Nothing But The Truth About Estate Planning, Probate, And Living Trusts

Leave A Lasting Legacy For Your Loved Ones

Lawrence Israeloff, Esq., CPA

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ATTORNEY INTRODUCTION

Lawrence Israeloff, Esq., CPA, CFP®, is an experienced New York tax attorney and CPA. His practice focuses on federal, state and local income tax planning for individuals and businesses, personal financial planning, transactional tax consulting and research, trusts, estates, and gift tax planning, tax return preparation and compliance, tax controversies, business entity formation, planning and compliance, and insurance and retirement planning.

He is also an adjunct professor of law at Pace University School of Law in White Plains, New York. Mr. Israeloff previously served as an associate with prestigious New York City law firms and Big 4 CPA firms. He has lectured, been quoted and written articles on various topics related to tax planning and compliance.

Mr. Israeloff is admitted to the bar of the State of New York, is licensed as a Certified Public Accountant in New York, is qualified as a Certified Financial Planner™, and holds a Bachelor of Science in Economics degree from the Wharton School of the University of Pennsylvania, a Juris Doctor degree from Columbia University School of Law, and a Masters of Law in Taxation (LL.M.) degree from New York University School of Law. He is a member of the American Bar Association, the New York State Bar Association, the American Institute of Certified Public Accountants, and the New York State Society of CPAs.

WHAT IS AN ESTATE PLAN?

From a simple standpoint, many people initially think of an estate plan as having a will. On the more complicated end, some think of an estate plan as an elaborate arrangement only rich people need to plan who gets what out of their millions of dollars. Most people think estate plans only apply to the ultra-wealthy.

But no matter how large or how modest, everyone has an estate. Your estate is comprised of everything you own—your car, home, bank accounts, investments, life insurance, furniture, personal possessions. And just like the wealthy, you probably want to control, with the least expense, how those things are given to the people or organizations you care most about. That is estate planning—making a written plan in advance with instructions stating whom you want to receive the things you own after you die.

Estate planning is not just for “the wealthy.” Good estate planning often means more to families with modest assets, because they can afford to lose the least.

WHAT HAPPENS IF SOMEONE DIES WITHOUT AN ESTATE PLAN IN PLACE?

A person who dies is known as the “decedent.” A decedent who dies without a will is known as dying “intestate.”

If a person dies without a will, a court of law must follow state law (instead of the decedent’s desires) to establish who is entitled to receive the decedent’s property. These state laws are called laws of intestate succession. State intestate laws generally direct the distribution of a decedent’s estate based on hereditary succession, i.e., to surviving relatives.

DYING WITHOUT A WILL

The court process that takes place after a person’s death to validate the will or to determine proper intestate succession is known as probate, and is discussed in more detail later in this book.

THE TRUST AS PART OF AN ESTATE PLAN

To the layperson, trusts can appear complicated. People often think trusts are only for the very wealthy. In reality, trusts can be useful for people of all income levels.

A trust is a legal arrangement under state law governed by a written trust agreement by which property or assets are owned in the name of one or more trustees with a fiduciary responsibility to protect and manage the property for the benefit of another person or persons. A trust divides the ownership of property into two parts: the legal title, which is in the name of trustee, and the beneficial ownership interest, which is managed by the trustee for the benefit of the beneficiaries.

A trust is created by the signing of the trust agreement by the creator (also called the grantor or the settler of the trust) and the trustee. The trust agreement specifies the duties and obligations of the trustee and how the income and principal of the trust will be distributed to the named beneficiaries. Trusts provide considerable flexibility in transferring property from one generation to another.

A trust created during the creator's lifetime is called an "inter vivos" trust or living trust. A living trust can be either a revocable trust or an irrevocable trust. A revocable trust is a trust that can be changed or revoked by the creator. An irrevocable trust cannot be changed or revoked by the creator (although an irrevocable trust can sometimes be changed or terminated by the trustee under certain circumstances).

A trust created in a will when the creator dies is called a testamentary trust. It is a part of the creator's estate plan. Testamentary trust is always an irrevocable trust, because the creator is not alive to change or revoke the trust.

Common Types of Trusts

Living trusts (revocable and irrevocable) and testamentary trusts can be created for many different purposes and are referred to using many different names depending on their main purpose, such as asset protection trust, charitable trust, special needs trust, credit shelter trust, bypass trust, dynasty trust, grantor trust, Crummey trust, life insurance trust, personal residence trust, and many others. Despite the variety of labels applied to them, all trusts are basically arrangements to hold and control property for the benefit of other people.

WHO ARE THE PARTIES INVOLVED IN A TRUST?

The person who creates a trust is called the creator, the settlor, or the grantor. The trustee is the person or persons who hold title to the trust property in their name. The trustee has a fiduciary duty to protect and manage the trust property for the benefit of the trust beneficiary. The beneficiary is the person or persons for whose benefit the trust is managed and administered.

