment, but they require careful analysis by a specialist in order to conform to all the rules and are beyond the scope of this book.

*The Trust Tax Return.*--A trust is taxed like an individual with certain important exceptions. A limited exemption--equivalent to a personal exemption--of \$300 for trusts required to distribute all income currently and \$100 for others, is allowed. For the 1993 tax year, undistributed income is taxed at 15 percent on the first \$1,500, at 28 percent on amounts from \$1,500 to \$3,500, at 31 percent on income from \$3,500 to \$5,500, and at 36 percent on amounts over \$5,500. A 10-percent surtax produces an effective 39.6-percent rate on taxable income above \$7,500. These rate thresholds are indexed for inflation.

Deductions and credits for trusts are similar to those for individuals, with some important differences for timber. For example, trusts are not eligible for the reforestation amortization and investment tax credit. These expenditures must be capitalized and recovered when the timber is sold or otherwise disposed of. The opportunity to immediately deduct certain depreciable costs under Section 179 of the IRC also is not available to trusts. Other differences are covered in Section 642.

Generally, the conduit principle applies to income distributed under a simple trust. The income is reported by the trust on its tax return and is then allowed as a deduction to the extent distributed or required to be distributed. Beneficiaries are taxed on the income required to be distributed to them whether received or not. Thus, the trust works as a conduit for income passed through to the beneficiaries. The distributable net income (DNI) concept limits the distribution deduction allowed the trustee. It also limits the amount includable in the beneficiaries' gross income. Distributable net income is defined in IRC Section 643(a).

**Example 10.1.** A simple timber trust requires that

all income be distributed currently to the life beneficiary. The trust has ordinary income in 1993 of \$18,000 from crop and hunting leases, expenses of \$750 chargeable to income, long-term capital gains of \$6,000 from timber sales, and \$2,250 in expenses chargeable to corpus.

The beneficiary would receive \$17,250 (\$18,000 minus \$750). The trust's DNI would be \$15,000 [ $\$18,000 - (\$750 + \$2,250)$ ], which is the taxable amount to the beneficiary (capital gains are excludable from DNI). The trust's taxable income is \$5,700 [ $(\$18,000 \text{ ordinary income} + \$6,000 \text{ capital gain}) - [(\$300 \text{ exemption} + \$3,000 \text{ expenses} + \$15,000 \text{ DNI})]$ ]. The result is that the trust beneficiary gets deductions that would ordinarily be charged to trust principal.

Example 10.1 is for a simple trust. Complex trusts, which may accumulate income or distribute principal, in addition to distributing income, are much more intricate and beyond the scope of this discussion.

The income tax basis for property transferred to a trust by lifetime gift is the donor's basis increased by the gift tax on the unrealized appreciation. On the other hand, property transferred to a trust from a decedent that is includable in his (her) estate receives a stepped-up basis equal to its value for estate tax purposes. This is an important consideration in dealing with highly appreciated assets such as is often the case with timberland. The stepped-up income tax basis for timber property that is valued in its current use under IRC Section 2032A (see chapter 13) is its special use value.

*Accumulated income.*--There may be many reasons for accumulating income in a trust. For example, if the beneficiary does not need all of the trust income currently, or if he (she) could not use it wisely, it could be accumulated if the trust instrument so permits. If the beneficiary's tax bracket is higher than that of the trust, the accumulation of income will produce an immediate tax saving. However, because the 28-percent tax bracket for trusts begins at \$1,500, the opportunity for this type of savings is limited.

When the trust accumulates income for high income beneficiaries, certain so-called "throwback rules" apply to the ultimate distributions. The basic premise is that distributions will be taxed as they would have been in the years the income was earned by the trust. A "short cut" method is now used for computing the tax, which is still quite complicated.

## **Estate Taxes**

When establishing a trust, the grantor must decide if he (she) wants the trust corpus included in his (her) estate. If the situation is such that the estate will be subject to tax, substantial estate tax benefits will accrue from exclusion of the property from the estate. The penalty is loss of control of the property during the grantor's lifetime. There are also advantages to be gained from keeping the property out of probate, such as continuity of management and probate cost savings, which will vary by State.

If the grantor is willing to relinquish control of trust property forever, the property's value will not be included in his (her) estate. However, if the property is an insurance policy on the life of the grantor, he (she) must transfer it to the trust more than 3 years before death in order to be excluded from the estate. Most grantors are reluctant to give up control even if it means large estate tax savings. Furthermore, tax problems are often associated with living trusts when it is not clear how much control or benefit has been retained by the grantor. There are a number of guidelines in several sections of the IRC that should be observed if the desired outcome is to prevail for the heirs.

*Power.*--The power to revoke, alter, amend, or terminate a trust should be given up. If such powers are retained, they will result in the trust assets being included in the grantor's estate. Furthermore, the changes should be made more than 3 years before the expected date of death (IRC Sections 2035 and 2038).

