



What is it?

A living trust (also known as a revocable or inter vivos trust) is a separate legal entity that you create to own property, such as your home, boat, or investments. You transfer some or all of your property to the trust as soon as it is created. During your lifetime, you control the trust; you can change the trust terms, or terminate the trust and take the property back. At your death, the trust becomes irrevocable and may continue to exist for many years. The trustee administers and distributes the trust property according to the terms of the trust.

People create living trusts because they're able to retain control over their assets while achieving other important goals, such as:

- Controlling the manner and timing of asset distributions to heirs
- Efficiently transferring assets to heirs
- Enabling someone else to manage property
- Protecting property in case of incapacity
- Avoiding probate

Tip: Though a living trust is a separate legal entity, it is not a separate taxpayer during your lifetime. You are considered the owner of the trust assets for income tax purposes; all income, deductions, credits, and losses flow through to you. Upon your death, the trust becomes a separate taxpayer and different tax rules will apply (see Tax Considerations below).

Caution: A living trust does not avoid estate taxes and does not protect assets from potential future creditors. To attain these objectives, the trust must be irrevocable. For more information, see Tradeoffs below.

When can it be used?

Cannot be used for some types of property

Although a living trust can hold most types of property, it cannot hold:

- Qualified stock options or stock acquired under such a plan, at least until the holding period has passed
- An interest in a partnership, if prohibited by state law
- An interest in a cooperative or condominium, if prohibited by your contract with your co-owners
- An interest in a professional corporation (e.g., a law firm), because such an interest generally can only be owned by a professional (e.g., a lawyer)
- An IRA, although you can name your living trust as beneficiary of your IRA

Strengths

Lets you control your property until your death

A living trust is revocable until your death. That means you can use or withdraw trust property, change the trust terms, add or remove beneficiaries, replace the trustee, or even revoke the trust entirely up until your death. This gives you flexibility to meet unknown future contingencies and still meet other goals.

Allows distribution of your property to be customized

A will generally transfers specific amounts or percentages of your property to your beneficiaries. By placing your property in a living trust, you can direct the trustee to distribute property only in certain situations, for example "to pay tuition," or on certain occasions such as "on my son's 30th birthday," or at the trustee's discretion, perhaps "to my children, as necessary to fund their educational needs."

This may be beneficial if you're worried your heirs may be unable to manage outright gifts, or if you want to create "rewards" for certain behaviors.

Caution: Although a trust transfers property like a will, you should still have a will as well because the trust will be unable to accomplish certain things that only a will can, such as naming an executor or a guardian for minor children.

Minimizes delays in the transfer of property

Probate takes time and your property generally won't be distributed until the process is completed. A small family allowance is sometimes paid, but it may be insufficient to provide for a family's ongoing needs. Transferring property through a living trust provides for a quicker, almost immediate transfer of property to those who need it.

Probate can also interfere with the management of property like a closely held business or stock portfolio. Although your executor is responsible for managing the property until probate is completed, he or she may not have the expertise or authority to make significant management decisions, and the property may lose value. Transferring the property with a living trust can result in a smoother transition in management.

Circumvents some limits on your power to transfer property

State law may limit your ability to leave property to charity. For example, some states invalidate any bequest to charity written within a month of your death. Other states won't let you leave more than a certain percentage of your property to charity. These laws often don't apply to living trusts.

State law may also force you to leave a certain percentage of your property to your spouse. In some states, these laws don't apply to living trusts.

Lets someone else manage your property for you

You may find that managing certain property is a burden, or that you do not possess the skills required to manage certain property competently. Or, you may be planning to be away from home for a period of time and unable to make financial decisions or transact certain business. Or, you may be entering public service and need to avoid the

appearance of a conflict of interest. A living trust lets you name someone who can successfully handle your financial affairs for you in these situations.

Caution: You will likely have to pay an annual fee if you hire a professional trustee.

Gives someone the power to manage your property if you become incapacitated

If incapacity strikes, you're trustee (or a co-trustee if you are the trustee) can take immediate control of your property to use it for your care and support, or in whatever way you have directed by the terms of the trust. This may help avoid the potential need for guardianship.

Avoids probate

Because property in a living trust is not included in the probate estate, some people may use them to avoid probate. Depending on your situation and your state's laws, the probate process can be simple, easy, and inexpensive or it can be relatively complex, resulting in delay and expense. This may be the case, for instance, if you own property in more than one state or in a foreign country, or have heirs that live overseas.

Avoiding probate may also be desirable if you are concerned about privacy. Probated documents (e.g., will, inventory) become a matter of public record. Generally, a trust document does not.

On the other hand, the probate process can serve many important functions, such as protecting the interests of beneficiaries and resolving disputes.

Determining whether avoiding probate would be advantageous, then, depends on many factors.

Tip: There are other ways to avoid the probate process other than using a living trust, such as titling property jointly.

