How Trust Mills Overlook Key Issues

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An accountant handling an estate tax return recently remarked, "The trust MILLS are keeping me busy cleaning up their messes."

A "trust mill" is a company that prepares cookie-cutter living trusts rather than custom-tailored living trusts. People are lured to a seminar and promised a living trust for $300-$1,000. A paralegal often meets with the client, a template form is run off the computer, and voila -- a living trust is created.

The problem is that cookie-cutter living trusts do not contain many of the provisions that most business owners and managers need. Thousands of dollars that should go to the family of the deceased end up going instead to the IRS in taxes. This article addresses three critical provisions often not addressed by the one-size-fits-all tactics of a trust mill.

Gift power to the trustee

When a person creates a living trust, he or she (the trustor) designates someone to act as a trustee or manager of the trust assets. The trust document lists the trustee's power. For example, a customized trust for someone whose estate will likely be subject to estate tax should give the trustee the power to make gifts of the trustor's property. That power to make gifts could save thou sands of dollars in estate taxes.

Here's an example: Assume that a single woman with a $1,500,000 estate consisting of $1 million of real estate dies in 2003. Since the "exemption amount" (in 2003) is $1,000,000, the heirs would be subject to an estate tax on $500,000 (the $1,500,000 value of her estate less the $1,000,000 exemption amount).

If, however, the woman's living trust allows the trustee to make gifts of assets, the trustee could gift 30% ($300,000) of her real estate to her family before her demise. Then, at her demise, she would own only $700,000 (70% of the original amount) of real estate.

By gifting a portion of the assets, the trustee created what is known as a "fractional interest." Because a fractional interest in real estate is considered less valuable proportionately than full ownership, the IRS may in this case allow the decedent's $700,000 of real estate to be discounted by up to 20%, a $140,000 discount. Assuming a tax rate of 48%, the tax saving on the $140,000 discount is about $58,000.

In other words, the living trust's provision allowing the trustee to make gifts saved the decedent's heirs approximately $58,000 in estate taxes.

Flexible distributions

As the name implies, a living trust is created during a person's lifetime. However, many living trusts provide that upon demise, something called a "bypass trust" will be formed. Most couples want the survivor to have use of the funds in the bypass trust for support. However, many trusts erroneously require that the survivor receive all income of the bypass trust instead of allowing the survivor to take the income as needed for support.

For example, assume that the bypass trust provisions require that all income be distributed to the surviving spouse, and that the bypass trust has $1 million of assets invested at 6%. If the spouse is in the 40% income tax bracket, she keeps 60%, or $36,000, of the $60,000 annual income after paying income tax.

Further, if the spouse's estate grows by $36,000 each year, after about five and a half years, the surviving spouse's estate has increased by about $200,000. Assuming a 42% tax rate, the $200,000 increase will result in $84,000 in estate taxes if the surviving spouse were to die. However, the increase in estate taxes could have been eliminated if the trust had provided for discretionary rather than mandatory income to the survivor.

Create a bypass trust

A married couple with a $2 million estate should have provisions for a bypass trust. Otherwise, estate taxes could eat up as much as 50% of the couple's estate. For example, if one spouse dies leaving all of his or her assets to the other spouse, the surviving spouse would have an estate totaling $2 million. If the surviving spouse then dies in 2003, the heirs would pay an estate tax on $1 million of assets (after the $1,000,000 exemption). If, on the other hand, the couple had a bypass trust, they would have completely eliminated the estate taxes.

In summary, a living trust should do more than avoid probate and provide a mechanism for assets to be managed in the event of incapacity. A living trust should also have provisions that minimize estate and income taxes. This article addresses only a few of the common issues that could be overlooked by "trust MILLS." The estate planning process should include enough legal analysis so issues such as business succession planning, charitable giving, and spousal property matters can be addressed. A cookie-cutter trust mill approach, by definition, does not.

As the saying goes, "You get what you pay for." Pay for what your family and business need and deserve. In the long run, it will pay off.

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