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THE LIVING TRUST AS AN ESTATE PLANNING TOOL
(2015)

Cautionary Note: This is general information for discussion purposes only, and does not constitute tax, legal, or other professional advice.

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1. **General Concept**. A "living trust" (sometimes referred to as a revocable inter vivos grantor trust) is a document (a "trust") established during your lifetime. It is called "revocable" because you may revoke the trust and change the beneficiaries or any other provisions during your lifetime. It is created "inter vivos" (that is, "during lifetime") as opposed to a "testamentary trust" which becomes established only at your death following a formal court supervised probate proceeding.

2. **Will Substitute**. A living trust is partly a Will substitute because it controls how trust assets are distributed at your death. It avoids probate because assets transferred into the trust are not subject to court supervised probate administration at death.

3. **Parties**. There are usually three parties to a living trust:

a. **Trustor**. The "trustor" or "settlor" is the creator of the trust. This is the person who transfers assets into the trust and states how the assets are to be managed and distributed during the trustor's lifetime and after the trustor's death. This is also the person who may revoke the trust and change the beneficiaries. If a married couple creates a trust together, then there would be two trustors/settlors.

b. **Trustee**. The "trustee" is the person designated by the trustor to manage the trust assets and to follow the trustor's instructions as set forth in the trust instrument. The trustor may designate two or more persons to serve together as co-trustees. The trustor may remove any trustee, and the trustor himself or herself may serve as the initial trustee. The trustor should designate successor trustees to serve if a trustee becomes incapacitated, dies, or resigns.

c. **Beneficiaries**. The "beneficiaries" are the persons who "benefit" by receiving payments or distributions from the trust.

4. **Typical Provisions**. A typical trust might provide that the trustor is to change title to the trustor's assets into the name of the trustee of the trust; that the trustee is to distribute to the trustor (as "beneficiary") all of the net income from the trust during the trustor's lifetime; that the principal (or corpus) of the trust may be invaded if necessary for the trustor's health, support and

maintenance; and that the trustor retains the right to designate from time to time who will receive the assets which remain in the trust at the trustor's death. The trustor may designate that the assets are to continue to be held in trust following the trustor's death, perhaps by providing that the trustor's spouse will receive all of the net income (and so much principal as is necessary for health, support and maintenance), with the balance passing at the surviving spouse's death in equal shares among the trustor's children or other named beneficiaries.

5. **Estate Tax Planning**. Under normal circumstances, a living trust does not become irrevocable (that is, unchangeable) until the trustor's death. If there are **two** trustors (for example, a husband and a wife), then the deceased spouse's portion of the trust may become irrevocable at the deceased spouse's death. The irrevocable portion might be called a "By-Pass Trust" because it may "by-pass" or escape Estate Taxes at the deaths of both the deceased spouse and the surviving spouse. Reduction or deferral of federal Estate Taxes may be accomplished in either a living trust or a testamentary trust.

6. **Advantages**. There are five primary advantages of a living trust:

a. **Avoids Probate**. A living trust avoids probate. It usually (1) reduces estate settlement costs (primarily attorney's fees and executor's compensation), (2) eliminates the need for detailed court accountings, (3) allows assets to be sold without court supervision and delays, and (4) speeds up the process of distributing income and assets to beneficiaries. It also keeps the deceased trustor's affairs relatively private. Wills and probate proceedings are open to public inspection, but living trusts do not normally require court disclosure or supervision.

b. **May Eliminate Need for a Conservatorship**. A living trust may provide management of your assets during your lifetime, and may permit you to designate a successor trustee to step in and manage your affairs if you desire to travel, or if you become incapacitated. A living trust may make it possible to avoid formal court supervised conservatorship proceedings (and the legal costs associated with them) if you become incapacitated.

c. **Retains Flexibility and Management Assistance**. A living trust is flexible. The trustor may (1) gradually give investment powers to a successor trustee (including a bank or other professional trustee, if desired), (2) amend the trust, (3) change the trustee, and (4) revoke the trust at any time, all as changing circumstances occur.

