



NOW YOU HAVE
A TRUST

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Now You Have a Trust

What you and your heirs need to understand about your estate plan

I. Introduction and definition of terms

The use of living trusts in estate planning has become very popular in recent years. Seminars are regularly offered by lawyers, financial planners, insurance salesmen and document preparers; the common theme is that **you** need a living trust.

The entire planning community seems to be eager to convince clients that living trusts are important, valuable and necessary. What that community has not done very well is to explain to clients how trusts work, what maintenance and attention they require and what will happen on the death or disability of the persons who establish those trusts. We hope to address that shortcoming here.

Before we delve into the mechanics of trusts, however, we need to make sure that the language makes sense. Lawyers (like most professionals) tend to use terms without considering whether clients are familiar with them. Trust planning and administration includes its share of such terms, including:

- A. **Trustor** (sometimes “Settlor” or “Grantor”)—the person who establishes the trust. In the case of a joint trust, of course, there may be two Trustors.
- B. **Trustee**—the person who manages trust assets. Once again, there may be two (or more) Trustees acting at the same time. The Trustor(s) may also be the Trustee(s).
- C. **Beneficiary**—the person for whose benefit the trust was established.

A beneficiary may be immediately entitled to benefits from the trust, and be referred to as an **Income Beneficiary**. Other beneficiaries may be entitled to receive benefits only after the death of the income beneficiary (or beneficiaries); such a beneficiary is called a **Remainder Beneficiary**. In most revocable living trusts, the Trustor is the Income Beneficiary (and also retains the power to revoke the trust altogether) and is also the Trustee. The status of a beneficiary may change upon, for example, the death of a Trustor—while the Trustor may have retained the lifetime power to change the trust to remove any beneficiary, that power might have expired with the Trustor's death. Although Arizona law is not completely clear on this point, assume that a beneficiary whose rights have become fixed (even though he or she might not be entitled to receive any income or principal until some future date) is probably entitled to information about the trust's terms, assets and expenditures, and the Trustee's role and address.

- D. **Fiduciary**—a general term encompassing trustees, agents acting under powers of attorney, executors and other persons acting for the benefit of another.
- E. **Incapacity** (sometimes, depending on context, **Incompetence** or **Disability**)—although these terms are not interchangeable, for our purposes they may all refer to the inability of a Trustee to manage the trust, usually because of mental limitations. The same terms are utilized in determining when a trust becomes irrevocable because a person who must sign any amendment or revocation is unable to do so.
- F. ***Inter vivos* Trust**—a trust established during the life of the Trustor(s).

To be distinguished from a trust established only in a will, usually called a **Testamentary Trust**.

- G. **Living Trust**—another term for an *inter vivos* trust (lawyers tend to prefer the Latin term, since it makes us sound well-educated).
- H. **Revocable Trust**—refers to any trust which is, by its own terms, revocable and/or amendable. Most trusts in common use today are revocable, at least until the death of one spouse. Some remain fully revocable even by the surviving spouse. The distinction between revocable and irrevocable trusts is usually (but not always) based on estate tax considerations. It is important to remember, however, that a completely revocable trust often becomes partly or completely irrevocable upon the death of one Trustor (or, sometimes, the surviving Trustor) or upon some other event.
- I. **Irrevocable Trust**—means any trust which was established as irrevocable (that is, no one reserved the power to revoke the trust) or which has become irrevocable (for example, because of the death or incapacity of a trustor).
- J. **“Crummey” Trust (or, sometimes, Irrevocable Life Insurance Trust)**—a trust with special provisions which require notice to be given to beneficiaries each time a contribution is made to the trust. The usual purpose of a “Crummey” trust is to transfer life insurance (or cash) to subsequent generations while retaining some limits on the use of the funds. Not all “Crummey” trusts involve life insurance. “Crummey” trusts, by the way, are named after the individual who first tested their validity with the IRS, and are not in any way “crummy.”
- K. **A/B Trust**—a special type of trust for married couples which splits

into two separate shares on the death of one Trustor. Usually used to maximize estate tax savings for a married couple whose combined assets exceed the federal estate tax threshold. Sometimes known as “**Credit Shelter**”, “**Survivor’s/Decedent’s**” or “**Bypass**” Trusts.

- L. **Special Needs Trust**—another special type of trust, this one usually for the benefit of disabled children who receive or may later be entitled to receive public benefits (such as Supplemental Security Income or Medicaid).
- M. **QTIP Trust**—yet another special type of trust, this one intended to provide estate tax benefits for the heirs of a married couple while preventing the surviving spouse from exercising too much control over the property.
- N. **QDOT Trust**—still another special type of trust, intended to provide estate tax benefits similar to the A/B or QTIP trust to couples where one spouse is not a U.S. citizen.

II. **While you (both) are still alive**

Trusts can be very effective estate planning devices, provided one remembers that management and administration requirements do not end with signing the document. Trust administration is fairly straightforward while the Trustor is still alive (or, in the case of a married couple, while both Trustors are still living), but there are still some important principles which must be followed.

A. **“Funding” the trust**

One of the common reasons for establishing a trust is to avoid the need for probate proceedings. For the trust to accomplish that goal, it is necessary that no assets (or few assets) be in the Trustor’s individual name as of the time of death.

