Chapter 9

Role of Trusts

Overview

A trust is an arrangement by which a person or entity called the trustee holds legal title to designated property in trust. The property in the trust, called the corpus, 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, 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 or settlor, might do himself (herself) and some things that he (she) cannot do because of lack of skill, illness, disability, distance from the forest land, or death. The ability to bridge the gap between life and death is one of the remarkable characteristics of a trust. A trust is recognized as a separate legal entity from the grantor under both Federal and State law.

Basic Considerations

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

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:

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

Trustee—This is the person or entity that 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 co-trustees 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 (the volume of merchantable timber and young growth present at the time the trust is created) 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 important particularly with respect to forest land because of sometimes rapid changes in markets, technology, and regulations.

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

Term—The term of the trust is its length. If a shorter period is not specified, State law limits the term of a trust under the "rule against perpetuities." Specific rules vary among States, but they generally specify a number of years following the death of the last surviving beneficiary or the last surviving settlor.

Bond—The trust may specify that the trustee post a bond, but most trusts exempt the trustee from this requirement. The bond provision also may 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, declines to serve, or becomes incapable of serving.

Fees—Payment of reasonable fees to the trustee is provided for, or alternatively, the trustee serves without fee. Institutional trustees always serve for a fee.

Nontax Benefits

Nontax benefits can include professional management of financial and real property assets, including forest land. A trust can be designed to ensure a forest landowner or beneficiaries of both income and protection from creditors. Trusts frequently are designed to benefit family members such as spouses, minor children and grandchildren, or aged parents.

A "living trust" is established during the life of the grantor and can extend beyond his (her) death; a "testamentary trust" is established upon an individual's death according to provisions in his (her) will. The trust supplies the missing elements of management and experience 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 ensuring professional management of forest land and other assets and by freeing the grantor and/or beneficiaries from management details. A trust ensures 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 below.

Income Taxes

A trust can be either a separate taxable entity or a conduit for passing income to beneficiaries, who then report it on their own income tax returns, or it can be both. 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, with the trust itself receiving a share. Grantor trusts, trusts with terms that cause the grantor to be treated as owner for income tax purposes, are excluded from the following discussion. The grantor of a grantor trust is taxed on trust income received, or trust income actually used for the support of someone who the grantor is legally obligated to support.

The Federal income tax savings associated with trusts have been limited severely by tax reform changes. Rules for short-term, income-splitting trusts such as Clifford and spousal remainder trusts (see chapter 8) have been changed; income from such trusts now is taxable to the grantor, eliminating them as effective devices for splitting income between grantor and beneficiary. Income from other types of trusts in excess of $1,800 (2008, as indexed) per year received by children under age 19 who can be claimed as dependents on their parents' tax returns is taxed at the parents' rate of income. Federal income tax rate schedules for trusts and estates have been revised to bracketed thresholds far below those of other noncorporate taxpayers. Also, trusts now must make estimated income tax payments; the current income tax rules on estimated payments and distributions to beneficiaries may increase the cost of trust administration. A number of ways remain for a trust 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 is allowed for trusts required to distribute all income currently, and $100 for others. For the 2008 tax year, undistributed income is taxed at:

15 percent on amounts up to $2,200
25 percent on amounts from $2,200 up to $5,150
28 percent on amounts from $5,150 up to $7,850
33 percent on amounts from $7,850 up to $10,700
35 percent on amounts over $10,700

These thresholds are indexed annually for inflation.

In general, an estate or trust is limited to the 2 percent of adjusted gross income (AGI) floor on miscellaneous itemized deductions. Other deductions and credits for trusts also are similar to those for individuals, with some important differences for timber. For example, trusts are not eligible for the reforestation deduction of the first $10,000 of qualified expenditures. As are all other taxpayers, however, they are eligible for amortization of all reforestation expenses over 84 months. The opportunity to immediately deduct certain depreciable costs under Section 179 of the Internal Revenue Code (IRC) also is not available to trusts. Other differences are covered in IRC section 642.