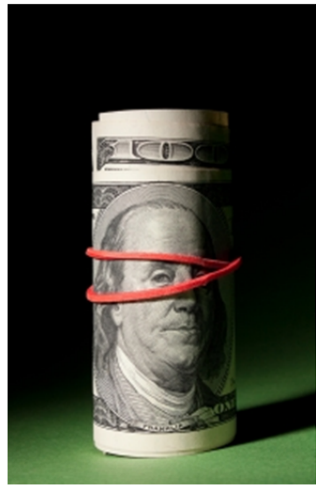
The creator of a trust can also be the trustee, the beneficiary, or both. A trustee who is not the creator can also be the beneficiary. So although the same person can occupy more than one role in a trust, each of the three roles remain separate and distinct.

The Costs Associated With Setting Up A Trust

A trust is created by signing a trust agreement with the trustee and then transferring property into the name of the trust (which is referred to as funding the trust).

A trust does not exist until property is actually transferred into it, even if a trust agreement is signed.

It does not take a long time to form a trust - only as long as it takes to draft and sign a trust agreement and then complete the necessary steps (usually the completion of paperwork) to transfer the property into the name of the trust. A trust can cost anywhere from a few hundred dollars to thousands of dollars in legal fees, depending on the complexity of the trust agreement's terms and the type and amount of property to be transferred into the trust.



WHAT ASSETS CAN BE OWNED BY A TRUST?

A trust can own almost any kind of asset except for retirement plans. The types of assets that can be retitled in the name of the trust include cash accounts such as checking accounts, savings accounts, money market accounts and CDs; brokerage accounts; non-qualified annuities (and the trust can also be named as the primary or secondary beneficiary); monies owed to you; oil, gas and mineral rights; and royalties, copyrights, trademarks, and patents.

Tangible personal property such as jewelry, clothing, books, household goods, furniture, antiques, collectibles, artwork and pets can also be owned by a trust.

Business interests including shares of stock in a closely held corporation, partnership interests, and membership interests in limited liability companies can also be transferred to a trust, but you should consult any shareholder agreements, partnership agreements, and operating agreements for restrictions on transfers and specific procedures to retitle the shares in the name of the trust.

Finally, real estate can be retitled (or purchased) in the name of the trust, but the transfer requires recording a new deed in the locality where the real property is located.

The Amount of Assets Required To Establish A Trust

There is no minimum amount of money or type of asset required to establish a trust. Although a trust can be funded with a small amount of money, whether or not to create one is a financial decision based on the overall benefits and the estate plan, and not on the amount of the trust itself.

Why Retain An Attorney To Establish A Trust?

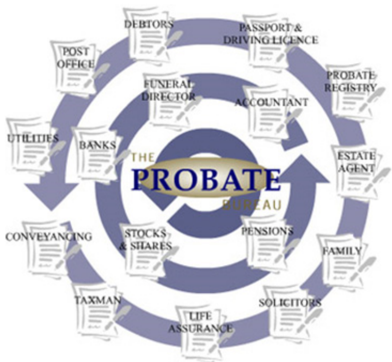
You should always work with a lawyer when setting up a trust. A poorly created trust can be confusing, expensive, and/or ineffective. The trouble with do-it-yourself planning is that even if your situation seems simple, you are not aware of and won't think of the many unusual things that can go wrong, especially with wills and trusts. These mistakes can end up costing you or your heirs a lot more than you saved in legal fees.

If you have a unique situation, need a special needs trust for a disabled beneficiary, or are overwhelmed by a complex or large estate, hiring a trusts and estates lawyer will help you answer any questions and ensure that a legal and effective trust is created.

As both an attorney and a CPA, I am a "one-stop shop" for legal, accounting, tax and financial planning services. I can help people more effectively manage their wealth and establish an estate plan that is coordinated with and fits neatly among all the pieces of their personal lives - household budget, cash flow, investments, education planning, taxes, and retirement planning.

WHAT IS PROBATE?

As previously mentioned, probate is the legal process that takes place after someone dies of proving the validity of a will or establishing who is entitled to receive the decedent's property under state intestate succession laws if there is no will. The probate process is handled by the local surrogate's court and governed by state law. Probate involves paperwork and court appearances by lawyers, which costs money.

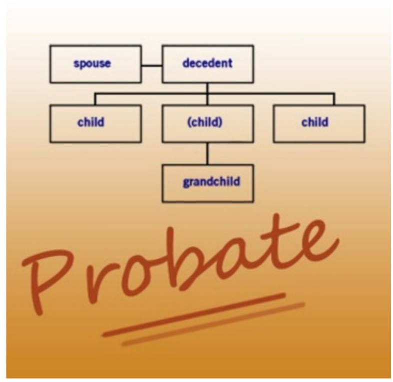


As a general rule, a will has no legal effect until it is probated. Probate includes proving in surrogate's court that a decedent's will is valid, identifying and collecting the decedent's property (also referred to as the decedent's estate), paying debts and taxes of the estate, and distributing the remaining property as the will (or state intestate law, if there is no will) directs. In effect, probate is the process that enables heirs to receive property that is rightfully theirs.

