

# ESTATE PLANNING AND USING TRUSTS – IS A REVOCABLE LIVING TRUST RIGHT FOR YOU?

By Toni M. Porter, CPA, MST, AEP

No one likes to think about their own mortality, which is why so many families are caught unprepared when a loved one dies unexpectedly. It is important for a person to make the conscious effort to plan for transferring assets to their heirs.

Why not just use a will? Traditionally, most individuals are familiar with the will as their major estate planning document. The will generally contains the individual's instructions as to how his or her property is to pass at death. This seems like a simple way to handle the transfer of assets until you look at some of the basic laws regarding wills and the resulting probate process that may be required for most estates.

Objections to the use of a will include the expense and delay of the probate process, which can last as long as three years and take up to 10% of the estate's value.

Secondly, the probate process can involve the loss of privacy. Once the will is filed for probate, it is a public document and may be examined by anyone. During one's lifetime, it is unlikely that anyone would want to publish their financial affairs for the whole world to view. Yet, that is exactly what happens after death when a will is the primary estate planning document.

Another objection is that an unhappy relative may, at little expense to him or her, complicate the probate process by filing objections to the probate of the will or the appointment of executors. This could cause a great inconvenience to the decedent's family, in addition to substantial delay and expense.

Is a living trust a good alternative?

"Revocable living trusts" have become popular

estate planning tools. Whether a living trust is right for someone depends on a number of factors.

A trust is a legal arrangement involving three parties—the trustee, the grantor (sometimes called the settler or creator) and the beneficiary. The grantor establishes the trust and the trustee is responsible for handling the trust's assets according to the trust agreement for the benefit of one or more beneficiaries. Some trusts are set up to benefit someone else, such as relatives or

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other heirs. However, a person can create a living trust for their own care or for them and their spouse. A living trust is a trust that a person sets up during their lifetime, to which they transfer most or all of their assets. The trust includes all the provisions typically found in a will, including use of all the mechanisms designed to reduce estate taxes, such as the unlimited marital deduction and the credit shelter exemption equivalent, which is \$2,000,000 in 2008.

The living trust agreement:

- Gives the trustee the legal right to manage and control the assets held in the trust.
- Instructs the trustee to manage the trust's assets for the grantor's benefit during their lifetime.
- Names the beneficiaries (persons or charitable organizations) who are to receive the trust's assets when the grantor dies.
- Gives guidance and certain powers and authority to the trustee to manage and



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distribute the trust's assets. The trustee is a fiduciary, which means he or she holds a position of trust and confidence and is subject to strict responsibilities and very high standards. For example, the trustee cannot use the trust's assets for his or her own personal use or benefit without the grantor's explicit permission. Instead, the trustee must hold and use trust assets solely for the benefit of the trust's beneficiaries.

- Can help ensure that trust assets will be managed according to the grantor's wishes—even if the grantor becomes unable to manage them.

Most people name themselves as the trustee in charge of managing their trust's assets. This way, even though the assets have been put into the trust, the grantor can remain in control of their assets during their lifetime. A grantor can also name a successor trustee (a person or an institution) who will manage the trust's assets if he/she ever becomes unable or unwilling to do so.

The grantor receives the income from the trust, and also has the right to withdraw principal. Since the trust is revocable, the grantor may make any desired changes from time to time, including adding property to the trust, withdrawing property from the trust, changing the dispositive provisions (i.e., who gets what) and even terminating the trust.

At death, the trust becomes irrevocable and its income and assets are disposed of under terms specified by the grantor in the trust documents.

The main advantage of the living trust is that its assets are distributed without going through the previously discussed court probate process. Also, after death, trustee fees are generally lower than nonfamily executors' or personal representatives' fees would be. Even if probate is avoided there may be the expense of preparing an estate tax return, valuing and transfer-

ring assets and making a formal accounting and settlement. To avoid probate, all probate assets must be included in the living trust. If some are left out, a probate proceeding would still be necessary. Since it is possible that not all of the grantor's assets will have been transferred to the trust at the time of death, it is common practice to have the grantor execute what is referred to as a "pour-over will." This will states that any property owned at death, which may have been omitted from the trust, is transferred to the trust.

Although both the will and living trust are used for estate planning purposes, the basic difference between the two is that the will does not take effect until death, while the trust is effective immediately and continues in spite of the grantor's incapacity or death. If the grantor becomes incapacitated, the trust continues with the other trustees managing the trust property without interruption. In the absence of a living revocable trust or a durable power of attorney, a probate court proceeding called a conservatorship is required for the purpose of appointing a conservator or guardian of the person and property of the incapacitated person. A conservatorship is not only expensive and time consuming, but could be messy if there are disagreements among family members concerning the appointment. Conservatorship proceedings are designed to help protect you at a time when you are vulnerable or incapable of managing your assets. However, they are also public in nature and can be costly because of the substantial court intervention. In addition, conservatorship proceedings may be less flexible in managing real estate or other interests than a well-managed living trust.