*Life Interest.*--If a life interest in the possession, enjoyment, or right to income from the trust property or the power to dictate who will enjoy the property is retained, it will result in the property being included in the grantor's estate. For example, reserving the right to hunt and fish or the right to hunting lease income from timberland will have the effect of including the entire property in the decedent's estate. This rule also applies to voting rights associated with stock in a "controlled corporation" (see chapter 17), which may own timberland in a trust.

*Reversionary Interest.*--Keeping a reversionary interest increases the possibility that property will return to the grantor's estate. If the reversionary interest is worth more than 5 percent of the total property value when the decedent dies, it may be included in his (her) estate (IRC Section 2036).

*General Power of Appointment.*--Retention of control to dispose of trust property in the grantor's favor, or in favor of his (her) estate or creditors, will result in the inclusion of the property in the estate (IRC Section 2041).

*Insurance Policy.*--If an insurance policy is to be part of the trust corpus, the estate should not be the beneficiary, and if someone else is the beneficiary, the insured should not retain "incidents of ownership in the policy" (IRC Section 2042) (see chapter 11). Transfers of any powers with respect to an insurance policy, within 3 years of death, will result in inclusion of the policy in the estate.

## **Gift Taxes**

A transfer of property to a trust involves a gift. The trust beneficiaries are the donees rather than the trustee. This fact has special significance in applying the annual gift tax exclusion. That is, there are as many exclusions available as there are beneficiaries for either the \$10,000 annual exclusion or the \$20,000 split gift tax exclusion (see chapter 8 and the trust example on page 66).

Transfers of nonincome-producing property to a trust can also pose a problem in connection with the annual exclusion. Timberland is generally treated as being nonproductive when it does not produce current income. This problem can be overcome by showing that the timber is an appreciating asset and that it is producing unrealized income in terms of volume and value growth. It may be advisable to incorporate growth projections and recommendations for producing periodic income by thinning and final harvests into the management plan. The information in the plan can be refined at anytime to show current annual increments and a schedule of accumulating values.

Trust benefits can be costly. The advantages outlined here must be balanced against the costs such as legal fees, the trustee's fees, and ongoing timberland management costs.

## **TYPES OF TRUSTS AND APPLICATIONS**

Trusts are flexible tools in estate planning that generally provide one or more otherwise unavailable benefits. These include shielding the trust's assets from creditor's claims, accumulating funds for college tuition, and providing necessary financial support for children or retired parents. Income or estate tax savings, or both, may also be a goal, as well as the desire to avoid probate.

### **Living Trusts**

A living trust is created during the grantor's lifetime. It can be either revocable or irrevocable depending on the goals of the grantor.

*Irrevocable Living Trust.*--The grantor gives up the trust property permanently, but in return gains supervised management and investment of the assets, and avoids probate. He (she) may pay gift tax upon establishment (see chapters 3 and 8), but the trust corpus is not includable in his (her) estate, and income is taxable to the beneficiaries as it is distributed annually. Other advantages of an irrevocable living trust include the possible saving of estate taxes in the grantor's estate and those of the life beneficiaries, providing protection for family assets, and perhaps saving income taxes for the family. Avoiding probate prevents public disclosure of the decedent's financial affairs, the size of the assets of the estate, and the listing of the beneficiaries and the property each received. With respect to timber, it eliminates the necessity of operating the tree farm as part of an estate while the estate is being settled. Probate fees and expenses are saved. Estate tax savings are achieved by keeping the trust assets, which may have appreciated considerably since the trust was established, out of the grantor's estate. This is accomplished by not retaining a life interest in the property (IRC Section 2036); not keeping a reversionary interest worth more than 5 percent of the property value on the date of death (IRC Section 2037); not keeping the power to alter, terminate, or revoke the trust (IRC Section 2038); not having a general power of appointment as defined in chapter 6 (IRC Section 2041); not possessing an incidence of ownership of a life insurance policy on his (her) life that names the trust as beneficiary, or not transferring ownership of the insurance policy on his (her) life within 3 years of death (IRC Sections 2042 and 2035)--all as discussed earlier.

The primary disadvantages of an irrevocable living trust are giving up control of the timber property and other assets placed in trust, and keeping a hands off posture forever. There are also, of course, the costs of distributing the trust corpus upon termination. Gift taxes will also be due if the transfer to a trust exceeds the \$10,000 (\$20,000 for split gifts) annual gift tax exclusion per beneficiary (donee) plus whatever unified credit equivalent is available.

*Revocable Living Trust.*--A revocable living trust may be changed or terminated by the grantor at any time. It may be funded or unfunded; it provides an opportunity for the grantor to try certain provisions and make changes as needed to meet his (her) goals. Because it is revocable, there are essentially

no tax savings associated with this type of trust. The income is taxable to the grantor. The fair market value of the trust assets are taxable in the grantor's estate. There is no gift tax, however.