Generally, a simple trust operates on the conduit principle; the trust reports income received on its tax return, then is allowed a deduction to the extend it distributes or is required to distribute the income to beneficiaries. Beneficiaries are taxed on income required to be distributed to them whether they receive it or not. The distributable net income (DNI) concept defined in IRC section 643(a) limits the distribution deduction allowed the trustee, as well as the amount includable in the beneficiaries' gross income.

> **Example 9.1.** A simple timber trust requires that all income be distributed currently to the life beneficiary. For 2008 the trust has ordinary income of $20,000 from crop and hunting leases, expenses of $850 chargeable to income, $3,000 in expenses chargeable to corpus, and a long-term capital gain of $8,000 from timber sales (capital gains are excludable from DNI).

The beneficiary will receive $19,150 ($20,000 – $850). The trust's DNI will be $16,150 [$20,000 – ($850 + $3,000)], which is the taxable amount to the beneficiary. The trust's taxable income is $7,700 [($20,000 ordinary income + $8,000 capital gain) – ($300 exemption + $3,850 in expenses + $16,150 DNI)]. The result is that the trust beneficiary gets deductions that ordinarily would be charged to the trust principal.

Example 9.1 is for a simple trust. Complex trusts—which in addition to distributing income may accumulate income or distribute principal—are much more intricate and beyond the scope of this discussion.

The income tax basis for property transferred to a trust by a lifetime gift is the donor's basis, increased by any gift tax on unrealized appreciation. In contrast, property includable in a decedent's estate that is transferred from the decedent to a trust 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 forest land. The stepped-up income tax basis for forested property that is valued in its current use under IRC section 2032 (see chapter 12) is its special use value.

Accumulated income—There are 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 permits. If the beneficiary's tax bracket is higher than that of the trust, the accumulation of income will produce an immediate tax savings; however, because the 25-percent tax bracket for trusts begins at $2,200 (for 2008), the opportunity for this type of saving is severely 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 are taxed at the rates in effect for the years the income was earned by the trust.

Estate Taxes

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

If the grantor is willing to permanently relinquish control of trust property, the property's value will not be included in his (her) estate. If the property is an insurance policy on the life of the grantor, however, he (she) must transfer it to the trust more than 3 years before death for it to be excluded from the estate (see chapter 8). Many grantors are reluctant to give up control even if it means large estate tax savings. Furthermore, tax problems often are associated with living trusts when it is not clear how much control or benefit has been retained by the grantor. Guidelines in a number of sections of the IRC should be observed to prevent the inclusion of trust assets in the grantor's estate.

Powers—If the grantor of a trust retains the power to revoke, alter, amend, or terminate a trust, the trust assets will be included in his (her) estate. Changes to the trust provisions to give up these powers should be made more than 3 years before the grantor's 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, the property also will be included in the grantor's estate. For example, reserving the right to hunt and fish or the right to hunting lease income from forest land will result in the entire property being included in the grantor's estate. This rule also applies to voting rights associated with stock in a "controlled corporation" (see chapter 16), which may own timber 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, the property may be included in his (her) estate (IRC section 2036). An example of this type of transfer is where A creates a trust with the current income payable to B and the principal payable to C on the trust's termination, but with the provision that if C predeceases A, the principal is payable to A. Some States prohibit this type of trust altogether.

General power of appointment—Retention of the right 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 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 10). Transfers of any powers with respect to an insurance policy within 3 years of death will result in the policy being included 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 annual exclusions available as there are beneficiaries for either the $12,000 annual exclusion or the $24,000 split gift tax exclusion (see chapter 8).

Transfers of non-income producing property to a trust also can pose a problem with the annual exclusion. Forest land generally is 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 that is producing unrealized income in terms of volumes 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 any time to show current annual increments and a schedule of accumulating values. It also may be prudent to include a mix of other income producing assets with forest land to provide cash flow in any non-income producing year.

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

Types of Trusts and Applications

Trusts are flexible tools in estate planning that can provide benefits that otherwise would be unavailable such as shielding assets from creditors' claims, accumulating college funds, and providing financial support for children or retired parents. Income or estate tax savings, or both, also may be a goal, as well as avoiding probate and the associated costs.

