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REVOCABLE LIVING TRUSTS & ESTATE PLANNING

What is a Revocable Living Trust?

A revocable living trust is a legal entity formed during the lifetime of the persons who create it. Its purpose is to hold assets and property for the use and benefit of its founders, and to allow the assets and property to be transferred to others at death without the need for probate administration. It is distinguished from other types of trusts which are set up to permanently transfer property for the use and benefit of others persons (*e.g.*, charitable trusts, educational trusts, trusts for minors or disabled persons, insurance trusts, etc.).

Legal documents often refer to the persons who set up or create a trust as the *settlers* or *trustors*. This paper will call them *settlers*. There may be one or more settlers of a trust.

The person or persons who hold and manage the property are called *trustees*. The trustee(s) are also responsible for distributing trust property upon death. Trustees must manage and distribute trust property in accordance with the directions contained in the *declaration of trust*, which is the legal document used to set up a trust. The *successor trustee* takes over management of a trust upon the death, resignation, removal, or incapacity of a settlor; and, after the settlor's death, he or she holds and distributes the trust assets as directed by the declaration of trust.

A *beneficiary* is a person who is entitled to receive income or principal of a trust. In the usual living trust arrangement, the settlor (founder) of the trust initially acts as trustee and is the sole beneficiary during his or her lifetime.

A living trust eliminates probate fees and delays, while allowing prompt distribution to the heirs and flexible management of assets. Assets placed in a living trust are under the complete control of the settlers, who are free to terminate (*revoke*) or amend the trust at any time. A well drafted trust also provides for the management of property and finances in the

event of the *incapacity* of either or both of the settlors. This is a flexible and less expensive alternative to a court-supervised conservatorship.

**What effect does a revocable living trust
have on taxes and debts?**

A revocable living trust is not a taxable entity during the settlor's lifetime, and no reports need be made to any government agency. The IRS treats income in a living trust the same as any other income of the settlor. No special trust tax returns need be filed, but the settlor still must file personal income tax returns and pay taxes. Having a revocable trust does not reduce or eliminate income taxes for a settlor during his or her lifetime.

California real property taxes are not increased *or* reduced by transferring real property to a living trust, because the law does not consider such a transfer to be a "change of ownership" for purposes of Proposition 13. California no longer imposes inheritance or gift taxes. These taxes were repealed by an initiative measure in 1982.

There is a federal tax on estates and gifts. For deaths occurring in 2013 estates of \$5,250,000 or less are exempt from the estate tax. (The technical name for this exemption is the *applicable exclusion amount*).

Having a living trust does not automatically eliminate or reduce federal estate taxes. But a living trust may contain provisions which save estate taxes by avoiding the accumulation of all the family assets in the surviving spouse's taxable estate, and by exempting \$5,250,000 from the estate of each spouse, thereby allowing a total 2013 exemption of \$10,500,000. This is accomplished by splitting the total family estate into two or more trusts upon the death of one of the spouses and giving the surviving spouse the income and right to use the deceased spouse's trust estate during the survivor's lifetime, with the remaining trust property to pass to children or others upon the death of the second spouse.

Community property transferred to a living trust may receive a full stepped-up basis for income tax purposes upon the death of either spouse. *Cost basis* is the value used on an income tax return to calculate gain or loss on the sale of an asset.

What are the advantages of a living trust?

The settlor may retain complete control over property in a living trust. He or she may revoke, amend or terminate the trust at any time.

Living trusts are confidential because they usually are not supervised by the court.

Unlike wills which have been admitted to probate, trust declarations and records ordinarily are not open to public inspection.

If a settlor becomes disabled or incapacitated, a living trust provides a flexible mechanism for managing family assets without the expense and inconvenience of a conservatorship, which is subject to court supervision. Living trusts also may incorporate arrangements for minor children, disabled beneficiaries, and other special circumstances.

Statutory probate fees are not incurred where a living trust is properly set up, funded, and administered.

What are the disadvantages?

