PacificCPE

COURSE
40401A

# Living Trusts, Powers of Attorney, and Alternatives

Revocable living trusts are widely discussed but often misunderstood. This course cuts through the myths to explain how living trusts actually work, how they're created, and how they can be used for charitable giving. It also walks through a detailed sample trust agreement so you can see the moving parts in action. The course then shifts to trust alternatives—powers of attorney, conservatorship, guardianship, and life insurance—giving you a well-rounded view of planning options for clients at every stage.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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## LEARNING ASSIGNMENTS AND OBJECTIVES

## Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

## Course Objectives

- Identify features of living trusts and how they can be used.
- Identify some of the trust alternatives available for managing an estate.
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# Chapter 1: THE LIVING TRUST – MYTH AND REALITY

*Chapter Objective*

**After completing this chapter, you should be able to:**

- Identify features of living trusts and how they can be used.

## I. INTRODUCTION

Although there are many, many different types of trusts, they can all generally be grouped into two broad categories: living trusts (those that become effective before the death of the trustor) and testamentary trusts (those that do not take effect until the trustor has died). Even within that broad category, there are two distinct types of trusts – revocable and irrevocable. This chapter focuses on revocable living trusts.

Some financial and estate planning professionals will have every person believe that they must have a living trust to avoid probate, limit their tax liability, ensure the smooth distribution of their assets upon death, and otherwise save the world. Although they are not required by everyone, there are certainly some important benefits to the use of a living trust.

Like most things, living trusts are not for everyone and will not help in every situation. This chapter will explore the nuts and bolts of living trusts, what they are good for and what they are not good for.

### A. FACTORS IN DETERMINING WHETHER A LIVING TRUST IS APPROPRIATE

There are a number of questions that a practitioner must ask when considering whether or not to recommend a living trust to a client. These questions include the following:

- The size and nature of the individual's estate, i.e., whether the gross estate will be below the threshold for probate in his or her state of domicile;
- The health and age of the individual;
- Concerns about competency;
- Costs of establishing and managing a trust, particularly if there is a paid trustee;
- The individual's overall estate plan; and
- The individual's familial status, i.e., whether or not the individual is married.

There is no one-size-fits-all answer for determining whether a revocable living trust is either necessary or even advantageous.

### B. REASONS FOR POPULARITY

Revocable living trusts are popular for a number of reasons. First, they allow the trustor to make changes to the trust during their lifetime with relative ease.

It is also the one type of trust that allows the trustor to act as trustee and beneficiary during their lifetime.

At common law, these characteristics rendered such a trust invalid because there was no real separation of authority or ownership of the corpus of the trust. The trust was, in essence, illusory. Modernly, such trusts are allowed and have flourished in an environment in which some attorneys and financial planners preach the evils of probate.

**TABLE 1.1 ADVANTAGES AND DISADVANTAGES OF REVOCABLE LIVING TRUSTS**

| Advantages of a Revocable Living Trust | Disadvantages of a Revocable Living Trust |
|---|---|
| Avoidance of probate for assets within the living trust. | Time and money. It can be time consuming to sell or encumber assets in a trust, i.e., when a couple with a living trust wants to refinance their home that is in a living trust. |
| Avoidance of guardianship when a successor trustee is appointed in the event the trustor becomes incapacitated. | Expense of administration. If the trustor appoints a bank or trust company as trustee, he or she will have fees to pay. Even in absence of trust fees, time will be spent in maintaining the trust. |
| Reduction of delays in distribution of the trustor's property after death. | Once the trust is created, the trustee must be sure that trust books are maintained and that all assets continue to be registered to the trustee. In addition, individuals or entities dealing with the trustee (such as banks and title insurance companies) may want to review the trust instrument to check on the trustee's powers and duties. |
| Continuity of management of the trustor's property after his or her death or incapacity, especially if he or she does not serve as the trustee. | |

In addition to the savings in probate expenses, the avoidance of probate administration has other advantages.

1. Privacy

The administration of a revocable living trust at the trustor's death is normally a private matter. Unlike probate, there are few if any public records to reveal the nature or amount of assets or the identity of any beneficiary.

2. Quick Distribution

Property contained in a living trust can usually be distributed to the beneficiaries shortly after the trustor's death, avoiding much of the delay encountered in some cases with the probate process. In addition, a trustee does not need approval from the probate court to sell or otherwise distribute property within the trust.