Living Trusts

A living trust is created during the grantor's lifetime, and can either be revocable or irrevocable.

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 on the trust property. He (she) may pay gift tax on the establishment of the trust (see chapters 3 and 8), but the trust corpus will not be includible in his (her) estate. Trust income is taxable to the beneficiaries as it is distributed. Other advantages of an irrevocable living trust include possible estate tax savings in the grantor's estate and in those of the life beneficiaries, providing protection for family assets, and perhaps income tax savings for the family. Avoiding probate also prevents public disclosure of the decedent's financial affairs, the size of the trust assets, and the names of the beneficiaries and the property each received.

With respect to forest land, a trust eliminates the necessity of operating the forest as part of an estate while the estate is being settled. Savings are achieved on probate expenses and estate taxes by keeping the trust assets—which may have appreciated considerably since the trust was established—out of the grantor's estate. This is accomplished specifically 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 any incidence of ownership in a life insurance policy on the grantor's life that names the trust as beneficiary, and not transferring ownership of the insurance policy within 3 years of death (IRC sections 2042 and 2035), as discussed above.

The primary disadvantages of an irrevocable living trust are giving up control of the timber property and other assets placed in the trust, and keeping a permanent hands-off posture. Of course, there also are the costs of distributing the trust corpus upon termination of the trust. Gift taxes also will be due if the transfer to a trust exceeds the $12,000 ($24,000 for split gifts; 2008, as indexed) annual gift tax exclusion per beneficiary (donee), plus whatever applicable lifetime gift tax exclusion is available.

Revocable living trust—A revocable living trust may be changed or terminated by the grantor at any time and may be funded or unfunded. It provides an opportunity for the grantor to try out different provisions and make changes to meet his (her) goals. Because it is revocable, there are virtually no tax savings with this type of trust. Any trust income is taxable to the grantor, and at his (her) death, the fair market value (or special use value if elected; see chapter 12) of the trust assets is taxable to the estate. There is no gift tax, however.

The advantages of a revocable living trust include:

1. Avoiding probate for the trust assets
2. Avoiding interruption of family income upon either the grantor's death or 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 forested properties in two or more States and avoiding ancillary probate by putting the title in trust
5. Enabling a business or other enterprise, such as a forest land, to continue operating

6. Relieving the grantor of an administrative burden such as timber management

7. Having generally less accounting and administrative 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 barring 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

10. Serving as an instrument to accept death benefits from employee plans and life insurance proceeds on the grantor's life

A revocable living trust has many advantages, but it is essential to have the instrument carefully drafted and coordinated with the grantor's will. As noted above, the disadvantages are that trust income is taxable to the grantor and the trust assets are includable in the grantor's estate.

A revocable living trust becomes irrevocable on the grantor's death (unless terminated at that time) and then becomes eligible for the tax advantages associated with an irrevocable trust. A revocable living trust may be established to avoid death taxes upon the death of the beneficiaries, although this procedure is subject to the generation-skipping tax. The trust incurs the cost 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 typically is revocable, but may be designed to become irrevocable on the grantor's disability. It provides supervised control and investment management if the grantor is disabled or absent, but income is taxable to the grantor and the fair market value of the trust property is includable in the estate. There is no gift tax liability.

Essentially, the standby trust is designed for the contingency of the grantor becoming unable to manage his (her) affairs for any reason. Its primary advantage is the 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 disadvantage is that there are no income or estate tax savings. Additionally, the standby trust may not be available under the laws of some States; however, the same general purposes may be achieved with a durable power of attorney (see chapter 5).

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 they occur over time. 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 annuity checks, 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 primary 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 primary beneficiary and does not become 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 is executed; it also should be kept separate and incorporated in the will by reference.

Grantor retained income trust—With the 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 are negligible, and the trust income is taxable to the grantor. The value of the trust corpus is not includable in the grantor's estate unless he (she) dies within the reserved income term (period). The gift tax due on establishment of the trust depends on the value of the remainder interest at the time the trust is created.

