

Living Trusts: *A Primer*

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Living Trusts: A Primer

Perhaps you've finally created a will and feel relieved to have it behind you. But are you finished? A will might only be the first step, because planning an estate—especially one that grows over time—is an ongoing process. So, before you lock that will away and wipe your hands clean of all estate-planning concerns, consider tools that can complement your will, such as living trusts.

A common misconception people have about living trusts is that they are only for the wealthy. On the contrary, living trusts can provide a number of estate-planning advantages for everyday people. This guide will help you decide if you should consider a living trust, explain the various kinds available and discuss your options for creating one.

What is a Living Trust?

Like a will, a living trust is an estate-planning tool that lets you transfer property to family, friends or favorite organizations after you die. The major difference between a will and a trust is that property placed in a trust passes directly to your *beneficiaries* (those who are inheriting from you) without first having to go through probate. Probate involves a special court proceeding to prove that your will is valid, to settle your debts and to distribute your property. If no valid will exists, the probate court will settle your estate according to your state's intestacy laws (meaning your property will be distributed to your closest relatives, regardless of your wishes). Probate can be time consuming and expensive, and is one of the major reasons living trusts have become popular.

Although living trusts are often marketed for their probate-avoidance quality, one of the most common reasons for creating one is to protect and preserve property for minor children if one or both parents die. The property in the trust is managed for the child's benefit until she is old enough, or responsible enough, to receive it.

Another popular reason for setting up a living trust is to provide for the continual management of your financial affairs if you become disabled or incapacitated. In the trust you would name someone (a trusted relative, friend or institution, such as a bank) to take over (write checks, make deposits, pay bills, etc.) if you can't. The person you name must manage your assets for your benefit under the terms of your trust. He or she could also be given the power to amend your trust as needed—for example, to accommodate changes in the tax code or to remove the name of a beneficiary who is no longer living.

One of the most common reasons for creating a living trust is to protect and preserve property for minor children if one or both parents die.

Planning ahead for these contingencies can give you peace of mind, help preserve your assets for loved ones, and in the case of incapacitation, eliminate the need for costly guardianship proceedings in court.

You create a trust by drafting and signing a *Declaration of Trust* that transfers legal title to your designated property to the trust. The person who creates a trust is known as the *grantor*. The person who manages the trust property is known as the *trustee* and the persons who ultimately receive the trust's property are known as the *beneficiaries*. Married couples often create, manage and benefit from a living trust together during their lifetime as co-grantors, trustees and beneficiaries. When one spouse dies, the surviving spouse continues to manage and benefit from the trust. After the second spouse dies, a *successor trustee* takes over the job of managing the trust and distributing its assets to the couple's beneficiaries. As discussed above, a successor trustee can also manage your affairs if you become disabled or incapacitated.

Because the law considers the trust a separate "legal" entity, any property you transfer to it belongs to the trust, not to you. The trust property is no longer considered part of your probate estate and is therefore not subject to probate, although it may still be subject to federal or state estate taxes, depending on the size of your estate.

The term "trust" is generic, much like the term "vehicle." Just as you might select from among many types of vehicles (a car, a van, a bus, a motorcycle) to satisfy your specific needs or conditions, you also have a choice among types of trusts, depending on your needs. Trusts are classified by whether they can be changed or canceled (revocable or irrevocable), and whether they take effect while you are alive or only after you die (living or testamentary).

Should I Create A Trust?

Although trusts can offer substantial benefits, some people go through life without one, while others create one only after accumulating a substantial amount of property. Here are some of the main

reasons people create living trusts and some equally convincing reasons why you may decide not to create one.

You may want to create a trust if:

- You have minor children and want to ensure your assets are properly managed for their benefit if you should die unexpectedly;
- You want to avoid probate because it's particularly burdensome or expensive in your state;
- You have real estate in more than one state. A living trust controls all of your assets and eliminates the need for multiple probates;
- You want to avoid competency hearings and the possibility of a court-appointed guardian should you become physically or mentally disabled. A living trust allows you to appoint someone to serve as guardian of your person and guardian of your financial affairs;
- You anticipate, and want to avoid, a will contest; or
- You are wealthy and want to ensure your estate is preserved for your heirs.