d. **Permits Continuity of Management**. A living trust provides continuity of management. The same trustee can continue to manage your financial affairs even after your death.

e. **May Avoid California Real Property Tax Reassessment**. There will not be any increase in real property taxes when real property is transferred into a revocable trust. The first spouse's death will not cause reassessment if the surviving spouse may continue to use the property during lifetime. The trustor's children may receive the Trustor's principal residence, plus as much as one million dollars of assessed value (under Proposition 13) of other real property in California, without reassessment.

7. **Disadvantages**. There are four primary disadvantages to a living trust:

a. **Higher Initial Expense**. It is more expensive to create a living trust than a Will, because title to your assets should be changed into the name of the trustee. If you designate a professional trustee (for example, a bank or a trust company), it will typically charge an annual management fee of perhaps 1-1/3% or more of the fair market value of the assets.

b. **Requires Changes to Title**. Title to assets must be changed into the name of the trustee. For example, deeds must be prepared and recorded to transfer real property into the name of the trustee. Under current federal regulations, consents may have to be obtained from certain lenders on commercial and multi-unit residential properties. A rider may be required to retain title insurance on trust real properties. Stock certificates, partnership and Limited Liability Company (LLC) interests, and significant savings accounts should also be changed into the name of the trustee. It is frequently important for income tax basis purposes to change title to existing assets from joint tenancy into community property (or community property with right of survivorship), even if no living trust is created. An example is attached at the end of this document.

c. **May Afford Somewhat Less Protection From Creditors**. Before 1992, a living trust may have afforded less protection against certain creditors than a probate proceeding. Probate administration normally cuts off claims of creditors not filed within four months after appointment of a personal representative (e.g., an executor). Probate administration therefore had advantages if you had unsecured or contingent creditors, or if you owned a business with substantial malpractice or product liability risks. Effective January 1, 1992, a Trustee may choose to implement creditor protection (which is similar to probate protection).

d. **Requires Minimal Record Keeping**. Most individuals find that the record keeping for a trust is no more difficult than they normally handle for income tax reporting purposes. Prior to November 23, 1981, living trusts were technically required to file annual federal and California "information" income tax returns even though the returns did not result in any income tax being paid. On November 23, 1981, a new regulation (U.S. Treasury Regulation §1.671-4) eliminated the necessity of obtaining an identification number (similar to a social security number) or filing trust income tax returns during such time as the trust remains revocable.

Illustration of 100% "step-up" in income tax basis for community property versus 50% "step-up" for joint tenancy titled property (2015) (married couples only)

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There are income tax advantages for a married couple to hold record title to appreciated assets in community property form (or as community property with right of survivorship; or in a trust where the assets are designated as community property), as opposed to holding record title in joint tenancy form. This result occurs because of Internal Revenue Code Section 1014(b)(6) and California Revenue and Taxation Code Section 18031.

1. Assumption: Husband and wife purchase securities or real property with community funds for $50,000 (this is their "cost basis"). At the first spouse's death, the securities (or real property) are worth $300,000 (this is the fair market value at the date of death or "FMV").

2. Result at first spouse's death:

a. Holding title as community property will result in a "step-up" in income tax basis to fair market value **both** for the deceased spouse's 50% interest and also for the surviving spouse's 50% interest.

$300,000 FMV at death
-$300,000 new cost basis (1/2 FMV of $150,000 + 1/2 FMV of $150,000)
NO GAIN for income tax purposes on post-death sale

b. Holding title as joint tenants will result in a "step-up" in income tax basis to fair market value **only for the deceased spouse's 50% interest**, while the basis of the surviving spouse's 50% interest stays at the original cost basis.

$300,000 FMV at death
-$175,000 new cost basis (1/2 FMV of $150,000 + 1/2 cost basis of $25,000)
$125,000 GAIN for income tax purposes on post-death sale