Advantages of Avoiding the Probate Process

Wills and probate proceedings are matters of public record. If you would like to keep your affairs private, and prefer that people don't know how your estate was distributed, avoiding probate through a trust or other mechanism is the only way to do so.

The probate process can be complicated and time consuming, so it may take several years to completely resolve everything. Typically, assets are frozen and unavailable to beneficiaries (including the surviving spouse) for a period of time without prior court approval. Avoiding probate can speed up the process of settling your estate.



Probate costs, including attorney's fees, can be expensive. This is especially true if you own real estate in a different state, because probate proceedings would be required in both states. A trust can help to correct this problem.

DO ALL OF A DECEDENT'S ASSETS GO THROUGH PROBATE, OR ARE THERE NON-PROBATE ASSETS?

Probate assets consist only of assets owned by the decedent at death that do not pass automatically (i.e., by operation of law) to the intended beneficiaries. A person's will deals only with probate assets – it does not control the transfer of non-probate assets.

Examples of non-probate assets include life insurance policies (because the insurance proceeds are paid to the beneficiaries of the policy according to the terms of the policy contract, not according to a will), retirement accounts (because upon the death of the owner of a retirement account such as an IRA or 401(k), the monies are paid to the person or persons listed on the decedent's beneficiary designation form) , and jointly owned property (such as a house or apartment owned jointly by a husband and wife). But keep in mind that a person's taxable estate for estate tax purposes includes both probate and non-probate assets.

The estate tax is discussed in more detail later in this book.

Creating A Trust Can Help Avoid Probate

Property that is owned by a trust is non-probate property, because at the creator's death the terms of the trust agreement determine what happens to the property, not the creator's will. Unlike a will, a trust does not have to go through probate. Thus, property owned by a trust avoids probate and is managed without the hassles and expense of probate court proceedings.

What Is The Estate Tax?

The estate tax is one component of the federal transfer tax system, which also includes the gift tax and the generation-skipping transfer tax. The estate tax is a tax imposed on the transfer of property at death. It is a transfer tax, which is a different tax than the familiar income tax.

Generally, the estate tax is determined by applying the transfer tax rate to the value of property on the date of death owned by the decedent in excess of a threshold amount (currently $5.43 million per person in 2015). The tax is technically imposed on the transfer of the decedent's property either outright or in trust to the decedent's heirs, but not including property transferred to the surviving spouse.

Most people will not be subject to the estate tax because most people will never own property with a total value in excess of the threshold amount. The threshold amount is referred to as the exemption amount, and is $5.43 million if you die in 2015. The exemption amount increases every year at the rate of inflation.

What Is The Gift Tax?

The gift tax is also a component of the federal transfer tax system and is a tax imposed on transfers (i.e., gifts) of property during life, either given outright or to a trust. Like the estate tax, the gift tax is a transfer tax distinct from the familiar income tax.

Generally, the gift tax is determined by applying the transfer tax rate (the same rate that applies to the estate tax) to the value of property above the exemption amount (the same exemption amount that applies to the estate tax) that is gifted by one person to another during their lifetime, but not including property transferred to a spouse.

Thus, the gift tax covers transfers of property during life, while the estate tax covers transfers of property at death. The two taxes work together, and are said to be unified.

So from a transfer tax perspective, is it better to give away property as a gift during life (subject to the gift tax), or to leave assets to heirs in a will at death (subject to the estate tax)? Generally, if you give assets away while you are still alive, you are also ridding your estate of the future appreciation in the value of that asset. The assets you give away now will trigger a lower gift tax (if any) today than an estate tax years from now because of the assets' appreciated value at death.

Gift Tax Annual Exclusion

Each year, a person can gift to any one or more other persons up to the annual exclusion amount (currently $14,000 per recipient in 2015) without triggering the gift tax. Married couples can combine their individual annual exclusion amounts and gift $28,000 each year to each person without triggering the gift tax.

Annual exclusion is meant to shield from tax the small common gifts made every year to friends and relatives, such as birthday presents, holiday gifts and small tokens of appreciation.

THE GENERATION SKIPPING TRANSFER TAX

The generation-skipping transfer tax is the third component of the federal transfer tax system. It applies to transfers of property to people two or more generations below the giver, which is a fancy way of saying to grandchildren or great-grandchildren.

Like the estate and gift tax, the generation skipping transfer tax only applies to transfers of property in excess of the exemption amount.