The advantages of a revocable living trust include: (1) avoiding probate; (2) avoiding interruption of family income upon either the grantor's death or upon his (her) becoming incompetent; (3) providing a trial period for trust operation and the power to make subsequent changes based on experience; (4) consolidating scattered real estate, such as timber properties, in two or more States by putting the title in trust and avoiding ancillary probate; (5) enabling a business or other enterprise, such as a tree farm, to continue operating; (6) relieving the grantor of an administrative burden, such as timber management; (7) having generally less accounting and administration requirements than a testamentary trust; (8) being possibly less vulnerable to judicial challenge of the grantor's capacity as compared to a testamentary trust; (9) depending on State law, possibly serving to bar the statutory rights of a surviving spouse to a share of the decedent's property and putting the property beyond the reach of the grantor's creditors; and (10) serving as an instrument to accept death benefits from employee plans and life insurance proceeds on the grantor's life. Thus, the revocable living trust has many advantages, but it is very important to have the instrument carefully drafted and coordinated with the grantor's will.

The disadvantages, as noted above, are that the income is taxable to the grantor and the trust's assets are includable in the grantor's estate. However, the trust becomes irrevocable on the grantor's death (unless terminated at that time) and then becomes eligible for tax advantages associated with irrevocable trusts. The trust may be established to avoid death taxes upon the death of the beneficiaries, although this procedure is subject to the generation-skipping tax (see chapter 9). The trust incurs the costs of establishment and operation during the grantor's life and may incur additional costs at death, such as those associated with filing Federal estate and State death tax returns.

*Standby Trust.*--The standby trust is generally revocable but may be established to become irrevocable upon the grantor's disability. It provides supervised control and investment management if the grantor is disabled or absent, but the income is taxable to the grantor, and the fair market value of the estate property is includable in his (her) estate. There is no gift tax liability. The standby trust is essentially

designed for the contingency of the grantor becoming mentally or physically disabled, or having the inability to manage his (her) affairs for any reason. Its primary advantage is prevention of incompetency proceedings under State law, while at the same time protecting the grantor's assets and providing for his (her) financial needs. The disadvantages are that there are no income or estate tax savings and it may not be available under the law in some States.

*Pourover Trust.*--The pourover trust is a living trust that may be either revocable or irrevocable, funded or unfunded. Its purpose is to receive and accumulate payouts and proceeds from various sources as these occur over time--such as insurance payments, annuity checks, and similar receipts. The tax treatment is the same as for other living trusts discussed above, depending on revocability. The pourover trust can be very useful as a means of collecting funds from disparate sources such as individual retirement accounts, Keogh plans, insurance policies, qualified employee benefit plans, and assets from estates and other trusts.

The pourover trust can be established to give the prime beneficiary of a life insurance policy a life interest in the insurance proceeds, rather than receiving them outright. The corpus of the proceeds is then directed to others on the death of the prime beneficiary and are not part of his (her) estate.

Pourover trusts are relatively new and some technical issues remain unresolved. When used with a will, the trust should be in existence before the will's execution, kept separate, and incorporated by reference.

*Grantor Retained Interest Trust.*--With the so-called grantor retained income trust (GRIT), grantor retained annuity trust (GRAT), and grantor retained unitrust (GRUT), the grantor reserves a qualified term interest in the form of either a fixed dollar or fixed percentage annuity (IRC Section 2702). At the end of the specified term, the principal passes to the remainder persons. The nontax benefits of such trusts are generally negligible. The trust income is taxable to the grantor. The value of the corpus is not taxable to the grantor's estate unless he (she) dies within the reserved income term (period). The gift tax that may be due on establishment of the trust depends on the value of the remainder interest at the time the trust is created.

The term of GRAT's and GRUT's is not limited by statute but by practical considerations. If the grantor dies within the term, the principal is taxable in his

(her) estate. Thus, the period of the trust should be substantially shorter than the grantor's life expectancy considering both mortality tables and actual life expectancy due to health and other factors.

Current rules substantially limit the use of GRIT's that provide transfers for the benefit of a family member. Family members are defined to include spouses, ancestors of the transferor or transferor's spouse, lineal descendants of the transferor or transferor's spouse, brothers and sisters of the transferor, and spouses of the above. Family members do not include nieces and nephews or friends. There are special rules for the valuation of tangible nondepreciable property, especially undeveloped land that generates limited or uncertain income. It would seem that forest land would be included in this category. The valuation under IRC Section 2702(d) of the term interest is the amount that the holder of the term interest establishes as the amount for which the interest could be sold to an unrelated third party.

### **Testamentary Trusts**

Trusts created in accordance with the instructions contained in a decedent's will are known as testamentary trusts. They provide supervised control and investment management of the trust assets, and trust income is taxed to the beneficiaries if currently distributed. The fair market value of the decedent's assets that are put into the trust are includable in his (her) estate, but there is no gift tax liability. Generally, a testamentary trust is utilized by individuals who are unwilling to give up control of assets while alive.

