

Farm Management

Choose a trust carefully

MANY estate plans involve trusts to minimize estate taxes, avoid probate and maintain more privacy for the estate. Trusts can be classified as either revocable or irrevocable.

Revocable trusts, often called living trusts, can be amended or even terminated during the life of the person establishing the trust (grantor), and the grantor maintains full control over

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the trust during his or her lifetime. Irrevocable trusts typically cannot be amended, and the grantor gives up all control of the trust and the assets in the trust. Irrevocable trusts have gained

popularity recently as a tool to reduce estate taxes and minimize the risk of losing assets to nursing home costs.

When a person places assets in an irrevocable trust and retains no interest or control over those assets, that person is giving up ownership of the assets. Upon death, the assets are usually transferred to heirs. By giving up ownership of the assets, the assets will



not be included in the person's estate upon death, thus saving estate taxes. Also, the irrevocable trust prevents the assets from being subject to nursing home costs and allows the person to become eligible for Medicaid after a five-year look-back period, assuming all assets are put into the irrevocable trust.

Irrevocable trust not a cure-all

While irrevocable trusts can be valuable estate planning and long-term care planning tools, they come with significant issues and are not the cure-all that some promoters would suggest.

The immediately recognizable issue is the lack of control over the trust and trust assets. The grantor names a trustee, and the trustee controls the trust and trust assets.

A less obvious problem with irrevocable trusts involves capital gains tax. When a person passes away, the assets owned at the time of death, including assets in a revocable trust, usually receive a step-up in tax basis. For example, Bob bought land in 1970 for \$100,000. The land has a tax basis of \$100,000 during Bob's life. At Bob's death, the land is appraised at \$1,000,000. Bob's heirs receive the land with a stepped-up \$1,000,000 tax basis. If the heirs sell the land for \$1,000,000, there is no capital gains. Remember that capital gains are the difference between the sale price and the tax basis on land.

Let's say instead, Bob set up an irrevocable trust, placed the land in the trust and retained no interest in the assets. At Bob's death, the land does not receive a step-up in basis because Bob does not own the land, the irrevocable trust owns the land. The land comes out of the irrevocable trust to the heirs with the same \$100,000 tax basis. When the heirs sell the land for \$1,000,000, they will pay capital gains tax on the gain of \$900,000. The resulting capital gains tax would likely be around \$198,000. By putting the land in the irrevocable trust, the heirs received \$198,000 less due to capital gains tax.

Bob put the land into the irrevocable trust because he was concerned about estate taxes and losing the land to nursing home costs. However, Bob did not fully analyze the tax implications of the irrevocable trust to his heirs. The tax liability (\$198,000) would have paid for three years of nursing home costs.

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