3. Support of Incapacitated Trustor

If, instead of dying, a trustor becomes physically or mentally incapacitated, property held in this trust can be used to support the trustor without the necessity of establishing a guardianship or a conservatorship. The successor trustee named in the trust document takes charge to manage the assets in the trust and pay the trustor's bills and otherwise provide for his or her support.

*Example*

Mary is a widow, without children or any close relatives. She is no longer able to live alone in her home or to handle her finances. She transfers her property and other assets to a trustee, who will sell the home and invest the proceeds, along with the other assets, under a revocable trust, to provide for Mary's support during her lifetime and to dispose of the same after Mary's death to such persons or charitable organizations as Mary desires. Should Mary change her mind as to any of them, or should an old friend for whom she had provided a gift die, Mary can make a simple amendment to the trust by a written letter or memo signed by her and delivered to the trustee. No witnesses are necessary.

To make the trust workable in the event of incapacitation, assets must be transferred into the trust while the trustor is competent, or an agent, under a durable power of attorney, would be given the authority to make transfers into the trust if the trustor became incapacitated.

At the trustor's death, the trust becomes irrevocable, and any remaining assets are distributed according to the directions in the trust agreement. A will can be drafted to "pour" into the trust any assets that were not transferred before death. The trust agreement needs to describe how and who is to determine if the trustor is incompetent, and directs how their financial affairs are to be managed by the successor trustee.

Alternatives to a revocable living trust for those concerned about incompetency include the durable power of attorney. This is discussed in Chapter 2, *Trust Alternatives: Powers of Attorney, Conservatorship, Guardianship, and Life Insurance*.

4. Managing Assets After Trustor's Death

Living trusts can also be used to manage assets long after the death of the trustor. Living trusts, like wills, give an individual latitude in distributing his or her property after death. The trust can specify how the trustee is to distribute the proceeds of the trust and when, i.e., to pay for a college education or to finance the purchase of a new home after marriage.

5. No Initial Funding Required

A living trust can be established without any initial funding other than a minimal amount. Therefore, it incurs no trustee fees until the fund receives the assets.

6. Not All Assets Can Be Included

Although good for most assets, a revocable living trust may not be appropriate for certain assets. If, for example, stock is owned in a subchapter S corporation, the trust must comply with certain technical income tax requirements to avoid terminating the subchapter S status. Also, if the trust is named as the primary beneficiary of a qualified pension or retirement plan, or an IRA account, a surviving spouse will be precluded from completing a "spousal rollover" and deferring the income tax until later. The more sophisticated an individual's financial position, the more likely a simple revocable living trust will not be sufficient to meet his or her lifetime or estate planning goals.

### C. WHEN TO CONSIDER A LIVING TRUST

There are certain situations, however, in which a living trust can be beneficial. Individuals may consider establishing a revocable living trust if:

- They own property in more than one state (a will must be filed and probated in each state in which property is owned);
- They are at the risk of becoming incapacitated;
- They desire to keep the terms of their trust confidential (a will is made public);
- They are concerned that a will might be contested; or
- They own property in such a way that probate could be costly and time-consuming.

## II. CREATING REVOCABLE LIVING TRUSTS

### A. BASIC PROCESS

1. State Law Governs

Creating a revocable living trust is a relatively simple process. The particulars are governed by the law of each state. Generally, the trustor (or his or her attorney) prepares a written declaration of trust in which he or she places certain identified property within the trust. The trustor will list the property to be placed in the trust. Other assets can be added later. With assets other than tangible personal property (i.e., jewelry) the trustor must place the assets in the name of the trust. This involves changing title to real property or account names in the case of a brokerage or bank account.

2. Both Spouses Must Participate

In some states, including California, a living trust can only be created by the participation of both spouses.

3. Trustor Retains Control

The trustor retains the right to place property inside the trust or to remove property from the trust. It is a flexible vehicle.

***Example***

Bridget creates a revocable living trust in which she places her house and her collection of art. Bridget names herself the trustee and the beneficiary. A year after creating the trust, Bridget's father dies and leaves her a home in Martha's Vineyard. Bridget is free to place the new home in the trust. If she chooses to do so, she will need to have title to the home placed in the name of the trust, i.e., "the Bridget Jones Revocable Living Trust."

