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## **LIVING TRUSTS**

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### Background

If you create a living trust, you retain the right to revoke the trust and reclaim the ownership of trust property during your lifetime. If you don't exercise this right, the trust becomes irrevocable upon your death, and the trust instrument, not your will, controls the disposition of trust property.

### Advantages of Living Trusts

A living trust that's properly set up and funded offers several advantages as an estate planning tool. While each of these advantages is significant, they have to be viewed in light of your particular needs.

Avoiding Probate: The main reason given for creating a living trust is to avoid the probate process and its related costs. In states where executor fees and attorney fees are based on a percentage of the probate estate, this certainly can be a valid reason because these costs can be significant. However, in jurisdictions where a family member can serve as executor (and waive the fee) and attorney's fees are based on an hourly rate, the cost of probate typically isn't an issue. Thus, prior to creating a revocable trust as a means to reduce probate costs, it's important to compare the cost of establishing and maintaining a trust with the estimated future probate costs. Only when the latter expenses are expected to be significantly higher and a less expensive means of avoiding probate (such as using joint ownership with right of survivorship or providing named beneficiaries on life insurance or retirement benefits) is not appropriate does a living trust provide a good alternative.

Your trust has to be **fully funded**; otherwise, the trust becomes useless. This requires all assets be **retitled into the name of the trust**. As a result, **deeds to real property** must be prepared, and stocks and bonds must be transferred from your name as an individual to your name as trustee. The disposition of retirement plans, IRAs, or life insurance will be determined by a separate beneficiary designation. Thus, these assets may not necessarily need to be retitled to avoid probate costs.

Consider executing a **pour over will** at the same time. It's a valid will specifying that all assets owned by the decedent at death **pass directly to the living trust** (which has become irrevocable as a result of the grantor's death). The pour over will is a precautionary measure ensuring that all assets owned by the trust creator will be distributed according to the terms of the trust. Unfortunately, the pour over will defeats the stated purpose of avoiding probate because it must be **admitted to probate** just as if the decedent had only a will and no revocable trust. However, in states that allow fees based on a percentage of the total estate, the majority of the decedent's assets will not be subject to probate costs as long as the trust is funded prior to death with the bulk of the decedent's assets. Thus, the trust may still provide significant savings in terms of probate expenses.

Trust Administration in Case of Incompetency: Another reason for using a living trust is to **avoid a court-supervised administration** in the event the trust creator becomes incompetent. A living trust allows clients to transfer all of their assets to the trust and to continue managing them as long as they desire. If they later decide to give up the responsibility of managing the property, they can resign as trustee, and the person designated as successor trustee assumes management responsibility for the trust's property. The ability to transfer management responsibility may be particularly desirable to elderly clients who are concerned about the possible future loss of their faculties and their ability to manage their assets.

Without a living trust or other appropriate documents, a guardianship proceeding is required to appoint someone to manage the assets of an incompetent individual. In a guardianship administration, the actions of the guardian must be reviewed and approved by the court. This degree of court supervision, coupled with the cost of providing a required annual accounting to the court, makes guardianship administration unattractive. Thus, a living trust can provide a viable alternative to a guardianship administration.

If your goal is to avoid a guardianship proceeding, you should fully fund the trust at the time of its creation. This ensures that the successor trustee has control over all of the person's property in the event the person is incapacitated. If it's impractical for the trust to be fully funded, the establishment of the living trust should be coupled with the granting of a durable power of attorney to the person who will ultimately serve as trustee in the event of incapacity. Under the terms of the power of attorney, the designated person should have the authority to transfer assets to the trust after the grantor suffers an incapacitating disability. If this funding method is desired, it is imperative that the durable power of attorney comply with the specific provisions of state law authorizing the attorney-in-fact to act as agent on the grantor's behalf after the grantor becomes disabled, incapacitated, or incompetent.

If your only reason for creating the living trust is to avoid a guardianship proceeding, it may be simpler and cheaper to grant a durable power of attorney over all of your assets to a trusted relative or friend, rather than to establish the trust. Because many people are uncomfortable giving even a family member a general power of attorney over their assets, some states provide for a "springing" power of attorney, which doesn't become effective until you, the grantor, become disabled. Thus, grantors can retain sole control over their assets unless they become disabled.

