

PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

UNDERSTANDING REVOCABLE AND IRREVOCABLE TRUSTS

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Farm succession planning is a critical need that ensures the seamless transition of farm ownership and management from one generation to the next, preserving the legacy and viability of the farm. Two key tools used for succession planning are revocable and irrevocable trusts. Understanding these two trusts is essential for effective farm succession planning. This bulletin compares the characteristics, advantages and disadvantages of each type of trust and explains how each can enable a farm succession plan.

WHAT IS A TRUST?

A trust is a legal instrument for managing assets. A trust “grantor or settlor” establishes a trust, directs assets into the trust, and appoints a trustee to oversee the trust. The trustee must manage and distribute trust assets and benefits according to the grantor’s instructions. Trusts are highly useful tools that can protect assets, provide for heirs, and offer tax advantages to the grantor and beneficiaries.

THE REVOCABLE TRUST

A revocable trust, also known as a “living trust,” is a trust the grantor can alter, amend, or revoke at any time during the grantor’s lifetime. For this reason, the grantor is often the trustee of the revocable trust.

1. Characteristics of a revocable trust

- **Control.** A grantor who is also the trustee can retain control over the trust and its assets.
- **Flexibility.** The terms of the trust can be changed as circumstances evolve. The trust can be changed at any time and as many times as needed up until the time of the death of the grantor.
- **Income.** The grantor can receive income from the trust during their lifetime.
- **Assets in trust.** The grantor can withdraw or contribute assets to the trust at any time.
- **Taxation.** The trust's income is typically reported on the grantor's personal tax return.

2. Advantages of a revocable trust

- **Avoidance of probate.** Upon the grantor's death, the assets in a revocable trust pass directly to the beneficiaries, bypassing the often lengthy and expensive probate process.
- **Privacy.** Trusts are private documents, whereas wills become public record through probate.
- **Management during incapacity.** If the grantor becomes incapacitated, the trustee can manage the trust assets without court intervention.
- **Amendments and asset management.** The trust terms can be changed at any time and assets can be contributed or withdrawn from the trust during the life of the grantor.
- **Stepped-up tax basis.** All assets in the trust will receive a stepped-up tax basis at the grantor's death resulting in significant tax benefit to the trust beneficiaries.

3. Disadvantages of a revocable trust

- **No tax benefits.** Revocable trusts do not provide tax benefits during the grantor's lifetime. All assets in a revocable trust will be included in the grantor's estate value.
- **No asset protection.** Assets in a revocable trust are not protected from creditors, including nursing homes, since the grantor retains control.

THE IRREVOCABLE TRUST

An irrevocable trust is a trust that, once established, cannot be altered, amended, or revoked by the grantor, except under specific conditions.

1. Characteristics of an irrevocable trust

- **Loss of control.** The grantor relinquishes control over the assets placed in the trust. The trustee of the trust, which cannot be the grantor, has legal authority of the trust assets.
- **Permanency.** Most terms of the trust are fixed and cannot be changed, providing certainty and permanency to the plan.
- **Separate tax entity.** The trust is considered a separate tax entity and may be required to file its own tax return.

2. Advantages of an irrevocable trust

- **Asset protection.** Assets are generally protected from creditors and legal claims.
- **Tax benefits.** Irrevocable trusts can offer tax advantages, such as reducing estate taxes.
- **Medicaid planning.** Assets in an irrevocable trust are not counted for Medicaid eligibility, which can be important for long-term care planning.¹

3. Disadvantages of an irrevocable trust

- **Inflexibility.** Once established, the terms of an irrevocable trust are difficult to change.
- **Complexity.** Creating and managing an irrevocable trust can be complex and may require professional assistance. The complexity of an irrevocable trust will often result in higher legal fees than a revocable trust.
- **Loss of control.** The grantor gives up control over the trust assets.