You probably don't need to create a trust if:

- You live in a state which has simplified its probate process. At least 16 states have adopted the Uniform Probate Code to make settling an estate easier;
- Your major assets would bypass probate anyway because they are co-owned with a spouse or others who will inherit them automatically;
- You have no minor children and are middle-aged, middle-income and in good health and can reasonably wait 20 or more years before worrying about probate;
- Your estate qualifies for simplified probate procedures (sometimes called small estate administration) because its value does not exceed your state's dollar limit (typically set at \$10,000 to \$50,000, although it can be as high as \$150,000); or
- Your estate planning needs are modest and met adequately by a simple will, a durable power of attorney for finances and a health-care proxy for health-care decision making.

What Are the Major Benefits of a Revocable Living Trust?

If you set up a revocable living trust, you gain these benefits:

Flexibility. Revocable living trusts can give you considerably more flexibility in exercising control over your property than any other estate-planning tool. As the person who sets up the trust, you get to decide how long the trust will hold your property, how the trust assets will be managed and invested, and how and when assets will be distributed. You can even reserve the right to change your mind and cancel the trust altogether if, for example, you divorce or remarry, you or your spouse becomes seriously ill, a beneficiary dies,

you move to another state or you sell a major asset in the trust (such as your home).

Control. You control how the assets are managed and when beneficiaries can receive them, or if you prefer, you can let another person or a corporation manage the assets for you. And your assets continue to be managed by someone you trust if you become unable to manage them yourself.

Probate Avoidance. Any assets you place in a living trust will bypass probate, the legal process for settling an estate. Probate can take anywhere from six months to two years or longer and can eat up a good chunk of your estate. By transferring your assets into a living trust (or by using other probate-avoidance techniques such as owning property as joint tenants with rights of survivorship) you can avoid the expense and delays of probate.

Will A Living Trust Reduce Taxes?

A simple probate-avoidance living trust will not reduce estate taxes. If your goal is to reduce estate taxes, you will need to create a more complex living trust, such as the marital or irrevocable living trust. An **irrevocable trust** can dramatically reduce your income and estate tax liability, and like its revocable counterpart, keep your assets out of probate. While it sounds attractive, to gain the tax advantage you must give up complete control over the property you place in the trust. Once you place property in the trust, you cannot personally benefit from it nor can you amend, revoke or terminate the trust. With such severe restrictions, it's absolutely necessary to consult an estate planning expert before taking this step. There are, however, tangible advantages to giving up control and rights to your assets (or at least some of your assets) in an irrevocable living trust. They are:

Reduced Estate Tax. Estate taxes are reduced or eliminated because the value of your estate has been reduced by the amount you transfer out of it. Taxes, however, may be due on the initial transfer of assets into an irrevocable trust. You are allowed to give tax-free gifts of up to \$12,000 per person, per year (in 2007). To the extent that the assets you transfer to the trust exceed the applicable exclusion amount available in the year of your death, you may have to pay gift taxes on those assets, without giving up your lifetime exemption of \$1 million.

Reduced Income Tax. By placing property in an irrevocable living trust, you reduce your income tax liability because you no longer own nor receive income from that property. However, the trust will have to pay income taxes. And if any income is distributed to a beneficiary, that beneficiary will have to pay taxes on it. If the beneficiary is a child, there is a kiddie tax where a child's unearned income (up to the age of 18) is taxed at the parent's rate.

What Information is Included in a Living Trust?

In general, a living trust includes the following information:

- your intent to create a trust;
- the parties to the trust;
- assets you are donating to the trust;
- the purpose of the trust; and
- the terms for distributing assets or income from the trust.

Intent to Create the Trust. Every trust must demonstrate that you intend to create a trust. Although there are no special or “legal” words that have to be used, uncertain or ambiguous terms certainly could invalidate your trust. The best way to avoid this is to state your intentions, simply and clearly, in writing. Some trusts must be in writing to comply with state laws.

The Parties. All trusts must designate the parties involved—the grantor, trustee and beneficiaries (and if desired, a successor trustee and alternate beneficiaries). Although not technically required, it is a good idea to designate a successor trustee, someone to take over if the original trustee dies or is otherwise unable to manage the trust. If you do not appoint a successor trustee, the court has authority to do so if one is needed.