A living trust is more complicated than a simple will, and involves more time and expense to create. A capable and conscientious successor trustee must be available because the court does not supervise the settlement and distribution of a living trust unless someone files a special petition asking for court intervention. There is always a danger that an irresponsible or dishonest trustee will dissipate trust assets or make foolish investment decisions.

A trust must be carefully set up and administered if it is to work. It is extremely important to make sure that all desired assets are transferred into the names of the trustees; otherwise, those assets won't be subject to the trust and may have to be administered in a probate proceeding. As assets are sold or acquired, title must continue to be granted from and vested in the trustees.

Some minor tax differences exist between trusts and estates or individuals. For example, a probate estate may select a fiscal year, while a trust must use a calendar year.

Stock transfer agents and title companies prefer court decrees, but will accept trust directions. Often there is a need for a lawyer to help with transfer of stock or real property held by a trust, or with other matters relating to trust administration.

Are there other ways to avoid probate?

Yes. There are several ways probate administration may be avoided without using a living trust. Estates of less than \$150,000 that do not contain real property may be settled in California through a statutory affidavit procedure in most instances. Even if a small estate under \$150,000 contains real property, there is a simplified court procedure that will avoid the full cost of a probate.

Joint tenancy ownership may avoid probate, but may cause tax problems and prevents distribution to anyone but the other joint tenant(s). Joint tenancy may have other adverse consequences. For example, putting someone's name on property is really a completed gift; and it may not be possible to "take back" the gift later on. In the case of a bank account, a joint tenant may have the power to withdraw all funds in the account without the knowledge of the other joint tenant.

Bank and financial institution "Totten" trust accounts and pay-on-death arrangements, and transfers to minors under the Uniform Transfers to Minors Act, also avoid probate.

Surviving spouses in California do not need to probate their deceased spouse's estate to the extent it passes to them as community property. Usually life insurance, retirement benefits, and IRA's aren't subject to probate administration.

Should the settlor of a living trust have a will?

While not legally necessary, it is strongly recommended that each settlor have a "pour-over" will. Ordinarily, such a will provides that if there are assets *not* held in the name of the trustee at the time of the settlor's death, those assets will "pour over" into the trust and be administered and distributed as provided in the declaration of trust. Where a living trust is properly created, funded and maintained, the "pour-over" will does not need to be probated and serves merely as a back-up protection for the plan of distribution included in the trust.

What happens after a settlor's death?

In many estates, only a limited amount of legal or accounting work may be needed to settle and distribute a living trust after a settlor's death. Ordinarily, this work can be completed promptly and without the need of a court proceeding. An attorney's assistance usually will be helpful but is not required by law. An accountant's assistance often will be necessary to prepare final income tax returns and estate tax returns, if required. For tax purposes, appraisal of all non-cash trust assets is usually required in order to determine the amount of the gross estate for tax purposes, and to establish a new stepped-up tax basis for each asset. Post mortem administration of large or complex trusts may require significant professional assistance from attorneys and accountants.

Gift Tax Deductions, Exclusions, and Credits

A. Federal Gift Tax System: The gift tax is imposed on lifetime transfers of property for less than adequate and full consideration in money or money's worth. IRC §§2501(a), 2512(b). Generally, gifts made are subject to the payment of gift tax if they do not qualify for

various exclusions. IRC §§2501-2524. The gift and estate tax systems are “unified.” That is, every dollar of the lifetime gift tax exclusion used by the donor reduces the estate tax exclusion by the same amount. See IRC §§2001(b), 2012(a). Some gifts are not subject to gift taxes because of exclusions and deductions.

Each gift requires careful analysis balancing the advantages of gift tax savings against the possible estate, generation-skipping transfer (GST) real property transfer, and income tax consequences.

Marital deduction. Gifts to spouses who are citizens or residents of the United States are generally exempt from gift taxes. IRC §2523(a).

Charitable deduction. An unlimited gift tax deduction is provided for gifts made to qualified charitable organizations as described in IRC §522(a). This deduction is similar to the deduction provided for estate taxes under IRC §2055, but organizations to which the transfer can be made and still qualify for the deduction differ.