Multistate Administration. An ancillary administration (or administration of the decedent's estate in more than one state) is necessary when decedents own real property located outside of their state of domicile. As with regular probate administration, the expense associated with an ancillary administration is directly related to the specific requirements of the state in which the real property is located. If an ancillary proceeding is fairly simple, it may not be cost effective to establish a living trust to avoid the additional administrative expenses. However, an ancillary administration usually requires the same degree of cost and involvement as a regular administration. In addition, another attorney will normally be required to handle an ancillary administration when the attorney handling the probate administration in the state of domicile isn't licensed in the other state. Thus, as an alternative to an ancillary administration, a living trust can be established to hold title to the property located in another state.

A living trust established solely to avoid an ancillary administration doesn't need to be fully funded to serve its purpose. Instead, it's only necessary to transfer title to the out-of-state real property to the revocable living trust. The transfer of title is what makes this trust an appropriate planning tool. If the real property is titled in the name of the living trust, there's no need to transfer title to the property at the death of the trust grantor (trustee). The title will already be vested in the trust, and administration of the decedent's estate in the other state will be avoided.

Privacy is another benefit of using a revocable living trust. An inventory of assets must be filed in a probate administration. This document becomes a matter of public record, subject to inspection by anyone who expresses an interest. If you are concerned about the privacy of your financial affairs, use a fully funded living trust to prevent public disclosure of their assets. With the availability of information over the Internet, this may become a greater concern than in the past.

Incompetency Challenge: A revocable living trust can also be used to minimize the risk associated with a will contested on the grounds of incompetency. When the competency of clients is in question, it may be better for them to establish a living trust to dispose of their assets. Generally, it is **easier to challenge a will than a trust**. If the trust is later challenged on the grounds that the grantor was incompetent at the time of creation, the previous will should still be valid. Conversely, if a person whose competency is in question executes a new will, the new will may be deemed effective to revoke the prior will even though it is not effective to transfer the property to the persons named in the later will. This could force the decedent's property to pass as if he or she died without a will.

### Disadvantages of Living Trust

Failing to Fully Fund the Trust. The goal to avoid probate will not be met if the trust is not fully funded. **Probate may still be required for any property that isn't transferred to the trust** prior to your death. Even if the trust is fully funded at the time of its creation, **subsequently acquired property must be titled in the name of the trust**. If for any reason this fails to occur, it will be necessary to have a will admitted to probate (even if it's a pour over will), and what was perhaps the primary purpose for establishing the trust will have been defeated.

Costs That Exceed the Benefits. Besides the time and effort required to set up and maintain a living trust, there are also some fairly significant costs involved. If the individual owns a large number of assets, changing the title on all the assets can be time-consuming and costly. Title to the assets needs to be changed twice, initially upon funding to the revocable trust by the grantor during lifetime, and then again upon transfer to the beneficiaries during the post-death administration. Additionally, it can be cumbersome to deal with third parties regarding assets that have been retitled to the trust. These and any other expenses involved have to be weighed against the hoped for benefits of the trust to determine if it appears to be worthwhile. Some clients will decide that it's not.

Property That's Less Appropriate for Ownership by a Living Trust. Certain property is more appropriate than other for ownership by a living trust. For example, **S corporation stock** may not be a desirable asset for such a trust because of the restrictions on trust ownership that could apply after the S corporation shareholder's death (i.e., ownership is generally limited to two years unless the trust meets the requirements of a qualified Subchapter S trust or electing small business trust). In addition, the \$25,000 rental real estate allowance available to individuals under the passive loss rules is not available to trusts. Therefore, funding a revocable trust with **rental real estate generating losses** may create adverse income tax consequences after the death of the grantor when the trust becomes irrevocable and is not entitled to the special allowance.

#### Tax Consequences of a Living Trust

All assets in the trust are **included in their gross estate**. Thus, by themselves, living trusts do **nothing to reduce an individual's taxable estate**. For income tax purposes, a revocable living trust is treated as a grantor trust. Accordingly, all items of income and deductions generated by the trust pass through directly to the grantor of the trust.

#### Selecting a Trustee

The initial trustee of a living trust is normally the grantor. For married couples, both husband and wife are usually named as **co-trustees**. The intention is to allow them to continue to handle the property as in the past, although they now hold the property in a fiduciary capacity subject to the terms of the trust instrument. It is important to designate a **successor trustee** for the trust. This is particularly true if one of the purposes for the trust is to provide for the possibility of incapacity of the grantor, or professional management for a surviving grantor. Careful consideration should be given to the selection of a successor trustee because this person will be responsible for **safeguarding and investing the assets** and making **distributions at the death or incapacity of the grantor**.