Tradeoffs

You may incur attorney's fees to create

A living trust is a sophisticated legal document that should be drafted by a competent attorney who understands your state's laws as well as your personal situation and objectives. An attorney will help you coordinate your trust with other estate planning and financial goals, and will advise you regarding how to effectively execute and fund this device.

Caution: Though there are "do-it-yourself" living trust kits available, you take many risks if you use one of these "one-size-fits-all" forms. It may end up costing you more if the trust is the wrong form, a form that is not valid in your state, is not appropriately customized to your situation, is not properly executed, or is not properly funded.

Funding the trust can be burdensome and costly

In order to be effective, you must transfer title to property being transferred to the trust. This can be complicated and burdensome, though your attorney will offer advice to help you. Transferring some types of property can be especially difficult and costly:

- Real estate: Some states assess a transfer tax or reassess property taxes whenever real property changes hands, even if it is only being transferred to a living trust. In other states, homeowner tax deductions are not available if the land is owned by a living trust.
- Secured or insured property: If property secures a loan, that loan may prohibit any transfer of the property, even to a living trust. Title or property insurance may also prohibit transfer of the property to the trust.

Should not be used to transfer some types of property

Although a living trust can hold most types of property, it is generally inappropriate for the following types of property:

- Stock acquired at less than market value under a restricted stock option or stock purchase plan, because income tax will be assessed on the gain
- Certificate of deposit, because of the penalty that will result if the bank considers the transfer an early withdrawal
- Real estate generating loss, since you probably cannot take losses on actively managed rental property owned by a living trust
- Personal property, such as furniture or clothing

Does not help achieve Medicaid eligibility

Assets in a revocable living trust are countable resources for the purposes of Medicaid eligibility. The assets are treated just as if you (the grantor) owned them outright. Thus, your eligibility for Medicaid is reduced to reflect any gifts you make from your living trust during the preceding 60 months.

Caution: Questions regarding Medicaid eligibility are extremely complex. You should seek specific assistance with these issues.

Does not avoid estate taxes

Unlike an irrevocable trust, a living trust does not inherently reduce estate taxes. Because you retained control over the trust during your lifetime, property in the living trust at your death will be included in your gross estate for estate tax purposes, even though they won't be considered part of your estate for probate purposes.

Tip: Spouses can use a special living trust (i.e., a bypass or credit shelter trust) to help minimize estate taxes on their combined estates. With such a trust, both spouses can more fully utilize their applicable exclusion amounts. However, you do not need a living trust to accomplish this; you can create the bypass trust at your death by including a provision in a pourover will. For more information, see bypass or credit shelter trust.

Does not protect property from creditors

The probate process requires that all claims against your estate be presented within months of your death, preventing delayed claims against your estate and beneficiaries. A creditor may be able to bring a claim against property that passed through your living trust for years after your death.

Tax considerations

Income Tax

During your life

While you are living, the IRS will ignore the trust entity. All income, gains, losses, deductions, and credits flow through directly to you. Generally, you do not need to obtain a taxpayer identification number (TIN) for the trust, though you may choose to do so. You may furnish your own name and Social Security number to banks, brokers, and others paying income to the trust. You report all income on your own Form 1040 in the year it is earned, regardless of whether it was distributed to you. You do not need to file Form 1041. If you are not the trustee, however, the trustee must send you a statement with all pertinent information you will need to prepare your Form 1040.

You may choose to furnish banks, brokers, and others paying income to the trust with a TIN. In this case, the trustee must file Form 1099 and Form 1041. And, if you are not the trustee, the trustee must also send you a statement with all pertinent information you will need to prepare your Form 1040.

If you create a living trust jointly with your spouse, and you and your spouse file separate returns, you must use the second method described above.

After your death

If your living trust doesn't distribute all of the property it owns at your death, it becomes an irrevocable trust and is subject to income tax as a separate taxpayer. The tax rules become very complicated and are much less advantageous. Among other things, the trust

- Cannot take a charitable deduction for income set aside for charity
- Must use a calendar tax year
- Cannot file a joint return with your surviving spouse in the year of your death
- Is allowed a smaller income tax exemption than for individuals
- Is subject to more compressed tax rates
- Cannot deduct losses on distributions of assets to beneficiaries
- Is assessed income tax on the gain if it takes ownership of stock acquired at less than market value under a restricted stock option or stock purchase plan
- Cannot take rental real estate losses

May be unable to continue to hold S corporation stock after your death

A living trust can hold S corporation stock during your life without jeopardizing the corporation's S corporation status, as long as certain conditions are met. However, after you die, the trust is permitted to continue as a shareholder only for the two-year period beginning on the date of your death.

Caution: This is an extremely complex area. You should consult an experienced tax professional.

Gift and Estate Tax

Must file gift tax returns when property is transferred to the trust

Although transferring property to a living trust does not result in any gift tax liability (because transfers to a revocable trust are not "complete"), you are required to disclose the living trust on a gift tax return.

Does not avoid estate taxes

Because you retained control over the property during your lifetime, all property in your living trust at your death will be included in your estate for estate tax purposes, even though it is not included in your estate for probate purposes.