Some of the other benefits and pitfalls of a living trust to consider are:

- Quicker distributions: Probating a will and gathering assets into the estate for distribution can take quite a bit of time. With a living trust, all assets are already gathered

together, so the trustee can make immediate distributions and continue paying bills as usual.

- **Protecting minors:** Living trusts can help control assets that are available to care for minor children during a grantor's incapacitation or after the grantor's death. It may avoid the need to appoint a conservator to manage children's interests, which can cause delay and add to administration costs. The will is still used to nominate guardians for the physical care of the minor children.
- **Privacy protection:** Since probate records are public, the size of your estate, and the names of beneficiaries and the amounts each received, can come into anyone's possession. The size and terms of a living trust are not public matters.
- **Contest of asset transfer:** Unhappy relatives have a much more difficult and expensive route to follow if they wish to overturn trust provisions since they are forced to bring litigation against the trustee. The will and probate process present a simpler method to challenge the decedent's disposition of his or her property.
- **Multiple properties:** If real property is owned in more than one state, it is necessary to probate the will in each jurisdiction where real property is owned by the decedent. This means additional expense and delays for the estate. When real property is owned by a revocable living trust, there is no need for any additional probates since the decedent does not own the real property in his or her name. The property is owned by the trust which is not affected by the death of the grantor.
- **Income taxes:** The revocable trust is taxed as a grantor trust under the Internal Revenue Code. This simply means that all

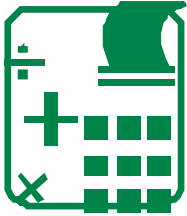
the income of the trust is taxed directly to the grantor in the same manner as if the trust had never been created. It is not necessary to obtain a tax identification number for the trust and it is not necessary for the trust to file fiduciary income returns during the grantor's lifetime, as long as the grantor remains capable of acting as the trustee. Therefore, the creation of a living trust should not generally cause any additional expense or inconvenience for preparation of income tax returns.

- **Gift taxes:** There are no gift tax consequences since the transfer does not become effective until death. Gift tax returns do not have to be filed since the gifts are incomplete due to the grantor's retained control.
- **Estate taxes:** It's a fairly common misconception that living trusts save estate taxes, but that's not necessarily the case. The trust assets will be subject to estate tax just as if you continued to own them outright. Therefore, basic estate planning techniques, such as dividing a married couple's assets to ensure that they receive the benefit of two unified credit exemption equivalent amounts, remain important in the context of living trusts as well as transfers at death by will.
- **Transfer of assets:** The major drawback of a living trust is a practical consideration. Title of all of the assets of the grantor must be transferred to the trust. A grantor will typically have several different types of assets. These might include real estate, farming or other business interests, securities, brokerage and bank accounts, art collections, automobiles, and other types of personal property. An attorney or other advisor can assist the grantor with the transfers to make the process easier.



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- Trustee issues: Because living trusts are not under direct court supervision, a trustee who does not act in a grantor's best interests may, in some cases, be able to take advantage of that grantor or the beneficiaries. (In a probate, direct court supervision of an executor reduces this risk.)
- Document costs: The cost of preparing a living trust can, in some cases, be higher than the cost of preparing a will, although it depends on the particular estate plan. The difference in cost may not be significant if the estate plan is complex. A living

trust can also create additional paperwork in some cases.

Living trusts make a lot of sense for some people and not for others. A person must consider all of the pluses and minuses as they relate to their particular situation to make an informed choice about a living trust.

If you are interested in finding out more information about living trusts and how they might work in your situation, don't hesitate to contact us at 559-432-2346. We would be happy to discuss whether a living trust might be the decision that's right for you.

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### **AMT PATCH**

Congress at last passed legislation to temporarily "patch" the problem of having millions of middle-income taxpayers falling prey to the Alternative Minimum Tax (AMT) in 2007.

The AMT is a parallel tax system which does not permit several of the deductions permissible under the regular tax system, such as state income taxes and property taxes. Taxpayers who may be subject to the AMT must calculate their tax liability under the regular federal tax system and under the AMT system, taking into account certain "preferences" and "adjustments." If their tax liability is found to be greater under the AMT system, that's what they owe the federal government. Originally enacted to make sure that wealthy Americans did not escape paying taxes, the AMT has started to apply to more middle-income taxpayers, due in part to the fact that the AMT parameters are not indexed for inflation.