WHAT IS THE DIFFERENCE BETWEEN THE TAXABLE ESTATE VS. THE PROBATE ESTATE?

The taxable estate is an estate tax concept. It includes the decedent's interest in every type of property owned at death, plus property over which the decedent had control at death, even if he or she did not actually own the property. The decedent's taxable estate includes his or her probate assets AND non-probate assets. Just because the distribution of certain assets at death, such as life insurance proceeds, a retirement account, or a jointly owned house, are not controlled by a will (and are not probate assets) does not mean that those assets are not subject to the estate tax.

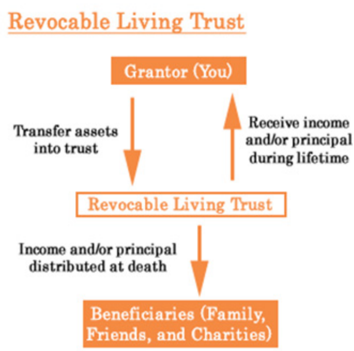
The probate estate includes only those assets that are subject to the decedent's will (or subject to intestate succession, discussed earlier in this book). The taxable estate includes all of the decedent's assets, even if the assets do not go through probate.

HOW DO REVOCABLE LIVING TRUSTS WORK?

A revocable living trust, or "RLT", serves as a will substitute. Like a will, a RLT names beneficiaries who inherit property upon the death of the creator. The trust agreement sets the conditions by which the trust property is to be held and distributed. Property owned by the RLT at the death of the creator does not have to go through the time-consuming court probate process to be maintained in the RLT or distributed to the beneficiaries in a timely and cost effective manner.

By avoiding probate, which produces public records and files that can be obtained and read by anyone, the trust property and trust agreement remain private and confidential. A RLT also serves to maintain control of property without the need for an expensive court proceeding to appoint a guardian in the event the creator becomes disabled.

The typical RLT is set up so that the creator is also the trustee and beneficiary during his or her lifetime. The creator maintains complete control of his or her assets as long as the creator has mental capacity. A RLT does not affect the creator's personal income taxes during his or her lifetime – all of the trust's income tax consequences are reported on the creator's individual income tax return as if the trust did not exist.



During the lifetime of the creator, he or she retains the right to amend or revoke the trust and reclaim ownership of the trust property. If the creator does not revoke the trust during his or her lifetime, the trust becomes irrevocable upon the creator's death and the trust agreement (rather than a will) controls the disposition of the trust property. The provisions of a RLT are typically identical to those that would have been included in the creator's will. Therefore, the RLT serves as a will substitute. But the trust eliminates the need to go to court to approve the transfer of property at the creator's death.

The trust agreement names a successor trustee (or a series of successor trustees) who takes over upon the creator's incapacity or death. At the creator's death, the successor trustee distributes or continues to manage the assets of the trust in accordance with the creator's wishes as described in the trust agreement with a minimum of cost and delay. Costly lawsuits due to will contests are also avoided.

Transferring the creator's property into the trust (also referred to as funding the trust, which involves re-titling property into the name of the trust) is a critical step in the process of implementing the RLT. The trust will not control any property that is not legally owned by the trust (i.e., in the name of the RLT), potentially frustrating the purpose of creating the trust and the intent of the creator.

Whenever a RLT is used, it is essential to also have a pour-over will to cover any property which is not held by the trust (intentionally or inadvertently), if any. A pour-over will works as a safety net for the RLT, covering assets left outside of (i.e., not owned by) the RLT. By the terms of the pour-over will, all the property the deceased owned at death is "caught" and is "poured-over" into the existing trust. Though the property caught by a pour-over will has to go through probate, it will eventually be managed or distributed according to the terms of the RLT instead of being distributed under the state law.

Please note that even if there are no assets outside of the RLT, a decedent's will may still need to be probated if the will serves to name guardians for the decedent's minor children.

ADVANTAGES OF A REVOCABLE LIVING TRUST

Many people assert that one of the principal advantages of a revocable living trust is the cost savings, in court fees and lawyer fees, attributable to the avoidance of probate.

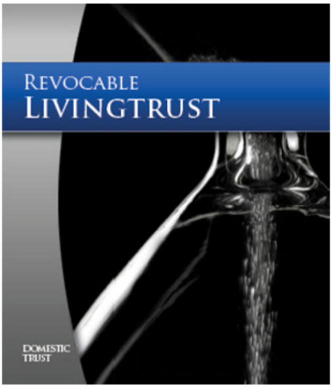
If probate is completely avoided because during life the decedent successfully and completely transferred 100 percent of his or her entire estate to the revocable living trust, then there might be some cost savings, although perhaps not at the level advertised by promoters of these trusts.