The advantage of a testamentary trust is that it can protect the trust property from successive estate tax levies as the income is utilized by successive generations, such as surviving spouse, then children, and then grandchildren. The generation-skipping transfer tax (see chapter 9) may become applicable upon final disposition of the property. The nonmarital credit trust is a good example of an estate tax-saving testamentary trust. Up to \$600,000 of the decedent's assets, including timber, could be put into trust at the decedent's death and qualify for the unified credit. The trust would then pay the surviving spouse income for life and permit use of the principal subject to ascertainable needs, but withhold control from him (her). The property will thus not be taxed in either the decedent's or the surviving spouse's estate and the corpus passes to the children or other second

generation beneficiaries estate-tax-free.

**Example 10.2.** Greentree owned 1,200 acres of timberland--one-half was a 10-year-old plantation valued at \$600,000 and growing currently at 25 percent per year; the other half was mature timber valued at \$1,500,000. Assume that this constituted the net taxable estate for his spouse, two married children, and four grandchildren. None of the unified credit had been previously utilized.

When Greentree died, his will's marital deduction formula clause directed the \$600,000 exemption equivalent into the nonmarital-unified credit trust (see fig. 10.1 on the following page). This transfer was protected from estate tax by the unified credit of \$192,800. The trustee had the discretion to pay the surviving spouse the trust income if needed, plus the option to invade the principal for her benefit if required, subject to an ascertainable standard of living. The executor funded this bequest with the plantation valued at \$600,000 so that its rapid appreciation would accumulate tax free for the children and their families.

The balance of the estate, \$1,500,000 in mature timber, went into a marital deduction trust for the surviving Greentree spouse. The estate tax was deferred by Greentree's marital deduction, and an additional \$600,000 will pass tax free to the children and their families at the spouse's death. In the meantime, the timber will be harvested and each family member will be given \$10,000 per year plus tuition while in college and gradate school. Because the surviving Greentree spouse has a life expectancy of 22 years and a yen for travel, these procedures are expected to thin the estate sufficiently to avoid significant tax problems at the second Greentree death.

### **The Importance of Flexibility**

Trusts are usually drafted to last for long periods of time, but many things change over the years that are difficult to anticipate in advance. With revocable trusts, these can be addressed by the grantor as required. With irrevocable trusts, however, it is necessary to build in flexibility so that the trustee has the power to respond to changed conditions in order to achieve the grantor's objectives. Psychologically, this is difficult to do for many grantors. Nevertheless,

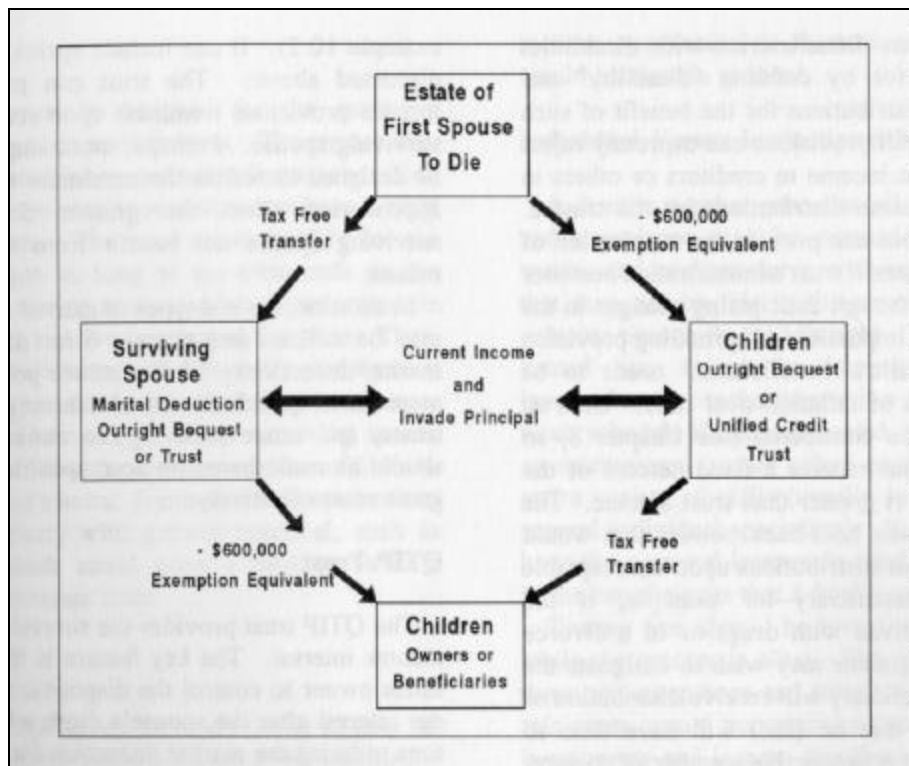


Figure 10.1-- Intergenerational transfer of timber assets using the unified credit with either a marital deduction trust or with an outright bequest.

there are a number of features that permit flexibility and safety for both the family and the trust assets.