The new law provides a one-year stopgap fix. Congress enacted legislation to extend the 2006 AMT exemption amounts for 2007,

along with a modest increase in these exemption amounts. Under the new law, for tax years beginning in 2007, the AMT exemption amounts are increased to: (1) \$66,250 for married individuals and surviving spouses; and (2) \$44,350 for unmarried individuals. If Congress had not acted, the exemption amounts for 2007 would have fallen back to the levels that would have applied in 2000, resulting in more than 20 million additional taxpayers facing the AMT in 2007.

### **MORTGAGE DEBT RELIEF**

The President recently signed into law a new measure giving tax breaks to homeowners who have mortgage debt forgiven. Under preexisting law, the debt forgiven by a lender, such as short sales and refinances, was generally taxable to the borrower as debt discharge income. With the passage of the Mortgage Forgiveness Debt Relief Act of 2007, a taxpayer does not have to pay federal income tax on up to \$2 million of debt forgiven for a loan secured by a qualified principal residence. The change in the tax law applies to debts discharged from January 1, 2007 to December 31, 2009.

# BUSINESS VALUATIONS PENALTIES

By Nancy S. Ervin

Accredited Valuation Analyst

***The IRS now has broader powers to penalize an appraiser when it significantly disagrees with a valuation.***



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Thanks to the Pension Protection Act (PPA) of 2006, the IRS now has broader powers to penalize an appraiser when it significantly disagrees with a valuation. Professionals performing valuations for tax purposes will need to develop appropriate evidence supporting their conclusions. One particular challenge will be to support valuation discounts on ownership interests in businesses or holding companies for marketability and control factors. These are especially common in the gifting of interests of family limited partnerships.

The law also changed the statutory definitions of qualified appraisal and qualified appraiser for charitable contributions. The term “qualified appraiser” is defined to mean an individual who: (1) has earned an appraisal designation from a recognized professional appraisal organization or has otherwise met minimum education and experience requirements to be determined by the IRS; (2) regularly performs appraisals for which the individual receives compensations; (3) demonstrates verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS at any time during the three years preceding the date of the appraisal; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.<sup>1</sup>

To be considered a qualified appraisal, the valuation report must be consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP).

Penalties are applied when the appraised value of property deviates from the correct value by certain set percentages. “Substantial Misstatement” in an income tax environment occurs when the valuation is 150 percent or more off

of actual value, or 65 percent in a transfer tax case. “Gross Misstatement” occurs if the value is 200 percent or more off of actual value in an income tax case or 40 percent or less in a transfer tax case.<sup>2</sup>

For example, in the case of estate or gift tax, a substantial misstatement occurs if the value exceeds the correct value by 65 percent or more. Let’s say an appraiser applies a 45 percent discount for a farming operation with an underlying value of \$1,000,000 for a discounted value of \$550,000. If the IRS and court determine that the discount should have only been 15 percent, the correct value would be \$850,000. The appraised value is only 64.7 percent (i.e., less than 65 percent) of the “correct” value. As a result, a 20 percent substantial understatement penalty would be levied on the appraiser’s fee.

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As penalties under Section 6695A are far more severe than prior to PPA, appraisers may be more conservative and might be forced to choose to restructure or raise their fees. If you think you may need a business valuation, educate yourself about the process and discuss the implications with your tax advisor and a valuation professional.

<sup>1</sup> Chang, Felicia, “IRS Guidelines on New Qualified Appraisal Rules,” Mitchell Silberberg & Knupp LLP, March 2, 2007, [www.msk.com](http://www.msk.com).

<sup>2</sup> Heller, Amy E., “The Pension Protection Act’s New Appraiser Penalties,” American Bar Association, [www.abanet.org](http://www.abanet.org).

# CALENDAR

- February 12 – 14** World Ag Expo, Tulare, CA. For information, call 1-800-999-9186 or visit [www.worldagexpo.com](http://www.worldagexpo.com).
- February 25 – 26** US Pistachio Industry 2008 Conference, Santa Barbara, CA. For information, contact Western Pistachio Association, [www.westernpistachio.org](http://www.westernpistachio.org).
- February 27 – 29** AgSafe Conference, Monterey, CA. For information, contact 559-278-4404 or [www.agsafe.org](http://www.agsafe.org).
- March 3rd** Due date for tax returns of taxpayers filing as farmers
- March 17** Due date for tax returns of calendar year-end corporations
- April 15** Due date for individual tax returns
- April 16** Tax Holiday. Baker, Peterson & Franklin office will be closed.
- April 18** Common Threads Luncheon – Honoring Women in Agriculture, California State University, Fresno. For tickets and additional information, contact Ag One, 559-278-4266.

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