But some of these savings may be unrealistic, since it is often necessary to probate the pour-over will to process any assets that the decedent failed, accidentally or intentionally, to transfer to the RLT and are not owned by the RLT at the time of death. To reduce probate costs, the RLT needs to be fully funded. This requires all assets titled in the name of the creator to be retitled into the name of the trust (which may also entail some transaction costs) and ensures that all of the decedent's assets are removed from the probate estate.

Probate costs can be kept to a manageable amount when a decedent's family member serves as the executor (and waives the fee). And of course there are costs involved in establishing and administrating a RLT that may be comparable to future probate costs. Many estates are not complicated and the probate process may not be as onerous as initially perceived.

Nevertheless, RLTs typically reduce the time required to settle a decedent's affairs after death that tie-up assets. And a court is not involved. When the creator of a RLT dies, there is no interruption in the continuation of the trust. The RLT simply continues, and payments needed from the trust can be made immediately.

RLTs provide for your incapacity/disability. The use of a RLT avoids a court-supervised administration in the event the creator becomes incapacitated or incompetent. Your successor trustee steps in without court action to manage the trust property according to your directions in the event you become mentally or physically incapacitated.



Titling your local and out-of-state real estate to your RLT avoids probate in every state where your property is located. An ancillary court administration is necessary if a decedent owned real estate located in a state other than his or her home state. To avoid the costs and involvement of an ancillary administration, a RLT can hold title to property located in another state.

Privacy is another benefit of using a RLT. At the death of the creator, survivors do not have to reveal the trust's assets through a public probate filing. With a will, a list of assets must be filed in a probate administration. This document becomes a matter of public record, subject to inspection by anyone. A person concerned about the privacy of his or her financial affairs can use a fully funded RLT to prevent public disclosure of his or her assets.

A RLT can also be used to minimize the risk of a will being contested on the grounds of incompetency. Generally, it is easier to challenge a will than a trust. RLTs protect assets for your spouse and beneficiaries from future divorces, remarriages, judgments, bankruptcy, creditors, and predators.

RLTs can be used for special needs planning to protect a dependent's needs-based government assistance, such as SSI benefits. An inheritance given outright to such an individual could disqualify them from receiving their benefits.

Disadvantages Of A Revocable Living Trust

To avoid probate, the trust must be fully funded. Failure to fully fund the trust usually results when the creator receives property after the trust's creation. If any property is not transferred to the trust before the creator dies, a probate administration may still be required. 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 this fails to occur, it will be necessary to probate a will (even if it is a pour-over will), and the purpose of avoiding probate will have been frustrated.

Creating and administrating a RLT has several costs. To be cost effective, such costs should be less than the costs of probating a will. If the person owns a large number of assets, changing the title on all the assets can be time-consuming and costly. And it can be cumbersome to deal with others regarding assets that are titled in the name of the RLT.

Certain property is less appropriate to be owned by a trust. For example, S corporation stock has trust ownership restrictions after the death of a stockholder, which could lead to the loss of S corporation status.

Transferring rental real estate to a RLT may create adverse income tax consequences after the death of the creator when the trust becomes irrevocable because a trust is not entitled to certain income tax deductions for losses generated from the rental property.

Also, a trust cannot take a tax loss deduction arising from certain depreciating assets.

COMMON MISCONCEPTIONS ABOUT RLTS

One misconception about trusts is that they are only used to avoid taxes. Although trusts can be useful for tax planning, they are also an effective tool for clients who want more control over how and when their assets are distributed to their beneficiaries. In many cases, trusts do not have any effect on taxes.

A trust can help in a variety of situations. For instance, people who plan to leave money to their children or grandchildren may not want them to have access to the money until they are mature enough to handle it wisely. A trust can place effective controls on how and when the money is used.

Trusts are not just for rich people. While the words "trust fund" might conjure up a misbehaving wealthy heir, using trusts wisely can be a wealth-building tool for people at all income levels. Especially those with kids. A trust provides peace of mind for many people, who know that their estates will be managed how they want and relatives won't be squabbling over each possession. People of all income levels might set one up to provide for the management of their finances in case they become disabled or otherwise unable to handle them, or to provide for loved ones who cannot manage their money.

Besides Tax Savings, What Other Objectives Can A Trust Achieve?

Many people have concerns about family members or beneficiaries that cannot manage their financial affairs. In this situation the estate plan can include a trust that will prevent beneficiaries from squandering their inheritance and protect them from creditors, lawsuits and divorces. In some cases, you may even be protecting the heir from other family members and friends who want to borrow money. The trust can be written in a way that will pass assets on to the beneficiaries immediately upon your death, or you can provide for distributions over time in amounts and even for reasons that you specify.

Families with second marriages and blended families present some additional estate planning challenges due to the various relationships involved. A potential hurdle is figuring out how to divide an estate when each spouse has children from a previous marriage.