**Income-sprinkling Clause.**--This clause permits the trustee to act as a parental substitute by distributing income as needed or accumulating it according to guidelines established by the grantor. When there are multiple beneficiaries, the guidelines should provide preferences and priorities with respect to the needs and purposes to be accomplished. They should address the treatment of excess income and plans for distribution as the beneficiaries come of age. This can be done by a letter outside the trust instrument. In the case of timber assets, it can be done in the forest management plan. The grantor may wish to consider a separate trust for each sibling in order to avoid conflicts. Income-sprinkling clauses can also be utilized to provide surviving spouses with fixed minimum levels of income by giving the trustee the power to sprinkle the spouse with funds as needed. It is important that the grantor be distanced from the decision in order to avoid having the assets revert to his (her) estate. The choice of the trustee is critical, and an institutional trustee may need to be accompanied by a cotrustee who knows the needs of the family members.

**Invasion of Trust Principal.**--The trustee should have the discretion to use the trust principal to benefit the income beneficiaries under an "ascertainable standard." Under IRS regulations, this may include education (including college), support in reasonable comfort, and other factors.

**Power of Beneficiary to Withdraw Principal.**--The beneficiary may be given the power to withdraw principal subject to the limitation that the total amount withdrawn in any 1 year may not exceed \$5,000 or 5 percent of the value of the current trust property, whichever is greater. In this way, the beneficiary is not totally subject to the trustee's discretion, and only the annual right of withdrawal is included in the beneficiary's estate.

**"Crummey" Power.**--The beneficiary is given a limited unilateral power, called the "Crummey" power, to withdraw income or principal or both from the trust. The power is generally exercisable only during a limited period of time, such as 30 days, each year. Inclusion of the "Crummey" power in a trust permits gifts made to the trust to qualify as gifts of present interests. This in turn permits such gifts up to \$10,000 per donee (\$20,000 per donee for split gifts) to qualify for the annual gift tax exclusion (see chapter 8 for discussion of the exclusion).

*Other Provisions.*--Beneficiaries with disabilities can be provided for by defining "disability" and addressing trust distributions for the benefit of such persons. Spendthrift provisions can expressly reject assignment of trust income to creditors or others in anticipation of income distributions by the trustee. Efficiency provisions can provide for termination of the trust by the trustee if trust administration becomes uneconomical. Although anticipating changes in the economy is nearly impossible, a sprinkling provision in the trust can allow beneficiaries' needs to be addressed in terms of inflation over time. Unitrust provisions might be considered (see Chapter 8) so that the beneficiaries receive a fixed percent of the trust principal if it is greater than trust income. The trustee may be given hold-back powers that would delay or cancel trust distributions upon unacceptable behavior by a beneficiary--for example, if the beneficiary is involved with drugs or in a divorce proceeding. The grantor may wish to designate the age at which a beneficiary will receive distribution of trust principal so that he (she) will have time to mature and become a productive member of society.

## **USE OF TRUSTS IN MARITAL DEDUCTION PLANNING**

Generally, the goal for married couples with significant wealth is to eliminate all estate taxes at the death of the first spouse and to minimize estate taxes on the death of the surviving spouse. This is usually done with a marital deduction bequest, which may be either outright or in trust (see chapter 6). Planning for a marital deduction trust must be coordinated with the bequests to the children or other heirs of property covered by the unified credit if the unified credit is also utilized. The unified credit portion can also be outright or in trust. Thus, if professional management of the tree farm will be in the surviving spouse's best interest, trusts can be used for the marital deduction bequest, the unified credit bequest, or both. A trust also provides protection against demands by children and creditors. For the remainder of this discussion, it is assumed that both bequests will be in trust.

The unified credit trust (sometimes called non-marital credit trust) provides for the surviving spouse as beneficiary, if he (she) needs the income, and the trust principal will be exempt from Federal estate taxation on his (her) death (see figure 10.1 and

example 10.2). It can include sprinkle provisions as discussed above. The trust can provide that the income provisions terminate upon remarriage of the surviving spouse. Perhaps, more importantly, it can be designed to realize the maximum benefit of estate appreciation when the grantor desires that the surviving spouse not benefit from it for whatever reason.

In addition, several types of marital deduction trusts may be utilized (see chapter 6 for discussion of the marital deduction). These include power of appointment trusts, qualified terminal interest property (QTIP) trusts, and estate trusts. The choice among these should be made based on accomplishing the grantor's goals most effectively.

### **QTIP Trust**

The QTIP trust provides the surviving spouse a life income interest. The key feature is the ability of the estate owner to control the disposition of the remainder interest after the spouse's death hile at the same time utilizing the marital deduction for the trust assets in his estate. For example, when there are children from previous marriages, the grantor can be assured that their wants will be met at the surviving spouse's death. The surviving spouse must be given the trust income payable, at least annually, for life. The QTIP election must be made by the executor; a full or partial election can be made based on the form of the bequest and the degree of utilization of the full unified credit. For a more extensive discussion of QTIP's, see chapter 6.

### **Power of Appointment Trust**

The power of appointment trust gives the surviving spouse a life income interest in the trust property, which must be paid at least annually. The surviving spouse or trustee is given the right to use the principal for designated purposes such as making gifts that qualify for the gift tax annual exclusion. Although it is not necessary that this right be granted, it is a means of reducing estate taxes in the surviving spouse's estate. A general power of appointment exercisable by will also gives the surviving spouse the right to provide in his (her) will for the disposition of the trust assets at his (her) death. The trust provides that, if the surviving spouse fails to exercise the right to name the beneficiaries of the trust assets, they will pass to beneficiaries, if any, named in the trust by the grantor.

