Season 1 – Episode 13 - Tax Blueprints: Unraveling the Lifecycle of a Living Trust in California

Date: August 4, 2023

Host: Daniel J. Rohr, CPA/PFS, EA, M.S. Tax

Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we're going to be discussing the lifecycle of a living trust in California. Let's start with the basics. What is a living trust? A living trust, also known as a revocable trust, which means it can be changed, is a legal document that holds ownership of your assets during your lifetime and then transfers them to your chosen beneficiaries when you pass away, all while avoiding probate.

The person who creates the trust is known as the grantor, or set lore, and the individual or entity managing the trust is the trustee. The beneficiaries are those who stand to receive the assets when the grantor dies. Setting up a living trust involves creating a trust document, which typically requires the help of an attorney and funding the trust by transferring your assets into it. This is a critical step in the opening of a trust, and I see in practice that this is sometimes overlooked, which negates the benefits of the trust. So what assets should go into the trust? In general, most of your assets, like your home bank accounts and nonretirement investment accounts, should go into the trust. There are certain assets, however, like IRAs retirement accounts and insurance policies that typically shouldn't be placed in the trust due to potential tax consequences and rules about distributions.

So this brings up a common question can you put shares of S corporations and partnership interests in a living trust? And the short answer is yes, you can. However, it's not always straightforward, and there are some important things to consider. First, let's talk about S Corporation shares. The S Corporation has strict requirements about who can be a shareholder. Only certain types of trusts, including grant tour trust, like a living trust, are permitted shareholders. So while you can transfer your S Corporation shares to your living trust, you must be careful not to jeopardize the S Corp. Status. And if the trust ceases to be a grand tour trust, for instance, after the Grand Tour's death, the trust may no longer qualify as a permitted shareholder, causing the corporation to lose its S Corporation status. This could have obviously significant tax consequences. So the solution to this conundrum is making a qualified subchapter S trust a QSS or an Electing Small Business Trust an ESBT election.

The QSS election allows a trust to hold S Corp. Shares after the death of the original owner. Without disqualifying the corporation's status, it's important to note that the income of the S Corp. Must be distributed out to each year to the beneficiary of the QSS. The beneficiary, not the trust, pays tax on the S Corp's income. Now, on the other hand, an ESBT is a type of trust that's allowed to hold S Corp. Shares and distribute the income from those shares among multiple beneficiaries. Unlike a QSS, an ESBT pays tax at the trust level, which can be significantly higher than individual income tax rates. Now, these elections can help provide flexibility and preserve the S Corporation status after the original owner's death, but they also come with their own set of rules and complexities, and I'll dive into that on a future podcast. Now, turning to partnership interests, these can generally be placed in a living trust, but there are a couple of things to keep in mind.

And first, you should review the partnership agreement. Some agreements restrict the transfer of partnership interests, and if that's the case, you'll need to get consent from the other partners or amend the agreement. Now, another common question that arises when discussing trusts is, if I have a trust, do I still need a will? And the answer, in many cases, is yes. Even if you have a living trust, it's often a good idea to have what's known as a pour over will. This type of will essentially catches any assets that you may have forgotten to transfer into your trust or acquired just before your death. And it directs that these assets should be added or poured over into your trust upon your death. First, as I mentioned earlier, not all assets are suitable for a trust. Certain retirement accounts and insurance policies, for example, have designated beneficiaries and are not typically transferred into a trust.

Second, as careful as you might be when transferring assets into a trust, it's easy to overlook something. And a pour over will provides a safety net for those forgotten assets, ensuring they're ultimately distributed according to the terms of the trust. Third, a will allows you to name a guardian for minor children. While the primary purpose of a will and trust is to handle the distribution of assets, if you have minor children, your will is the document where you can make your wishes known about who should take care of them if you pass away. However, it's important to note that any assets that go through the will and into your trust upon your death will have to go through probate first. On the flip side, if all your assets have been properly funded into your trust, the need for a will is diminished. And in this case, a will would only serve as a backup document to catch any stray assets.

So why it's important to have a living trust in California? The main reason is to avoid probate and probate is a legal process that takes place after someone dies, where their assets are identified, their debts and taxes are paid, and the remaining property is distributed as the deceased person. Or the state law, in the absence of a will, has directed. Some key reasons why people wish to avoid probate is due to its potentially high cost and the fact that probate proceedings are public information. In California, for example, probate fees are calculated based on the gross value of the estate that's before deducting any debts, taxes or liens. This can significantly reduce the assets that are passed on to the heirs. Here's a quick rundown on how those fees work. Probate law in California has a schedule for attorney and executor fees based on the value of the estate.

So, for instance, for an estate valued at 200,000, the fee would be $7,000. For an estate valued at a million, the fee jumps to 23,000. And remember, this doesn't include any additional costs like court fees, appraisal costs, or other expenses related to the probate process. And like I mentioned, probate proceedings are a matter of public record. That means anyone can go to the local courthouse or in some jurisdictions, even look them up online to find the details of a probate case. They can see what assets were in the estate, how much they were worth, who the beneficiaries were, and what those beneficiaries inherited. A well-crafted living trust, on the other hand, is a private document. While it must be shared with the beneficiaries and certain others like the IRS, if necessary, it doesn't become public, and therefore the details of your estate will remain confidential, which can be especially beneficial if you have substantial assets or a complex distribution plan.

In addition to cost and being public, info probate can also be a lengthy process. In California, a simple probate process can take nine to 18 months and can go on for years if there are complications. All right, so now back to a living trust. So, while you're alive, the living trust is considered a disregarded entity for tax purposes, meaning it's not treated as a separate tax entity. Instead, the IRS considers it a grantor trust. So all income and deductions are reported on your personal income tax return. There's no need to file a separate return to report earnings on the assets inside the trust, like a taxable brokerage account or a rental property. So what happens when the grand tour dies? Upon the grand tour's death, the trust becomes an irrevocable trust, meaning it can't be changed. The trust will need to obtain an employer Identification Number, or Ein from the IRS.

At this point, it becomes a separate tax entity and needs to file its own tax returns to report the income earned by the trust. During the administration phase, the trustee now steps in to manage the trust assets. This includes settling any debts and taxes and following the instructions outlined in the trust to distribute the assets to the beneficiaries. When all the assets have been distributed, it's time to close down the trust. And to do this, if required due to income, the trustee will need to file a final income tax return for the trust. The final tax return for the trust will produce a form K One for each beneficiary, reporting the final trust year's, income and expenses like attorney and CPA fees to each beneficiary. The beneficiaries will then include that K One information on their individual returns. I will include more detailed information regarding the tax laws applicable to a death in a future podcast.

And so, once the final trust return is filed, the trust can be formally closed, concluding the Lifecycle of the Living Trust remember, while living trust can provide many benefits, it is a complex legal document and it's important to consult with a knowledgeable estate planning attorney to ensure it is set up and managed correctly.

That's all for this episode of Tax Blueprints of Rohr CPAs podcast. You can find us online at Rohrcpas.com/podcast and don't forget to subscribe on Apple podcasts or Spotify. If you enjoy the show, please consider rating or reviewing us wherever you listen. I'm your host, Daniel Rohr. Thanks for listening.