Living Trusts: What are They?

I am going to write about an estate planning tool that gets a lot of attention: the "living trust." Some articles leave you thinking that this one legal instrument can cure every estate planning problem. Some argue that a living trust is indispensable for avoiding death taxes, but the federal death tax is diminishing in importance for most people. On January 1, 2006 the threshold for the tax went up to $2.0 million with a further increase to $3.0 million scheduled for January 1, 2009. Does that mean that such trusts are going to become obsolete? I don't think so.

First, let's define some terms. What is a trust? In this context, it is a written agreement where one person, the "grantor" gives legal ownership of property to a "trustee" who manages that property in accordance with the terms of the agreement. Although the grantor and trustee are two separate roles, they can be performed by the same person, if the grantor so desires. The trust document can be either a written agreement, or a portion of the last will and testament of the "grantor."

When a trust is established by a person's will it is a "testamentary trust" and takes effect after the executor of the will transfers property to the trustee who agrees to perform the duties set out in the trust portion of the will.

When a trust is established by a written agreement between two living people it is an "inter vivos" trust. The Latin phrase means "between the living." The term "living trust" comes from shortening the translation of "inter vivos trust." Such trusts are either revocable or irrevocable. Unless a power to revoke or modify is reserved by the grantor (usually the case), a trust is automatically irrevocable.

Living trusts have been useful in minimizing death taxes because they have enabled a married couple to shelter selected assets at the first death to occur, utilizing the maximum amount of protection (currently $2 million) from the death tax. It does this by excluding the trust assets from taxable estate of the surviving spouse when the "second death" occurs. In that fashion the exempt amount ($2 million in 2006 and $3.5 million starting in 2009) can be used twice by a married couple so as to maximize the property going to their children tax-free.

A living trust can be the best vehicle for handling a complex set of assets. For example, a Georgia resident owning real estate in North Carolina would face a separate probate there at his or her death. Ownership of the land in a trust would avoid that second probate proceeding.

Other uses include management of financial investments outside of a retirement account as a hedge against a disabling illness or injury. A designated successor trustee will provide continuity of management. In this time of patchwork families and prenuptial agreements, a revocable trust also might be a method of allocating some or all of those assets to children from a previous marriage, with non-trust assets passing to a surviving spouse through a will.

Irrevocable trusts are most often used for large insurance policies (i.e. $500,000 or more). This avoids having the death benefits hit by a death tax that currently starts at 46% for any property above $2 million that goes to someone other than a surviving spouse or a charity.

Living trusts could be important for families with a permanently disabled child. Because of government benefit programs such as SSI and Medicare, a trust for a disabled child with “supplemental needs” provisions will avoid wealth transfers to the child that make the child too “rich” and therefore disqualified for the programs. Until the assets are consumed so as to render the child “poor” again, their very existence will disrupt the arrangements made for the child.

Choosing a trustee and/or a successor trustee is not easy. You need someone with good judgment and complete honesty. The trustee can and should select professional advisors (e.g., investment advisor, accountant and attorney), so a good trustee need not possess the expertise of all those professionals. Corporate trustees (with those skills all in one organization) are an alternative when a grantor has no “live” person available to serve as trustee.

Beware of anyone who suggests that a living trust is a cure-all for your legal needs. It is one tool that may belong in the estate plan you should be designing with your attorney’s advice. Plan carefully and you will rest easy.

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