Current rules substantially limit the use of GRITs that provide transfers for the benefit of family members, defined to include the transferor's spouse, 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, nephews, or friends. There are special rules for the valuation of tangible nondepreciable property, especially undeveloped land such as forest land that generates limited or uncertain income. Under IRC section 2702(d) the valuation 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.

The term of GRATs and GRUTs 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 that the grantor's life expectancy.

Testamentary Trusts

Trusts created in accordance with 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 is includible in his (her) estate, but there is no gift tax liability. Generally, a testamentary trust is used 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 used by successive generations, such as the surviving spouse, the children, and grandchildren. The generation-skipping transfer tax may become applicable upon final disposition of the property. The non-marital credit trust is a good example of an estate tax-saving testamentary trust. Up to $2 million (2006 through 2008) of the decedent's assets, including forest land, could be put into trust at the decedent's death and qualify for the allowable credit. The trust then would 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 thus would not be taxed in either the decedent's or the surviving spouse's estate and the corpus would pass to the children or other second generation beneficiaries' estate tax-free.

> **Example 9.2.** When he died in 2008, Green owned 2,500 acres of forest land. Three-fifths (1,500 acres) was stocked with young pine plantations valued at $2 million, in which the timber was growing at rates varying from 15 to 25 percent per year. The other two-fifths (1,000 acres) was stocked with mature sawtimber valued at $3.5 million. Assume that this constituted the net taxable estate for his spouse, two married children, and four grandchildren. None of the applicable credit amount had been previously utilized.
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> Green's will contained a marital deduction formula clause which directed $2 million into an applicable credit trust (see fig. 9.1). This entire transfer was protected from estate tax by the $780,800 applicable credit amount. 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, subject to an ascertainable standard of living. The executor funded this bequest primarily with the young plantations so that the rapid appreciation would accumulate tax free for the children and their families. As a practical matter some mature timber was included to provide liquidity in this trust until thinning income from the plantations was sufficient to meet cash flow needs. The balance of the estate, $3.5 million primarily in mature timber, went into a marital deduction trust for the surviving spouse.
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> As a result, Green's bequest to the children was shielded from estate tax by the applicable credit amount; his bequest to the surviving spouse was shielded from estate tax by the marital deduction; and the opportunity remains to use the applicable credit amount an additional time to shield part or all of the surviving spouse's estate—up to $2 million if she also dies in 2008 and up to $3.5 million if she dies in 2009—from tax. This strategy results in considerable savings of estate tax and administrative expenses (see table 2.1).
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> If the surviving spouse has sufficient assets of her own that taxes on her estate remain a concern, she can thin the estate by a combination of pursuing personal interests—such as a yen for travel—and aggressively taking advantage of the exclusions for gifts under the annual exclusion and gifts of tuition and medical expenses. The major disadvantage of placing forest land in trust is that all reforestation expenses must be amortized over 84 months because, unlike other taxpayers, trusts are not eligible to immediately deduct the first $10,000 of such expenses.

The Importance of Flexibility

Trusts usually are drafted to last for many years; it is difficult, however, to anticipate all the changes that can affect family finances over a long period. With a revocable trust, provisions can be revised or added by the grantor as required. With an irrevocable trust, however, the provisions need to be built with enough flexibility that the trustee can continue to achieve the grantor's objectives even if conditions change. Though many grantors find it psychologically difficult to adopt them, there are a number of provisions that can be added to an irrevocable trust to add flexibility and safety for both the family and the trust assets.

Income-sprinkling clause—This provision permits the trustee to act as a surrogate family member by distributing or accumulating income 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 for each. The guidelines also should address the treatment of excess income and plans for distribution as minor beneficiaries come of age. This can be done by a letter outside the trust instrument, or in the case of forested land, it can be included in the forest management plan. Income-sprinkling clauses most often are used to address the unforeseen needs of minor children. Where there is more than one child the grantor may wish to consider a separate trust for each, to avoid conflicts. Income-sprinkling clauses also can be used to provide for surviving spouses with fixed minimum levels of income, by giving the trustee the power to distribute additional funds to the spouse as needed.

