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SETTING UP LIVING TRUSTS

— by Neil E. Harl*

The recent enthusiasm for setting up revocable living trusts is supported by two pluses — (1) a way to assure flexibility in management for property in those later years when individuals may not be in a good position to manage their assets and (2) an opportunity for some simplification in estate settlement.¹ However, several factors of a technical or practical nature should be taken into account before the decision is made to establish a revocable living trust.

Income tax returns

So long as the grantor is also the trustee and all items of income, deduction and credit are treated as owned by the grantor,² it is not necessary for the grantor to file a Form 1041. The information is reported on the grantor's individual income tax return.³

However, if someone other than the grantor serves as trustee, a Form 1041, Fiduciary Income Tax Return, must be filed with a statement showing income, deductions and credits attributable to the grantor from the trust.⁴ Schedule K-1 is to be used to show amounts taxable to the grantor.

Taxpayer identification number

The trust is to obtain a taxpayer identification number.⁵ However, for a trust where the same individual is both grantor and trustee, and is treated as the owner of all assets held by the trust, the requirement of obtaining an identification number has been eliminated.⁶

Tax year

The Tax Reform Act of 1986 required all trusts (both existing and newly created), other than tax exempt and charitable trusts, to adopt the calendar year as the taxable year.⁷ The provision was effective for taxable years beginning after December 31, 1986.⁸

However, a trust treated as wholly owned by the grantor need not adopt the calendar year as the tax year.⁹

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Conveyance of assets

Contrary to the impression one gets from promoters of living trusts who market trust forms, merely executing a trust instrument does not accomplish the creation of an operational trust. It is necessary for assets to be conveyed to the trust in order for the advantages of living trusts to be realized.

Thus, all land, vacation residences, vehicles, machinery and equipment, checking and savings accounts, certificates of deposit and all other assets should be conveyed formally to the trust. For some, this may be an objectionable step as titled assets thereafter bear an indication that the asset is actually owned by the trust rather than by the grantor personally. Certainly, individuals considering setting up a living trust should be advised that ownership of property necessarily shifts to the trust. The effect is generally more psychological than real inasmuch as the grantor almost always retains the power to amend, revoke or modify the trust and to recover back the property if desired.

In the next issue, we will consider the possible consequences of transferring assets to a revocable inter vivos trust.

FOOTNOTES

- 1 See generally 8 Harl, *Agricultural Law* § 62.04 (1992) for a discussion of revocable living trusts.
- 2 I.R.C. § 671.
- 3 Treas. Reg. § 1.671-4(b).
- 4 Treas. Reg. § 1.671-4(b).
- 5 I.R.C. § 6109.
- 6 Treas. Reg. § 301.6109-1(a)(2).
- 7 Pub. L. 99-514, Sec. 1403(a), 100 Stat. 2713 (1986), adding I.R.C. § 645.
- 8 Pub. L. 99-514, Sec. 1403(c)(1) 100 Stat. 2713 (1986).
- 9 Rev. Rul. 90-55, 1990-2 C.B. 161.