For example, in a blended family, the husband may use a trust to make sure that his biological children are the beneficiaries of his life insurance benefits. Without a trust in place, it is possible that his current wife receives the benefits and when she dies, that money would pass to her biological children, leaving the husband's children with nothing.

Unlike a will, which is public information, trusts are confidential. For this reason, people who want to protect their privacy can benefit from a trust. This can be helpful for peopel who wish to maintain privacy over how and to whom their assets are distributed.

Unmarried couples miss out on the biggest estate tax break there is: the unlimited spousal exemption. The couple might assume that each will leave the other everything. If this occurs, the first to die might pay an estate tax and then the inherited assets will be included in the estate of the second person, who might have to pay an estate tax on the same assets when they die. Ideally in this situation they should leave property in a trust for the other to avoid paying taxes on the same money twice. Unmarried couples also need to beware of the consequences of unintended gifting during life. Rules about transferring property freely between husband and wife do not apply to unmarried couples.

Passing the family business intact from one generation to the next is one of today's most challenging estate planning problems. The challenge is compounded in situations where a business owner is trying to give company ownership to one child who is active in the business while maintaining proportionate payments to other childern who are not. Using a trust can help keep a family business in the family for years to come. Couples without children may be concerned about who will look after their financial interests later in life. By setting up a trust, they can appoint a trust company to serve as a financial fiduciary giving them peace of mind in case they are ever in a position where they cannot manage their own finances.

DO LIVING TRUSTS PROVIDE ASSET PROTECTION?

Revocable living trusts do not protect your assets from people with legal claims against you. That's because although the trust is a separate legal entity, you are still treated as the owner of the trust assets. Since a revocable living trust can be changed or revoked at any time, the trust creator maintains ownership of his or her assets during the creator's lifetime.

When you set up a typical probate-avoidance revocable living trust, you name yourself as a trustee. That allows you to keep control over the assets you transfer to the trust. You can put property in the trust, take it out, sell it, or give it away at any time, with no restrictions. As a practical matter, the property is still yours. As a result, a revocable living trust is not a vehicle for asset protection.

Although a simple probate-avoidance trust can't shield assets from creditors, there's a whole industry devoted to asset protection. If you put money in an irrevocable trust—one you don't control and can't revoke—then the money probably won't be considered yours any more, and it won't be available to creditors. Wealthy people who are worried about lawsuits may create very complex trusts, often set up with an offshore trustee. They may also set up limited liability companies or entities called "family limited partnerships." Asset protection is an attractive feature for people in professions that carry a substantial amount of risk such as business owners, doctors, architects and lawyers.

If you're concerned about creditors and lawsuits, there are also simpler methods to protect assets, such as putting your money in assets that your state protects from creditors. (For example, even if you file for bankruptcy, you can keep the money in your retirement plan accounts; and in some states creditors can't take your house, no matter how much it's worth.) And of course, you can buy insurance.

Are Offshore Trusts Necessary Or Just An Expensive Scam?

An offshore trust is an appropriate strategy in certain circumstances for wealthy people who own assets that are subject to a higher risk of liability claims or creditor attack. By using an offshore trust rather than a domestic trust, you can enjoy additional protections not available under United States law.

An offshore trust is similar to a traditional domestic asset protection trust in that the end goal is to protect your assets. It is also similar in relation to the parties involved: a creator, a trustee, and the beneficiaries. The difference is that with an offshore trust, also called a foreign trust, the trustee is a financial institution that is not in the same country as the creator.

Having an offshore trust may be your best option when it comes to protecting your assets. You can work with an asset protection trust institution that is in a jurisdiction with lower taxes and advantageous wealth protection laws. By using an offshore trust rather than a domestic trust, it's possible to enjoy additional protections not available in the U.S.

WHAT ASSETS CANNOT BE OWNED BY A RLT?

Certain types of assets cannot be transferred to a revocable living trust. Qualified retirement accounts, including 401(k)s, 403(b)s, IRAs and qualified annuities, should not be transferred to your RLT. Why not? Because if this type of account is retitled in the name of your trust, then the transfer will be treated as a complete withdrawal of the funds from your retirement account and 100% of the value will be subject to income tax in the year of the transfer. Instead, the primary or secondary beneficiary of your account should be changed to your RLT. The same is true for health savings accounts and medical savings accounts. You should consult with an estate planning attorney to determine who should be named as your beneficiaries in your particular situation.

Uniform Transfers to Minor accounts (UTMA) or Uniform Gifts to Minor accounts (UGMA) cannot be titled in the name of the RLT. These accounts are established for the benefit of the minor child so the child is deemed to be the owner, not the creator or the custodian of the account.

While in general motor vehicles can be retitled into your RLT, some states view the transfer as a sale and will charge a significant transfer tax for issuing a new title in the name of the trust. If this is the case in your state, then you may want to wait and purchase your new vehicle in the name of the trust. Aside from this, in some states probate is not necessary to transfer ownership of a motor vehicle after the owner dies and a handful of states now allow vehicle owners to designate a beneficiary after death. You should check with an estate planning attorney to understand how to avoid probate of your vehicles in your state.