It is important that the grantor be distanced from the decisions 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 paired with a co-trustee 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 Internal Revenue Service (IRS) regulations, this may include education (including college), support in reasonable comfort, health care, 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—Here 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 exercisable only for 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 a present interest, so they qualify for the annual gift tax exclusion (see chapter 8).

Other provisions—Beneficiaries with disabilities can be provided for by defining "disability" and setting 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 (see chapter 8) provisions might be considered that provide the beneficiaries the greater of the trust income or a fixed percent of the trust principal. The trustee may be given hold-back powers to 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.

Use of Trusts and Disclaimers 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 usually is 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 covered by the applicable credit amount, if the applicable credit is to be utilized. The applicable credit portion also can be outright or in trust. Thus, if professional management of the forest land will be in the surviving spouse's best interest, trusts can be used for the marital deduction bequest, the applicable 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 applicable credit trust (sometimes called a 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 fig. 9.1 and example 9.2). It can include income-sprinkling provisions as discussed above. The trust can provide that the income provision terminates 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 for some reason that the surviving spouse not benefit from appreciation.

In addition, several types of marital deduction trusts may be utilized. These include qualified terminal interest property (QTIP) trusts, power of appointment 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 with a life interest in the trust principal, without having the principal enter his (her) own estate. At the same time, it allows the grantor full use of the marital deduction for trust assets in his (her) estate while retaining control over disposition of the remainder interest in the trust after the surviving spouse's death. A QTIP trust is a particularly useful tool with blended families. The decision of whether to use it is more personal than tax-related, but a QTIP trust can protect the interests of the grantor's children in second or third marriages. The surviving spouse must be given the trust income payable, at least annually, for life. The QTIP election must be made by

Two Estate Transfers—MD and Credit

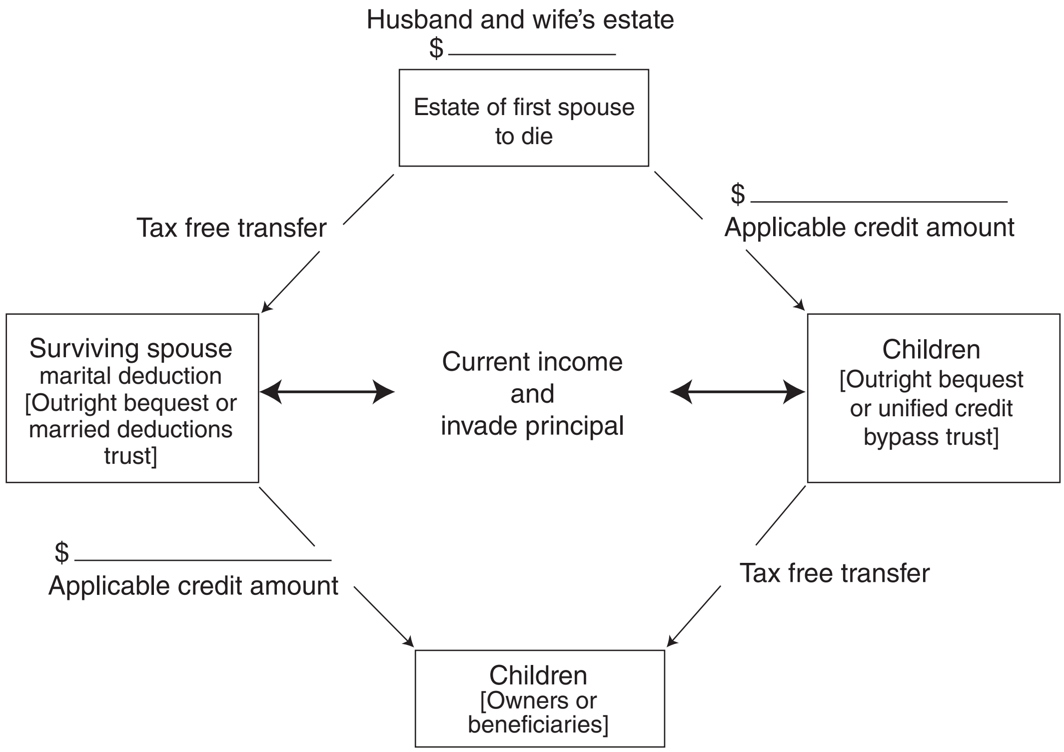

Figure 9.1—Marital deduction and applicable credit planning for two estate transfers.