Annual Exclusion. There is an annual exclusion of \$14,000 per donor per donee per year in 2013. IRC §2503(b); Rev Proc 2012-41, 2012-2 Cum Bull 539. (The amount of the annual exclusion is indexed to the cost of living and usually changes from year to year.) Thus, a donor may make gifts of \$14,000 per year to any number of individuals. Those gifts are excluded from gift taxes and are not counted against the lifetime exclusion. IRC §2503(b). The annual exclusion applies only to gifts of present interests and does not apply to gifts of future interests. IRC §2503(b)(1).

Example- A client has four children and six grandchildren to whom she would like to make gifts. The client could give a total of \$140,000 (10x \$14,000) per year free of gift taxes. If the client is married and her spouse consents to split gifts under IRC §2513, the client and spouse could give away \$280,000 per year and incur no gift tax. The gifted amount would pass out of the client’s estate without gift or estate taxes.

Exclusion for education expenses. A donor may pay for tuition (but no room, board, or supplies) for a beneficiary as long as the check is made payable to the school, college, or university. IRC §2503(e).

Exclusion for medical expenses. Likewise, a donor may pay medical expenses for a beneficiary as long as the check is made payable to the medical service provider. IRC §2503 (e). Payments of medical expenses must be paid directly to the medical service provider, not as a reimbursement to an individual who previously paid a medical service provider. Treas Reg §25.2503-6.

Note: The exclusion for education or medical expenses under IRC §2503(e) is not limited in amount. It is available in addition to the annual gift exclusion and without regard to the relationship between the donor and the donee. Treas Reg §25.2503-6(a).

Gift tax credit. Gifts that exceed the annual and other exclusions are subject to the payment of gift taxes. However, in addition to the annual exclusion, each taxpayer has a \$5,250,000 lifetime exclusion for 2013 (IRC §2505; Rev Proc 2013-15, 2013-5 Int Rev Bull 444). This exclusion is unified with the estate tax exclusion. See IRC §2001 (b), discussed in §19.16. Thus, each dollar of the lifetime gift tax exclusion used reduces the applicable estate tax basic exclusion amount (which is also \$5,250,000 for 2013; Rev Proc 2013-15, 2013-5 Int Rev Bull 444) by one dollar. IRC §2010(c).

If a legal problem arises, California law provides a simple procedure for submitting trust legal questions to the court.

NOTE: This sheet is intended to give you some very basic information about revocable living trusts and estate planning. Of necessity, it is presented in very simple terms which may not apply to your own individual situation. This sheet is no substitute for competent legal advice concerning your personal affairs and estate plan.

FARM PLANNING PROCESS

HUMAN RELATIONS PLAN

COMMUNICATION SKILLS
 DECISION MAKING SKILLS
 CONFLICT RESOLUTION SKILLS
 PERSONNEL MANAGEMENT SKILLS

SELF ASSESSMENT

GOAL SETTING

PERSONAL GOALS

BUSINESS

RESOURCE INVENTORY
 PHYSICAL, FISCAL, PERSONAL
 MISSION
 WHY ARE WE HERE? WHAT DO WE BELIEVE IN?
 BUSINESS GOALS
 WHAT DO WE WANT TO DO? WHAT DO WE WANT TO BE?
 OBJECTIVES
 HOW ARE WE GOING TO GET THERE?
 HOW WILL WE KNOW WHEN WE HAVE ARRIVED?

Planning must be done at the same time because each planning area affects all other planning areas.

BUSINESS PLANNING

Opportunities
 Threats
 Strengths
 Weaknesses
 One year
 Two years
 Five years
 Ten years

RETIREMENT PLANNING

Timing
 Residence
 Income source
 Household budget
 Recreational needs
 Health care needs
 Long term needs

TRANSFER PLANNING

Income
 Amount
 Source
 Method
 Household budget
 Management
 Business entity
 Shared decisions
 1. Production plans
 2. Marketing plans
 3. Financial plans
 Assets
 Which assets
 When

ESTATE PLANNING

Equal vs. equitable
 Business assets
 Personal assets
 Consistency
 Flexibility
 Legal documents
 Liquidity needs
 Tax consequences