¹ Assets contributed to an irrevocable trust are subject to the 5-year Medicaid lookback rule. See *Long-Term Care and the Farm*, available at farmoffice.osu.edu, for a thorough discussion of Medicaid rules and asset protection.

- **No stepped-up basis.** Some irrevocable trusts do not allow for the assets held in the trust to receive a stepped-up tax basis at the grantor's death. The determination as to whether a stepped-up tax basis is available depends on what benefits or control, if any, the grantor retains. For example, if the grantor retains the income rights from the trust, the trust assets will receive a stepped-up tax basis at death.

USING TRUSTS IN FARM SUCCESSION PLANNING

Revocable and irrevocable trusts can play vital roles in farm transition planning, but the choice of which to use depends upon the situation. Where flexibility and continuity are important, a revocable trust will likely be a better fit for a plan. On the other hand, if protecting assets and minimizing taxes are primary concerns, an irrevocable trust may be the best choice. And a plan might require the use of both types of trusts. Here is a review of the strengths of each type, as well as thoughts on incorporating both trusts into a farm succession plan.

1. Strengths of revocable trusts

- **Management continuity.** A revocable trust allows the current farm owner to maintain control over the farm operations while planning for future succession.
- **Smooth transition.** By transferring farm assets into a revocable trust, the transition to the next generation can be smoother and more organized, avoiding the probate process.
- **Flexibility.** Given the dynamic nature of farming and potential changes in family circumstances, the flexibility of a revocable trust is advantageous. The terms can be adjusted as needed.
- **Incapacity planning.** If the farm owner becomes incapacitated, the successor trustee can seamlessly step in to manage the farm without court intervention.

2. Strengths of irrevocable trusts

- **Asset protection.** Placing farm assets in an irrevocable trust can protect it from creditors and legal claims, ensuring the farm remains in the family.
- **Tax efficiency.** Irrevocable trusts can be structured to minimize estate and gift taxes, preserving more of the farm's value for the next generation.
- **Medicaid planning.** For farm owners concerned about long-term care costs, an irrevocable trust can help shield farm assets when planning for Medicaid eligibility.

3. Strategic use of both trusts

In many cases, using a combination of revocable and irrevocable trusts may be the most effective approach for farm succession planning. Consider these examples that illustrate how and when both trusts can benefit a plan:

- **Initial flexibility.** A farm owner might start with a revocable trust to maintain control and flexibility during their lifetime.
- **Transition to irrevocable trust.** As the farm owner ages or as part of an estate planning strategy, they might transfer certain assets into an irrevocable trust to gain the benefits of asset protection and tax advantages.

- **Layered approach.** Different farm assets might be placed in different types of trusts based on their nature and the family’s goals. For instance, operational assets might stay in a revocable trust for flexibility, while land and equipment could be placed in an irrevocable trust for protection and tax benefits.
- **Preservation of family legacy.** Either type of trust can ensure that the farm is preserved and managed according to the grantor’s wishes, maintaining the family legacy.

PLANNING PROFESSIONALS CAN TAILOR TRUST PLANS FOR FARM OWNERS

Each farm business and farm family is unique, and so are the trusts that can benefit a family’s succession plan. Revocable trusts provide flexibility, control, and ease of management during the grantor’s lifetime, making them a valuable tool for initial succession planning stages. On the other hand, irrevocable trusts offer robust asset protection and some tax benefits.

It’s important to recognize that “one size” or type of trust doesn’t fit every farm situation. That’s where knowledgeable professionals come into play. Attorneys, accountants, financial planners, and other professionals who specialize in agricultural succession planning can tailor a trust plan to meet the specific needs and goals of the farm and its owners. Farmers should take care to work closely with farm succession planning professionals to determine whether revocable or irrevocable trusts can help them accomplish their goals to plan for the future of the farm.

Find all of our
Planning for the Future of Your Farm
 bulletins and resources on the
 Farm Office website at
go.osu.edu/farmplanning

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