You should also consult with an estate planning attorney before transferring ownership of a life insurance policy to a revocable living trust. While the owner of a life insurance policy can be changed to the trustee of the insured's RLT without creating any negative income tax consequences, in some states a RLT is not a protected “individual” for creditor protection purposes.

WHAT COMMON MISTAKES DO PEOPLE MAKE IN ESTABLISHING OR UTILIZING A TRUST?

Anyone who creates a trust has an interest in seeing that any property placed in trust is held according to the terms of the living trust and for the benefit of the named party. While a trust is a fairly straightforward instrument, simple mistakes can interfere and invalidate what would otherwise seem a simple transfer of property. Here is an overview of common mistakes people sometimes make when creating a trust.

Because a trust is a transfer of property, no trust can be created until the property in question actually changes hands. In the trust context, the transfer of property is often referred to as "funding the trust." Funding has two component parts: the first is the act of funding itself. The second is the nature or quantity of the property. Failure to deliver the property or failure to place an adequate item or sum in trust will result in the trust failing. Generally, if some property, even a nominal sum, is delivered, the trust will survive.

Another common mistake is to fail to name appropriate beneficiaries. A trust is created for the benefit of a specific third party beneficiary. If the property is to be managed and overseen according to the intent of the party who created the trust, he or she must have identified a specific person or group of persons to whom the benefits of the trust are to be conveyed. If a trust is created without naming some beneficiary, then the court and named trustee cannot oversee the trust with any real confidence, since the beneficiaries are not ascertainable. A viable trust will name beneficiaries and set out both the terms of the trust and the duties the trustee owes the beneficiaries.

Another less common problem is failure to put the trust in writing. A trust must appear in writing in order to be considered valid. This requirement seems obvious to most --- who would choose to fail to place the trust terms in writing? But a striking number of people fail to comply with this basic requirement, thinking that oral arrangements made with family or close friends will never see the inside of a courtroom. Any prudent person will always put the terms of any large transaction in writing, just in case of some unforeseen eventuality.

A related mistake is not having a properly prepared trust document. Too many people try to save money by using online or do-it-yourself forms, or choosing an attorney with the lowest price. If the documents are not properly prepared, you have wasted your money. Your trust may not work the way you intended or, worse, you could be left with no valid plan at all. It's best to go with a local, experienced estate planning attorney who will be able to provide you with well-written documents and valuable counsel. Finding the right attorney may take some time, but it will be well worth it in the end.

Although trusts can often present complex financial problems and difficult personal questions, the creation of a living trust can be relatively simple and straightforward. With a little careful attention, the formal requirements of trust creation should not prevent a trust grant from benefiting the desired parties.

How Is A Trust Treated For Income Tax Purposes?

Revocable living trusts are disregarded for tax purposes (which means that under the tax law RLTs are treated as if they do not exist and are ignored), while irrevocable trusts create a separate taxable entity required to report income and file tax returns.

Revocable living trusts are treated as "grantor trusts" for state and federal tax purposes. Grantor trusts are ignored for tax purposes and the IRS treats them as if they do not exist. RLTs are not required to file a separate tax return, and are not treated as a separate taxable entity. The creator's and the beneficiaries' tax returns do not even reference their RLT because the IRS does not care whether they exist or not.

In most cases, at the death of the second spouse, the RLT becomes irrevocable and continues for the benefit of the creator's children or grandchildren. At that time, the RLT (now irrevocable) becomes a taxable entity. It is assigned a separate federal taxpayer identification number and is required to file federal and state income tax returns as long as it continues to exist.

For the vast majority of individuals, income tax planning is now more important than avoiding federal estate taxes. In the past, the primary focus in estate planning has been to minimize the value of property by transferring wealth as quickly as possible during a person's lifetime because estate tax rates greatly exceeded capital gain tax rates. Now, holding assets until death, even if their value increases, may make more sense from a tax perspective. Doing so can help avoid capital gains taxes on the appreciation in value up to the date of the decedent's death. This is because the assets generally receive a "step-up in tax basis," assuming they have increased in value, upon the decedent's death.

A "step-up in basis" is the readjustment of the tax basis, also known as cost basis, of an appreciated asset for tax purposes when a person dies. With a step-up in basis, the tax basis of each appreciated asset included in a decedent's estate becomes the increased market value of the asset at the time of the decedent’s death, not the cost at which the asset was originally purchased.

Generally, an asset's original tax basis or cost basis is its cost to the owner. But if you received the asset as an inheritance, its basis might be stepped-up.

Assets owned by a RLT are included in the creator’s taxable estate (but not the probate estate) and are entitled to a step-up in tax basis at death.