The trustee and successor trustee you name should be responsible, business-minded and able to deal fairly with all of your beneficiaries. People name themselves, spouses, siblings, friends or institutions as trustees. When you create the trust, you must include instructions for the trustee in the document and give the trustee the authority needed to carry them out. This is typically done under a clause titled “Trustees Powers and Duties.”

A trust must also name the beneficiaries—the people or institutions who will receive the trust property outright or who will benefit from it (such as receiving the interest generated by a trust’s account). *Alternate beneficiaries* and *residual beneficiaries* can also be named in

case the original beneficiaries cannot receive the assets. For example, if one of your original beneficiaries dies unexpectedly, an alternate can be named to receive his or her portion of the trust property. Or, a *residual beneficiary* (a brother or sister, for example) could be named to receive whatever money or property remains in the trust after specific distributions have been made.

When designating beneficiaries, you can name an individual (John Smith), a class of individuals (the children of John Smith), or one or more charitable organizations. If you name a minor as a beneficiary, you must also name an adult to manage that beneficiary’s trust property until the minor turns a certain age (for example, 20, 30 or 40).

The Assets. You can put anything you own into a trust, such as stocks, bonds, a bank or money market account, a mutual fund account, personal property, your home, other real estate or your life insurance policy; in short, any item you own or have the right to transfer can be put into a trust. To bypass probate, you should put everything you own into the trust, with the exception of items that would avoid probate anyway, such as property owned jointly with rights of survivorship (see HALT’s *Everyday Law Series* article “Owning Real Property” for more information on different types of property ownership), property that you buy and sell frequently, property that has little monetary value and automobiles (some insurance companies won’t insure a vehicle owned by a trust because of uncertainty over who will actually own the vehicle after the trust expires).

Purpose of the Trust. A trust can be created for any purpose that does not violate the law or public policy. There is a wide variety of valid purposes for which trusts are created. For example, people set up trusts to limit their tax obligations, to take care of a disabled loved one, or to fund a child’s education. The most common reason for establishing a trust is to make sure its assets are managed, conserved and distributed according to your wishes.

Terms of Distribution. Your trust document should leave explicit instructions about how, when and to whom the trust property is to be distributed. For example, will the trust property go directly to a surviving spouse,

be divided equally among beneficiaries, or be held for distribution at a particular time (a daughter's 30th birthday) or for a particular need (a son's college tuition)?

How Do I Put My Assets Into a Trust?

Transferring property to a trust is called “funding” the trust. If your trust is still unfunded at the time of your death (meaning you haven't taken the necessary steps to formally transfer ownership of your property to the trust), your living trust is useless and all or some of your property will be subject to probate.

For items such as real estate, bank accounts, stocks, or any other item that requires an ownership paper like a deed, you need to retitle the property into the name of the trust. Do-it-yourself products (such as Nolo's *Make Your Own Living Trust* and Nova's *Living Trusts Simplified*) provide information and step-by-step instructions for handling this task. Or, you can hire a professional to do it for you. Transferring loose items (things for which you have no ownership papers) is done by listing those items (e.g., books, appliances, clothing, jewelry, furniture, etc.) on a trust schedule.

How Will My Trust Assets Be Distributed?

With a revocable living trust, you have full access to the trust's assets during your lifetime. As trustee, you can sell, transfer or give away trust property at any time. After you die, your trust property will be distributed to your named beneficiaries as instructed by your trust. As with any investment, the assets are either the *principal* (the property owned by the trust) or the income generated by the principal. You can leave instructions to your successor trustee to pay out only the trust's income or to distribute the principal as well. Any of the following distribution plans can be used:

Lump-Sum Distribution. The entire balance is received by the beneficiaries in a single tax year, typically in a single large (or lump sum) payment.

Periodic Distribution. Trust income or principal may also be paid out at scheduled intervals—for example, monthly, quarterly or annually. The payments, in effect, provide the beneficiary with regular income. This type of arrangement is often used to augment a regular payment such as Social Security or a pension.

Discretionary or “Sprinkle” Distribution. Under this arrangement, the trustee has discretion to “sprinkle” money where and when it's most needed—for example, giving an unemployed child twice as much each month as an employed child. Typically, the trustee has complete control over how much will be paid out and when, although the grantor can leave instructions or guidelines for the discretionary payment.