### **Estate Trust**

The estate trust is designed for the surviving spouse who does not need income. The trustee may be given the discretion to make distributions based on need, but the surviving spouse does not have a right to demand them. The trust assets qualify for the marital deduction as long as the trust ends on the death of the surviving spouse and the trust assets are to be paid to the survivor's estate at that time. Thus, the survivor's will controls the disposition of the trust assets. This type of trust can also eliminate income distributions on remarriage of the surviving spouse and accumulate them for the eventual benefit of the surviving spouse's heirs. It can also hold nonincome-producing property with growth potential, such as timberland, which could pose a problem with a power of appointment trust.

### **A Disclaimer**

A qualified disclaimer by a surviving spouse (as discussed in chapter 7) is valid even if the will directs the property disclaimed to a marital deduction trust in which the surviving spouse has an income interest. Similarly, the children can use a disclaimer to disclaim legacies that will permit the surviving spouse to receive a larger marital deduction amount. (See chapter 7 for more on disclaimers.)

## **TRUSTEES**

The selection of and powers given to the trustee(s) are a critical problem that bedevil many otherwise sound trust plans. The person or institution chosen as trustee must, of course, measure up in a practical sense. If timberland is an important part of the estate assets, a forester with business experience may be preferred, if not as sole trustee, perhaps as a cotrustee. Ability, integrity, judgment and durability are all important qualities for a trustee. State law requirements must be satisfied. These are particularly important with respect to the rules regarding trust property in one State and trustee(s) who reside in another State.

Tax considerations come into play if the grantor names himself (herself) as trustee with powers over income and principal, which can make the income taxable to the grantor. Similarly, if nongrantor trustees have the power solely or partially to vest income or principal in themselves, the trust income would be taxable to them.

### **Individual Versus Institutional Trustee**

A family member who has all the requisite skills and experience may be persuaded to be named a trustee and perhaps serve without a fee. However, that may not be fair to the trustee because it takes valuable time to do the job right. The family member named may resent the imposition of the duties involved and/or make them a low priority in his (her) work schedule if uncompensated. On the other hand, an institutional trustee offers experience, continuity, and a variety of skills (usually in a department with several individual specialists). It may not, however, have the personal interest in the timberland assets or in the beneficiaries that a family member would have.

Trustee fees should be investigated and negotiated while the grantor is alive. For institutional trustees, there are acceptance and termination fees, as well as minimum annual management fees for handling trust investments and income distributions. There may be additional fees for handling timber sales, preparation of fiduciary income tax returns, and other services that may be required. These fees will vary by institution and should be carefully investigated when determining if an institutional trustee has the ability and the interest in the tree farm to do the job that the grantor requires. There is always the element of uncertainty over an institutional trustee's acceptance of the trust corpus. Is the property sufficiently large to be attractive, and will the trustee have the skill to manage it effectively? Some trust departments are experienced at managing timber properties, but others may want to dispose of the woodland and invest in more liquid investments.

### **Family Cotrustees**

In some cases a family member may serve as cotrustee with an institutional trustee. He (she) brings a common touch to the personal needs of the beneficiaries and a personal, sometimes sentimental, family attachment to the timber property. However, this will cost more, even if the cotrustee serves without fee, because additional time will be required for meetings, consultations, and resolution of conflicts. The cotrustee may also deserve a fee, which would be an additional expense. Thus, there are benefits and costs for both personal service and financial skills, which should be carefully considered and balanced. Appropriate language should be included in the trust

instrument to insure that favorable tax treatment will not be compromised by having beneficiaries as cotrustees.

### **Successor Trustees**

Naming of alternate trustees should be considered. Family members age and change, and institutions also change and may go out of business. Thus, the original trustee may not or cannot continue to serve at some point in time. Alternates should be named, or procedures should be in place, to address this contingency. Such foresight may save court fees, bond costs, and valuable time. A grantor can retain the power to appoint a successor institutional trustee only if the trustee resigns or is removed by judicial order (Revenue Ruling 77-182); broader powers to the grantor will most likely result in the property being includable in his (her) estate.

### **Trustee Powers**

The trustee should be given sufficient power to enable him (her) to accomplish the objectives of the grantor. State law will address any powers omitted from the trust instrument. With timber assets, special provisions may be needed to address the distinction between principal (timber capital and/or growing stock) and income (growth). Because timberland may be nonincome producing in some years, the allocation of value appreciation should be considered. In years with income, the allocation of timber sale revenue to capital expenditures, operating expenses, and income distributions must be addressed. It is often prudent to include other income-producing assets in the trust in addition to timber in order to cover expenses in nonincome years or to permit retention of timber sale income for that purpose. The trustee needs sufficient flexibility to respond to changing economic and environmental conditions, market opportunities, and beneficiary needs.