4. Funding a Living Trust

After a living trust is established, it must be funded. This means transferring assets to the trust. A living trust cannot protect property from probate unless the property has been transferred to the trust. All property with ownership documents should be re-titled in the trust's name. This includes bank accounts, money market accounts, stocks, mutual funds, bonds, safe deposit boxes, etc. In some cases, a trustor will decide not to fund the trust until a later date, or upon his or her death. This type of unfunded trust is referred to as a "standby trust."

5. Title to Property Held in Name of Trust

When a trustor places property into a living trust, the trust becomes its owner. However, where the trustor retains the right to use or dispose of the assets, which is typically the case in a revocable living trust, real ownership of the asset does not change. This is why such arrangements are typically ignored by the IRS and therefore result in no tax savings. This is discussed in greater detail below.

**B. TRUSTEE OF A LIVING TRUST**

1. Selecting a Trustee

Trustors of revocable living trusts commonly name themselves as trustee. A trustor is free, however, to name another person or entity as trustee or to appoint another person or entity as a successor trustee in the event the trustor becomes incapacitated. It is generally advisable to do so since the future is always uncertain. Some trustors prefer to make a financial institution – such as a bank's trust department or trust company – the successor trustee.

There are circumstances in which a trustor will want the successor trustee to have financial expertise. For example, if any of the trust's beneficiaries are minors or disabled or the trust is to continue, the successor will have to manage the trust property until they reach the ages at which the trustor specified the property would be distributed to them or to their remaindermen (i.e., those who have a future interest in the trust). This may involve preparing tax returns, investing funds, and other financial decisions requiring more expertise.

2. Trust Document Governs

The trust agreement document contains instructions to the trustee regarding investment and management of the trust assets, who is to receive income from the trust, and what happens to the trust if the person creating the trust becomes incompetent or dies. A trustee is required to manage the trust's assets according to the directions in the trust agreement. The trustee can do only what the trust agreement specifies. Ultimately, the trust agreement will provide when the trust is to be terminated and assets distributed to the beneficiaries.

A living trust is commonly used to avoid the necessity of appointing a guardian or custodianship when an individual, typically an elderly person, is no longer able to make competent financial decisions. A successor trustee is particularly important in such cases.

3. Co-Trustees

When children are beneficiaries of the living trust, parents often choose to make them all equal co-beneficiaries, and therefore it makes sense to name them co-successor trustees as well. However, if there is concern that the children will not agree, this is not advisable. Parents may consider naming only one child as trustee in such a situation but including a mechanism in the trust instrument allowing for a resolution of conflicts.

In the case of a joint marital living trust, both spouses are frequently co-trustees; when the first spouse dies or becomes unable to act, the survivor becomes the sole trustee.

4. Detailed Statement of Authority

The trustor should set forth the successor's powers in as much detail as possible in the trust instrument. Such powers or authority is normally broadly phrased to give the trustee maximum flexibility to deal with unforeseen circumstances that may arise in the future. However, the trustor is free to be as restrictive as possible in granting authority to the trustee.

### C. BENEFICIARIES

Beneficiaries of the trust are designated by the trustor and can be individual(s) who formed the trust, friends, family members, a college or university, hospital, library, charity or other organization. Unless the beneficiary is also the trustor, he or she has no control over the trust.

The trust agreement should identify what is to be done with the trust property at the termination of the trust (often at the death of the trustor) and what happens to a beneficiary's share if he or she dies before the trust terminates.

1. Limiting Right of Transfer

A trustor may wish to consider writing safeguards into the trust so that beneficiaries cannot transfer their trust interest to a third party, or to protect beneficiaries' trust interests from creditor claims. The revocable living trust assets are not protected from creditor claims against the trustor nor does a trust insulate the grantor from claims of a surviving spouse.

2. Contingent or Remainder Beneficiaries

A trustor may also elect to name contingent beneficiaries or remainder beneficiaries. A remainder beneficiary is one who receives the assets of the trust following the death of the primary beneficiary.

*Example*

Rusty creates a revocable living trust in which he is both trustee and beneficiary. Upon his death, however, the language of the trust provides that a successor trustee, his CPA Rich, is to be appointed and his grandchildren are to become the new beneficiaries of the trust. Upon his death, the trust will become irrevocable. The grandchildren are referred to as the remainder beneficiaries.

## III. MYTHS ABOUT LIVING TRUSTS

### A. MYTH #1: PROBATE AVOIDANCE

Myth #1 about living trusts is that they are necessary to avoid probate when the trustor dies. There are many ways to avoid probate aside from living trusts. These include holding assets in joint