Per Stirpes Distribution. If one of your beneficiaries dies before you do, the amount that beneficiary would have received goes to their children, grandchildren or direct descendants.

Per Capita Distribution. If one of your beneficiaries dies before you do, all your remaining living descendants could inherit equal shares of your estate.

Does a Trust Shield My Assets From Creditors?

If you're trying to hide assets from creditors by putting them into a revocable living trust, you're out of luck. Your trustee (or successor trustee) is responsible for paying your debts and expenses, just as the executor of a will would be. Creditors who are not paid may litigate and, if successful, go after your beneficiaries to get payment. And, unlike the probate process which creates a cut-off period for creditors' claims, a living trust typically does not, meaning your assets could be subject to claims indefinitely. A small number of states are instituting a probate-like notice procedure for trusts which means creditors must be notified after your death and given a chance to file claims against your trust property. If they miss the deadline for filing claims (typically six months to three years) they are out of luck.

What Are Special-Purpose Trusts?

There are special-purpose trusts that allow you to meet certain estate-planning needs. These include marital trusts, children's (or support) trusts; insurance trusts; and charitable trusts.

Marital Trusts. Marital trusts allow married couples to take full advantage of both federal tax exemption and the unlimited marital deduction by setting up one or a package of trusts. The most common type of marital trust is an A-B Trust, where both spouses leave all or most of their property to the trust rather than to the surviving spouse. This will avoid a heavy federal estate tax burden if the surviving spouse's estate is greater than \$4 million. (There is a \$2 million federal estate tax exemption for each individual until 2008.) These trusts can be complex and it is important to understand that the surviving spouse will have only restricted rights over the deceased spouse's assets, which are technically "owned" by the trust.

Support Trusts. Support trusts (or support provisions within a trust) allow you to control how much property the beneficiary will receive and when. You might, for example, set up a support trust to provide a family member, such as an elderly parent, with a regular income or to fund a child's future education. Typically, the trust is designed to end and distribute assets to the beneficiaries when they reach the age of 25, the age when most people are considered capable of handling their own financial affairs, but later distributions are possible too.

Insurance Trusts. Insurance trusts own and hold the proceeds from insurance policies—most often life insurance. People whose assets exceed the federal estate tax limit, including their life insurance proceeds, can use this kind of trust to minimize the federal estate tax bite. Such a trust can also give you control over when, how much of and to whom the proceeds will be released while avoiding probate.

Charitable Trusts. Charitable trusts are established to contribute to charities, such as hospitals, universities, or individual nonprofit organizations like HALT. Because

these types of organizations benefit the general public, such trusts get special tax treatment. For more information on including HALT as a beneficiary in your living trust, please contact us by e-mail at halt@halt.org or toll-free at (888) 367-4258.

How Can I Create A Living Trust?

If your needs are relatively simple, you can create your own revocable living trust with the help of do-it-yourself legal products, such as Nolo's **Make Your Own Living Trust** (a HALT Do-It-Yourself Best Buy) or Nova's **Living Trust Simplified**.

If your situation is too complex for do-it-yourself products, you can hire an estate-planning professional to create a living trust for you. Low-cost alternatives to hiring a lawyer in some states include independent paralegals and document preparation offices that offer routine legal services and access to self-help publications. If you belong to a pre-paid legal service plan, check the plan benefits to see if a free living trust is included in the membership fee. If not, you may at least be able to get referred to an attorney who can help you create one at a discount.

Special-purpose trusts and irrevocable living trusts should be drafted by a professional.

You should hire a professional to draft your trust if your estate exceeds the federal estate tax limit and your primary purpose is to avoid taxes, if you are creating a charitable trust, or if you need to address complicated personal issues.

Whether using an estate-planning professional, a legal service plan, or an independent paralegal, be sure to shop around. To learn more about your options, read *HALT's Citizens Legal Guide Where Do I Go for Legal Help?*

If your needs are relatively simple, you can create your own revocable living trust with the help of do-it-yourself legal products.

Does a Living Trust Cover All my Estate Planning Needs?