## **TRUST APPLICATIONS FOR FORESTRY**

Timber is a unique asset. In most States, the title to standing timber can be legally separated from the title to the land on which it grows. In such a case, the timber continues to grow after severance of the title. Because the timber represents both the principal and income and the land remains dedicated to the production of the timber, the severance of title

necessarily reduces the value of the land because of the incumbrance. Therefore, the value of the land can be reduced for estate purposes without affecting its ability to produce a timber crop and thus income. This severance is not without cost, however, and may result in higher administration and management costs.

### **Example 10.3.** The Irrevocable Living Trust--A Case Study.

This is an actual case study that illustrates how a well-planned, well-managed, irrevocable trust involving timberland has worked over a 3-year period for a 20-year Washington Farm Forestry Association small timber landowner.<sup>1</sup> The following factors, all discussed in more detail elsewhere in this book, were considered by the grantor in establishing this trust.

Once the trust instrument--the guiding document that controls the trust, its assets, and the functions of the trustees for the duration of the trust--is completed, funding of the trust actually starts the business and management of the trust. This funding is achieved with property (timberland) and/or securities (stocks, bonds, or money accounts) and should involve good financial planning and knowledge of the way income will be produced, the income tax provisions, the cost basis of assets gifted to beneficiaries through the trust vehicle, and the impact of capital gains taxation, if the trust should sell timber or securities. Certain basic facts regarding gifts and taxation that are important are listed below.

- (1) Gift taxes are exempt on the first \$10,000 gift per donee per year or on the first \$20,000 from a married couple to each donee. If property is separately owned by one person with the \$10,000 exemption, the exemption can be increased to \$20,000 if the spouse consents, even though the spouse does not own the property. If the person or married couple decide they wish to exceed the \$10,000 or \$20,000 annual exemption, then a gift tax report must be filed, but no taxes need to be paid because the excess gifts can carry over to proportionately use up the unified credit for estate taxes--a \$600,000 estate tax exemption.
- (2) If the gift donor's estate assets are above the Federal estate tax level (\$600,000 for one person or \$1,200,000 for a married couple),

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<sup>1</sup> Used with permission of the author, who, although wishing to remain anonymous, welcomes any criticisms, comments, or inquiries by writing to Lori I. Rasor, Editor, "Northwest Woodlands," 4033 S.W. Canyon Road, Portland, OR 97221.

astute estate planning will involve gifting assets into the trust that have the potential of growing rapidly or that have longer term growth such as land (a scarce commodity), timber, which is also becoming scarce and is experiencing escalating market prices, and certain securities, namely common stocks in good investment grade companies over the long term. Stocks have outperformed most other investments, according to past history performance. Mature timber on good site land can grow 7 percent a year in board feet volume, compounded; therefore, timber value can *double* in 10 years in board feet volume.

- (3) The capital gain or loss basis for income taxes for the trust assets is the cost basis of the assets gifted of the donor, which is carried over permanently to the donee. So, if assets such as timber are sold in the future, capital gains tax will be paid on the difference between the donor's original cost and the donee's sale value. The market value of the gifted asset, at the time of gifting, is used for the asset value at the time the gift is made, applicable where considering gift tax exemption calculations.
- (4) Consideration should be made by the gift donor as to the annual income produced by the asset and the annual needs of the trust to cover expenses. The needs of the trust beneficiaries for annual income distributions for personal family support also should be considered.

In gifting securities, one would need to gift high-dividend or high-interest-producing securities to produce cash flow for the trust. These might be high-dividend stocks such as utility, petroleum, or natural resource stocks. The latter two pay good dividends and have a good growth record. Bonds have no growth factor other than high income (8 to 10 percent), which if reinvested, like compound interest, acts as an asset growth factor.

The following actual case history of a 3-year duration, family-oriented, irrevocable living trust, illustrates the above factors in funding a trust through gifts and eliminating future estate taxation problems.

The trust is named "XYZ Family Farm Trust." Its purpose is to hold, control, manage, and distribute assets and income from the trust to the children and

grandchildren of the trust grantors, and to create a vehicle for future gifts of farm and timberland and nonreal estate assets for the future benefit of the beneficiaries.

The goal and wishes of the donors, in funding this trust, is that management through its trustees will preserve the assets of the trust, help those assets grow in value and not distribute the capital assets to beneficiaries without specific needs, such as worthy economic or business needs or support; housing, educational, or health needs; or necessary retirement income.