Stepped-up basis is a valuable adjustment for people who inherit appreciated assets because for income tax purposes the basis step-up will reduce the amount of taxable capital gain that a .beneficiary will have to report if the assets is eventually sold. When you sell an asset, the difference between the tax basis in the asset and the amount you sell it for (also called the amount realized) is a capital gain or a capital loss. You have a taxable capital gain if you sell the asset for more than your basis. You have a capital loss if you sell the asset for less than your basis. Losses from the sale of personal-use property, such as your home or car, are not deductible.

BENEFICIAL PROVISIONS OF A TRUST

Trusts can be drafted so that they are flexible and useful in various life situations, not just the situation that exists at the time the creator establishes the trust. As circumstances change, the trustee should have the flexibility to utilize trust funds to pay for new life situations as they arise.

In a properly drafted trust, the trustee is granted sufficient authority to deal with changes during the lifetime of the beneficiary such as illness and disability. Revocable living trusts can also provide for the payment of medical expenses and funeral expenses.

For a family with a disabled child, a special needs plan should be carefully designed to make sure the disabled child continues to receive their government benefits. Inheriting even modest assets from any source can cause them to lose important benefits such as health care and housing. A trust can be created to ensure that a disabled child will be taken care of once their parents are gone. The disabled beneficiary can enjoy assets that were intended for their benefit without disqualifying them from important governmental benefits. If the beneficiary lacks the mental capacity to handle financial affairs, the trustee, who can be a family member, will administer the trust and look out for the beneficiary's best interests, giving parents peace of mind.

Trusts For Married Couples

If you and your spouse own assets together, you may want to make a trust together. Many couples prefer to make one shared trust so that they do not have to divide property they own together. For example, to hold a co-owned house in two separate trusts would require the spouses to sign and record a deed transferring a half interest in the house to each spouse as trustee. And to transfer household furnishings to separate trusts, spouses would have to allocate each item to a trust -- or end up transferring a half interest in a couch to separate trusts.

There is another advantage to creating a shared trust if you and your spouse want to leave property to each other. With a shared trust, property left by one spouse to the survivor stays in the living trust when the first spouse dies; no transfer is necessary. With separate trusts, property left to the survivor must usually be transferred first from the trust to the survivor, and then (to avoid probate) to the survivor's living trust.

If you and your spouse own most of your property together, but each of you has some separate property, a shared trust can still work. You can transfer all property to the trust, and each spouse can name beneficiaries (including each other) to receive his or her separate property.

If, however, you and your spouse own most of your property separately, you may want to create individual trusts. Another reason to create separate trusts is if each of you wants to keep sole control over your own property. With a shared trust, each of you has authority over all trust property while both are alive. Your decision may be affected by the marital property laws of your state.

WHICH STATES ARE MOST FAVORABLE FOR ESTABLISHING A TRUST?

There are several factors to consider when deciding where to set up a trust and what governing law to choose. For example, while many individuals establish trusts to avoid estate taxes, it is also important to consider how the trust will be taxed for state income tax purposes, which varies from state to state.

Another factor is state laws regarding the extent and variety of permitted trustee powers. Also, many states have laws allowing the transfer of irrevocable trust assets to a new trust under certain circumstances to be able to take advantage of changed circumstances.

People often worry that the development of their children's work ethic will suffer if he or she knows about the existence of a trust. Those people may be more comfortable establishing a "quiet trust" in a state that allows them. With a quiet trust, the creator may be able to provide that the trustee is not obligated (or is even forbidden) to notify the beneficiary of the existence of the trust. Most states do not have laws authorizing quiet trusts, and in fact require that significant disclosures be made to beneficiaries at regular intervals. States that authorize quiet trusts, on the other hand, may enable the creator or trustees to decide what information will be provided, and when.

Asset protection is a major concern for many donors, and "spendthrift trusts" are traditionally used to build in protection for trust beneficiaries against creditors. State asset protection laws differ, which is an important consideration when choosing a state for trust governance.

A primary intention in establishing an irrevocable trust may to be to set aside money that will benefit descendants for many years to come. However, most states have laws limiting the duration of trusts. This may reduce the attractiveness of a trust for a donor who wants to preserve assets for future generations.

Planning Ahead Before Creating A Trust

The advantages of using a trust should be analyzed in light of a person's unique circumstances. In some situations, the need for a trust may be obvious; in others it may not be so clear. A person should be made aware of all the advantages and disadvantages before the plan is finalized.

A revocable living trust can provide continuity of management, privacy, and avoidance of probate. But it also requires the preparation of a trust agreement, the payment of professional fees, and other administrative burdens. Trusts are complex instruments with important legal ramifications. Advance planning is critical when considering the creation of a trust, and working with a lawyer is essential to assuring that your trust is properly drafted.

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