You should have a will even if you have put your assets into a living trust. A will can ensure that assets not covered in your trust document (a last-minute inheritance, for instance) get into the trust. Creating a “pour-over provision” in a will protects assets that, for whatever reason, are left outside of the trust’s umbrella. A will can also take care of other significant matters, such as naming a guardian for minor children.

In addition to creating legal documents—such as a living trust or will—that will ensure your property is distributed the way you would like and that dependent loved ones will be taken care of after you’re gone, it’s a good idea to have a plan in place should future illnesses or incapacities (like Alzheimer’s Disease) render you incapable of making important decisions about your health, finances or other personal matters.

A durable power of attorney for finances is a legal document that allows you to appoint someone (called your “agent” or “attorney-in-fact,” although the person need not be a lawyer) to take care of your financial obligations if you become incapacitated. A durable power of attorney for health care lets you appoint someone (called a health-care proxy) to make medical decisions for you if you are unable to make them for yourself. A living will (another type of health-care directive) allows you to state in writing ahead of time what kind of medical treatment you want and whether you want your life prolonged if there is no hope of recovery. Many living wills include a section that lets you appoint a health-care proxy to oversee your directive and if necessary, make decisions on your behalf. To learn more about your options, read HALT’s *Citizens Legal Guide* **Durable Power of Attorney: Do You Need One?**

By supplementing your living trust with these additional tools, you can ensure that all of your personal and estate-planning needs are covered.

Living Trust Mills

You may have seen advertisements or received phone calls about free seminars on living trusts. Be wary of these seminars, which are often little more than aggressive sales pitches for “cookie-cutter” trusts that are often sold to unwary consumers and can cost exorbitant amounts of money.

Most seminars prey on unsuspecting seniors by using fear tactics, exaggerating how long probate will take or cost and lying about what a living trust can do. Using hard-sell techniques, they bully seniors into purchasing trusts they don’t need or that don’t fit their circumstances. Some living trust mills also try to use the financial information they get from seniors to sell them unnecessary insurance annuities. In this way, con artists, many of whom falsely claim to be either experts in estate planning or even lawyers, swindle thousands of dollars out of trusting seniors each year.

You can fight back. While living trusts are great estate planning tools, they’re not for everyone. Take your time making your decision and base it on information you get from a reputable source such as one of the do-it-yourself living trust products recommended by HALT, a financial advisor, or an estate planning attorney. If you have been a victim of a living trust scam or someone is pressuring you to purchase a trust, contact your state or local consumer protection office, a local office of the Better Business Bureau, or the Federal Trade Commission at 877-FTC-HELP.

Glossary of Terms:

Assets: Money and real or personal property owned by a person, corporation or legal entity like a trust.

Beneficiary: Person who is named to receive some benefit or money from a legal document such as a trust or will.

Estate: All property, real or personal, that a person owns.

Grantor: Person who creates a trust.

Intestate: Not leaving a valid will.

Irrevocable Living Trust: Trust established and in operation during the grantor's life that cannot be canceled or changed.

Pour-Over Will Provision: Language in a will that distributes assets to a previously established trust.

Probate: Legal process of establishing the validity of a deceased person's last will and testament; commonly refers to the process and laws for settling an estate.

Residual Beneficiary: Person who is named to receive some benefit or money from the remaining assets of an estate once the primary beneficiaries under the trust or will have either been paid or died.

Real Property: Property that's immovable, such as land, buildings, and whatever else is attached to or growing on land.

Revocable Living Trust: Trust established and in operation during a grantor's life that can be canceled or changed.

Successor Trustee: Person who takes over the rights and responsibilities of an original trustee.

Trustee: Person who manages a trust and carries out duties outlined in the trust.

Will: Legal document that declares how a person wishes property to be distributed to beneficiaries after death.

Where to Find More Information

More information about trusts and estate planning is available on HALT's Web site, www.halt.org, in HALT's *Everyday Law Series*, and in HALT's *Citizens Legal Manual*

Your Guide to Living Trusts and Other Trusts: How Trusts Can Help You Avoid Probate and Taxes and HALT's *Citizens Legal Guide Plan Your Estate*.

Join Our Fight For Reform

Since 1978, HALT has provided a powerful voice working on your behalf in Washington and across the nation to help Americans navigate the legal system with or without a lawyer. We need your help. Join HALT to help us allow more people to settle their legal affairs simply and affordably.

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