THE USE OF LIVING TRUSTS IN ESTATE PLANNING

Margaret M. Hand
Law Offices of Margaret M. Hand, PC
1939 Harrison Street, Suite 200
Oakland, California 94612

(510) 444-6044
(510) 444-7044
email@handlaw.com

Living trusts, sometimes called revocable inter vivos trusts, may be the most commonly recommended estate planning tool used in California.

Brief History

A trust is established when a property owner entrusts his or her property to another person for the purpose of providing a benefit to the trust's beneficiaries. Historically, to create a trust there had to be an actual transfer of property from the property owner, called the "settlor," to another person, called the "trustee," for the benefit of yet a third person, the "beneficiary." Thus, for example, a wealthy landowner (the settlor) might entrust his real estate to a neighbor (the trustee) for the period of time necessary for the settlor's eldest son (the beneficiary) to reach maturity. During the term of the trust, the trustee would manage the estate, using the income from the land to pay the expenses of administration and to support the beneficiary. Under trust law, the attributes of property ownership were divided between the trustee, who had legal ownership, and the beneficiary, who had beneficial ownership. As legal owner, the trustee could do anything a prudent owner might do with his own property, but the trustee's duties to the beneficiary required the trustee to act only for the benefit of the beneficiary.

Modern Trusts

Today, it is no longer necessary for the settlor, trustee and beneficiary to be three different people. The law of trusts now allows one person (the settlor) to transfer his "estate" to himself as trustee, for his own benefit.

The legal fiction of a transfer remains important, however and it is the transfer of assets from the settlor to the trustee that makes trusts the useful estate planning mechanism they have become. After the transfer, though the same human being owns the assets, under the law of trusts the assets are owned by a different *legal* person, the trustee. When the settlor-trustee dies, a new person steps into the role of trustee, but it is not necessary to change legal ownership of the assets. They are already owned by the trustee.

The trustee is only the legal owner, however, and he or she is required by law to administer the assets according to the terms of the trust. Often, this means the trustee must pay the settlor's debts, taxes and expenses and then distribute the trust assets to the settlor's chosen beneficiaries. In effect, the successor trustee of a trust has the same responsibilities as does an executor of a will, but the trustee is not subject to a court-supervised probate.

Probate is unnecessary because there is no change in ownership. The trustee is the owner both during the settlor's life and after the settlor dies. The person who occupies the role of trustee may change, but ownership need not. In other words, when the settlor dies, legal ownership does not change, only beneficial ownership changes. Beneficial ownership changes because the settlor is no longer the beneficiary. The new beneficiaries are those people named by the settlor in the trust instrument. The following example illustrates these principles.

Consider, for example, a young married couple that establishes a trust for estate-planning purposes. Typically, the husband and wife (the settlors) will serve as co-trustees during their joint lifetimes and they will be the sole beneficiaries of the trust during that time. As co-trustees, they will manage their financial affairs just as they did before the trust was established, but title on their home and financial accounts will reflect that the assets are owned by the husband and wife as co-trustees. Should either spouse become incapacitated, the other spouse may continue to manage the trust assets, spending money as necessary for his or her own support, for the support of the incapacitated spouse, and to discharge the couple's legal obligation to support their children. The court-supervised proceeding called "conservatorship" should not be necessary because one spouse will have all the power necessary to manage the couple's affairs. Similarly, at the death of the first spouse to die, the surviving spouse should be able to avoid probate because it will not be necessary to get a court order changing title on the couple's assets.

Conservatorship Avoidance

In a conservatorship, the court appoints a conservator to manage the affairs of an incapacitated person. The conservatorship typically lasts for the lifetime of the incapacitated person. During this time, the conservator is required to account to the court annually or semi-annually and must get court approval of all major decisions. Conservatorships are costly, because the conservator almost always requires legal assistance for every court appearance. The procedures designed to protect the incapacitated person are complicated and difficult to follow, even for lawyers, and this complexity creates many delays. As mentioned above, if the settlor of a trust becomes incapacitated, his or her trustee may continue to administer the trust assets for the settlor's benefit, thereby avoiding the expense and inconvenience of a conservatorship.

Probate Avoidance

Probate cannot always be avoided with a trust, because the trustee has power only over trust assets. Thus, if a couple establishes a trust but fails to transfer their assets to the trust, a probate may be necessary to establish the transfer. Probate may also be necessary if, for example, a personal representative must be appointed to continue or initiate a law suit. For most people, however, a fully funded revocable trust provides a mechanism for avoiding probate.

Avoiding probate usually means that the decedent's assets may be distributed to the beneficiaries more quickly. Court-supervised proceedings are notoriously time consuming and fraught with delay. Avoiding probate is not the same as avoiding lawyers, however. The successor trustee charged with administering the trust of a deceased settlor should usually consult with an attorney, at least in the early stages of the post-death administration. Though a well-drafted trust will contain most of the instructions a trustee will need, even well-drafted instruments may be difficult to read and hard to interpret. Plus, a lawyer with expertise in estates and trusts will have the wisdom of experience necessary to protect the successor trustee from the mistakes trustees commonly make.