the executor, and a full or partial election can be made based on the form of the bequest and the degree of utilization of the full applicable credit amount. For a more extensive discussion of QTIPs, 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 trust 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 exercised, 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, the assets 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 surviving spouse's estate at that time. Thus, the survivor's will controls the disposition of the trust assets. This type of trust also can eliminate income distributions on remarriage of the surviving spouse and accumulate them for the eventual benefit of the surviving spouse's heirs. As well, it can hold non-income producing property with growth potential, such as forest land, which might pose a problem with a power of appointment trust.

Non-marital trust—The non-marital trust is used as a "backup." It can be highly effective as a measure to meet current or future income needs of the intended beneficiaries, while avoiding inclusion of the trust assets in the estate of the surviving spouse at his (her) death.

Portion trust—A portion trust is one administered as a single trust but which contains two or more sub-trusts, each with its own allocation provisions. A portion trust may work where the cost of a two-trust plan, using the marital deduction and applicable credit bypass trusts, is too high, or where asset values are too low to attract a professional trustee to accept one or both trusts.

Disclaimer

A disclaimer by a surviving spouse 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 bequests that will permit the surviving spouse to receive a larger marital deduction amount (see chapter 7).

Trustees

The selection of and powers given to trustee(s) is a critical issue that can bedevil an otherwise sound trust plan. The person or institution chosen as trustee must, of course, measure up in a practical sense. If forest land is an important part of the estate assets, a forester with business experience may be preferred, if not as sole trustee, perhaps as a co-trustee. Ability, integrity, judgment, and durability all are important qualities for a trustee. State law requirements must be satisfied; this is important particularly 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. That may not be fair to the trustee, however, because it takes valuable time to do the job right, and the family member may come to resent the duties involved and/or make them a low priority if uncompensated. On the other hand, an institutional trustee (usually in a department with several individual specialists), though it offers experience, continuity, and a variety of skills, may not have the personal interest in the forest 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 investment and income distributions. There may be additional fees for handling timber sales, preparing fiduciary income tax returns, and other services. 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 forest land to do the job that the grantor requires. There always is 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 forested properties, but others may want to dispose of the forest land and invest in more liquid investments.

Family Co-Trustees

In some cases a family member may serve as co-trustee with an institutional trustee, bringing knowledge of the personal needs of the beneficiaries, and sometimes, a personal attachment to the forest property. This arrangement will cost more, even if the co-trustee serves without fee, because additional time will be required for meetings, consultations, and resolution of conflicts. The co-trustee also may require a fee, which would be an additional expense. Benefits and costs should be carefully considered and balanced; appropriate language should be included in the trust instrument to ensure that favorable tax treatment will not be compromised if beneficiaries serve as co-trustees.

Successor Trustees

Naming alternate trustees should be considered, since the capacity of the original trustee(s) to serve may change at some point in the future. Family members age, move, or die; institutions also change or go out of business. Alternate trustees should be named or procedures put in place to address such contingencies. Foresight in this area 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, 1977-1 CB 273); 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 accomplish the grantor's objectives. Default provisions of 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 (the volume of merchantable timber present at the time the trust is created) and income (the subsequent growth). Because forest land may not produce income 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 may be prudent to include other income-producing assets in the trust to cover expenses in years there is no timber income or to permit retention of some timber sale income for forest management purposes. The trustee needs sufficient flexibility to respond to changing economic and environmental conditions, market opportunities, and beneficiary needs.