The trust was funded in the following manner:

12-31-86--Initial funding

Real estate (timberland) deed recorded for first undivided one-third of 80 acres fully stocked with timber	\$70,000
Stocks--720 shares of Borg Warner @ 38 1/8	<u>27,145</u>
Total 1986	\$97,145

1987--Funding trust

2-4-87--Real estate (timberland) deed recorded for a second undivided one-third of above 80 acres	\$70,000
3-4-87--Cash gift to establish a checking/savings account	<u>1,000</u>
Total 1987	\$71,000

1988--Funding trust

3-3-88--Real estate (timberland) deed recorded deed recorded for a third undivided one-third of above 80 acres	\$70,000
12-24-88--Stocks (valued at closing of market Dec. 22)	
500 shares of Pacificorp @ 35 7/8	\$17,937.50
300 shares of Wash Water PWR @ 27 1/2	8,250.00
300 shares of Walgreen @ 30 5/8	9,187.50
400 shares of Enron @ 35 1/2	14,600.00
Total 1988	<u>49,975</u> \$119,975

1989--Funding trust

12-21-89--Real estate (timberland)

deed recorded for 22.4 acres, fully stocked with timber	<u>\$132,670</u>
Total funding of trust, 3 years through 12/31/89	\$420,790

The summary of annual income, income distributions, and taxation are as follows:

1987--Income	
Dividends on stocks	\$ 356.00
Interest on bonds	333.33
Interest on bank accounts	<u>1,146.00</u>
	<u>1,835.33</u>
Long-term capital gains	<u>31,145.58</u>
	<u>32,980.91</u>
Less expenses	6.50
Net taxable income	<u>\$32,974.41</u>

1988--Income  
Note: Borg Warner stock merger 4/22/87 resulted in a \$31,145.58 capital gain. Income distribution: 30 percent retained in trust and taxed at an 11-percent starting rate. Seventy percent was distributed to beneficiaries and taxed mainly at 28 percent.

Interest on bank accounts	\$ 115.73
Interest on corporate bonds	1,500.00
Interest on tax-free bonds	<u>654.44</u>
	2,270.17
Less expenses	<u>165.42</u>
Net income	2,104.75
Less tax-free interest	<u>654.44</u>
Net taxable income	\$1,450.31

1989--Income	
Dividends on stocks	\$3,376.65
Interest on bank accounts	170.14
Interest on corporate bonds	1,500.00
Interest on tax-free bonds	<u>950.00</u>
	5,996.79
Less expenses	<u>141.60</u>
Net income	5,855.19
Less tax-free interest	<u>950.00</u>
Net taxable income	\$4,905.19

The year-end annual inventory of assets on December 31 of each year is as follows:

1986	
Real estate, parcel 1, 80 acres (first one-third value)	\$ 70,000.00
Stock	<u>27,145.00</u>
Total 1986	\$ 97,145.00

1987	
Real estate, parcel 1 (two	

one-thirds value)	\$140,000.00
Bank accounts	3,279.74
Bonds	<u>25,374.73</u>
Total 1987	\$168,654.47

1988	
Real estate parcel 2 (three one-thirds value)	\$210,000.00
Bank accounts	3,375.90
Bonds	25,374.73
Stocks	<u>49,475.00</u>
Total 1988	\$288,654.47

1989	
Real estate, parcel 1 (three one-thirds value)	\$210,000.00
Real estate, parcel 2 (22.4 acres of timberland)	132,670.00
Bank accounts	5,073.93
Bonds	25,374.73
Stocks	<u>71,764.58</u>
Total 1989 (on 12/20/89)	\$444,883.24

This case history of an irrevocable living trust for a 3 year duration illustrates an example of the original purpose and goal of the trust as mentioned above:

- (1) Gifts of timberland and/or securities into the trust (\$97,145 initially, cumulative current value \$420,790) removes these assets from the donor's estate and future estate and inheritance taxation.
- (2) The goals and wishes of the funding donors of the trust have been dramatically fulfilled--assets have grown in value. The current inventory of timberland is valued at the time of gifting into the trust and does not indicate current market prices for timber in parcel 1 nor does it include the annual compounded 7-percent growth in board feet volume. Present values are markedly higher today.
- (3) Securities, mainly stocks, had remarkable growth in value in 1 year--\$49,975 at the end of 1988 versus \$71,764.58 at the end of 1989--for an increased value of 43.6 percent, surpassing the growth in 1989 of the Dow Jones Industrial Average increase of roughly 20 percent. Note: The 43.6-percent increase includes income reinvested in the Dividend Reinvestment Program.
- (4) The trust vehicle, under supervision of an experienced trustee, provides continuity of control of assets and, hopefully, good man-

agement by one entity for the benefit, in this case history, of seven beneficiaries, of whom four are minors, and prevents injudicious expenditures of capital assets by a spendthrift beneficiary.

The timberland and securities were gifted into the trust over 13 months (3 tax years) in order to utilize the annual gift tax exclusions for the seven beneficiaries. Only one timberland appraisal was necessary because the assets were transferred into the

trust over a span of 13 calendar months, which, by using the end of 1 tax year and the beginning of 2 others, actually covered 3 tax years.

The rate of value appreciation for the timber, including both growth and price appreciation to mid-1992, was a robust 25.6 percent. Since then the stumpage prices for Douglas-fir, which comprises most of the standing timber, have more than doubled.

The grantor is the trustee, but he faces perhaps the most challenging aspect of the trust strategy in identifying a successor trustee who has the business acumen to manage securities and timber plus the personal interest in the welfare of the family.