A trustee may not be able to avoid lawyers completely, but trustee's attorney fees may be less than the fees granted by law to an executor's attorney. The statutory attorney fee for the probate of a $500,000 estate is $13,000. This amount will pay for 47 hours of services from an attorney whose usual hourly rate is $275. Typically, but not always, successor trustees require fewer than 47 hours of counseling to administer the trust of a deceased settlor. Thus, trusts often save families a considerable amount in attorney fees.

Estate Taxes

Both trusts and wills that contain trust provisions may provide married couples a mechanism for avoiding taxes on the death of the first spouse to die and for minimizing taxes on the death of the second spouse. Understanding this mechanism requires an understanding of two tax-planning principles.

The Applicable Exclusion Amount

Each taxpayer may make gratuitous transfers worth an aggregate $1.5 million and pay no tax on those transfers. This amount, called the "applicable exclusion amount," is scheduled to increase to $2 million in 2006 and to $3.5 million in 2009. In 2010, the estate tax is scheduled for repeal, but commentators debate whether this will really happen. If the estate tax is repealed, the capital gain tax, now a relatively minor concern, will become a much more serious problem and estate plans drafted to minimize estate taxes should be reconsidered. In 2011, the estate tax is scheduled for re-enactment, and the applicable exclusion amount will then be only $1 million.

Think of the applicable exclusion amount as the amount one can give to *anyone*, tax free. Spouses are separate taxpayers and each has an applicable exclusion amount. Thus, the wife may give away up to $1.5 million and pay no tax and the husband may do the same. Together, spouses may give away a total of $3 million and pay no tax. Again, this amount is scheduled to increase and in 2009, the sum of two applicable exclusion amounts will be $7 million. Many spouses think of this as the amount they can give to their children, tax free.

Preserving the applicable exclusion amount of the first spouse to die is the most important transfer-tax saving measure spouses can take. To preserve the first spouse's applicable exclusion amount, the surviving spouse must earmark $1.5 million (or $2 million, or $3.5 million, as the case may be) of the deceased spouse's estate and keep the earmarked funds segregated from the estate of the surviving spouse. Often, this segregation is accomplished by placing the funds in a separate trust, the bypass trust. The terms of the bypass trust may be contained in the document establishing a living trust or in a will. Assets transferred to the bypass trust may be distributed to the surviving spouse during his or her lifetime, but when possible, it is best to treat the bypass trust as a vehicle for transferring assets to the next generation. Otherwise, the assets end up in the hands of the surviving spouse and are then taxed as part of his or her estate. What many spouses choose to do is to name the surviving spouse as the beneficiary of the bypass trust, trusting that the surviving spouse will exhaust his or her taxable estate before invading the tax-sheltered assets of the bypass trust. Typically, a married couple with children will provide that the assets of the bypass trust pass to the children upon the death of the surviving spouse.

Non-married taxpayers also have applicable exclusion amounts, but do not face the challenge of segregating the deceased spouse's assets from the assets of the surviving spouse. Thus, on the death of a non-married person, his or her assets will receive protection from the estate tax up to the amount of his or her applicable exclusion amount, but the assets do not have to be segregated in a bypass trust.

The Marital Deduction

For spouses fortunate enough to own estates worth more than their combined applicable exclusion amounts, there is no simple way of avoiding estate tax altogether and the more sophisticated planning techniques are too complicated to address here. Spouses whose estates exceed $3 million may avoid paying any tax on the death of the first spouse to die, however, by taking advantage of the marital deduction from the estate tax.

If one spouse makes a gift to the other, during lifetime or at death, there is no gift or estate tax on that gift. When the recipient spouse dies, if the asset remains in his or her estate, the asset is taxed then, at its then present value. Gifts to a spouse qualify for the marital deduction if they are outright gifts or if they are gifts in trust that qualify for the marital deduction.

The most common type of marital deduction trust is called a QTIP ("qualifying terminable interest property") trust. To qualify as a QTIP, the trust must provide the surviving spouse with all of the trust's income for life and during the surviving spouse's lifetime, the trustee may not provide benefits to anyone but the surviving spouse. The settlor of a QTIP trust (the first spouse to die) does not have to grant the trustee power to distribute anything other than income to the surviving spouse, but typically spouses name each other as trustee and grant one another as much power as the tax code will allow. Assets remaining in the QTIP trust on the death of the second spouse to die are included in that spouse's gross estate for the purpose of the estate tax.

Revocable Trusts

Living trusts are typically revocable during the settlor’s lifetime. Thus, a non-married settlor may change his or her trust at least as easily as one may change a will. Married settlors may change any aspect of the trust during their joint lives, but on the death of the first spouse to die, the bypass and QTIP trusts become irrevocable.

Creditors

Living trusts do not provide "asset protection" in the sense of shielding the settlor's assets from judgment creditors. So-called "asset protection trusts" are arrangements whereby a settlor irrevocably transfers his or her assets to a trust over which the settlor has no control. Such trusts are fraught with problems and a discussion of asset protection trusts is beyond the scope of this paper.

The advantages to living trusts are now well established and there are virtually no offsetting disadvantages.