This usually means that most (or even all) assets need to be changed into the trust's name—a process referred to as “funding” the trust. One major exception to this principle is the treatment of retirement benefits (see the discussion below). At FLEMING & CURTI, P.L.C., we work with clients to accomplish asset transfers at the time the trust is created. The combined efforts of lawyer and client are often required to ensure that assets intended to be held in trust are actually transferred into the trust's name.

1. Title to trust assets

Most assets will either be in the name of the trust (actually, in the, Trustee's name and identifying the trust) or name the trust as beneficiary upon the Trustor's death. The usual formula for naming the trust in either case is to name the Trustee and identify the trust by name and date. For example, title might be held by “Thomas A. Curti and Lois K. Curti, as Trustees of the Curti Family Trust Dated February 14, 1981.” Even if the trust is later amended, its name remains the same. If the Trustees change, it may sometimes require a change in the asset's titling, as discussed later.

2. Transferring existing assets into the trust's name

Most assets will be transferred into the trust's name when the trust is created. This includes bank accounts, brokerage accounts, real estate and even personal property. There are usually a handful of assets, however, that are simply not worth the trouble to transfer into the trust. While it would be nice to get automobiles into the trust, for example, the cost of doing so may not be justified, particularly since Arizona law permits use of a simple affidavit process to “collect” personal property up to \$50,000 in value after the Trustor's death. Similarly, household

furnishings and furniture usually need not be actually transferred into the trust, especially if there is nothing of extraordinary value. With those practical exceptions, most assets need to be transferred to the trust (and maintained in the trust's name). Fine art or valuable collectibles, for example, may be transferred to the trust by signing a simple bill of sale.

a. Real estate—is title insurance necessary?

Real estate, including the family home, is almost always retitled to the trust. This requires that a deed be signed and recorded. For out-of-state property, it may be necessary to retain a lawyer to review the transfer documents and assist with the transfer. It is advisable to secure a rider on existing title insurance coverage to ensure continued coverage, though this adds another small expense to the process.

Arizona law requires that trust ownership of real estate must disclose the names of the trust beneficiaries. Since that may change over time, it may be necessary to record additional documents even after the trust has been in place for many years. Follow-up disclosure is also required if the Trustees change, so death of one spouse usually requires at least a simple filing with the Recorder's office. Most other states do not impose a similar requirement.

b. Fire and Homeowner's Insurance

You should contact your insurance company and let them know that you have transferred your home into the trust's name. The trust should be listed as an "additional insured" on those policies. There should be no charge for the change.

c. Bank accounts

Transferring bank accounts to the trust's name is usually as simple as retitling the account (although the bank may insist on moving the funds into a new account in the trust's name). For operating checking accounts, however, there may be another wrinkle: direct deposit of Social Security, pension benefits and/or payroll will require that the account remain in the individual's (or couple's) name. This problem can be solved by leaving the operating checking account (and, if necessary, a related savings account) in the individual's name, but with a "Pay on Death" (POD) designation in favor of the trust.

d. Stocks, brokerage accounts and mutual funds

Usually there is no problem with transferring stock accounts into the trust's name. Most brokerage houses and mutual fund companies will require that a new account be opened, and then transfer the contents of the current account into the trust's account. Individual stock certificates will need to be reissued. That may require considerable work in securing appropriate signatures, mailing original certificates to the stock transfer agent, and monitoring the process; most Trustors find it easier to simply deposit the stock certificates with a brokerage house, direct the transfer of the entire account into the trust's name, and "order out" the stock certificates in the trust's name. Some find that they actually prefer to leave the stock in the brokerage account, but there is no requirement that one or the other approach be followed.

e. **Business interests**

Closely-held corporations, Subchapter S corporations and Limited Liability Company interests should, in most cases, be transferred into the trust's name. Subchapter S corporations, particularly, require special care; before "S Corp." stock is transferred into the trust's name, the trust must have special language permitting it to hold such stock. Because there may be other considerations (partners' rights, succession plans, capital gains taxes, etc.), you should take care to discuss business transfers with both your attorney and your accountant.

f. **Partnerships**

It may be difficult to transfer either General or Limited Partnership interests into the trust's name, and the partnership may even prohibit such a change. Assuming that it is permissible, the partnership interest should usually be transferred. If you are uncertain about partnership interests, talk to your attorney.

g. **Automobiles and other personal property**

As mentioned before, it may be more trouble than benefit to transfer existing automobiles. Future automobiles can be purchased in the trust's name, after checking with the automobile insurance company to make sure there will be no difficulty with insurance (there should not be any problem, but it may take some education of individual agents).

If personal property has unusual value (and particularly if there is a title or provenance issue, as with fine art), it may be

advisable to actually transfer it into the trust. Otherwise, a simple declaration (in a separate document or in the Trustor's will) that all property is transferred to the trust should suffice.

3. Purchase of new assets

Any assets purchased after establishment of the trust should be titled in the trust's name. Although this should be obvious, it is surprising how often assets do not get added to the trust. It may be appropriate to schedule a periodic review of asset titles with your lawyer, financial adviser or accountant.

One of the most common scenarios occurs with changes in assets. A rental home, for example, might be titled to the trust but later sold. If the Trustors take the proceeds from that sale and open a bank or brokerage account in their own name, they have removed the asset from the trust. Even if the account carries a beneficiary designation, they may have caused problems with estate tax computation or payment, and may have changed the ultimate disposition of the property. Once the expense of establishing a trust has been incurred, it is important that the Trustor(s) and Trustee(s) be vigilant in monitoring the funding status of trust assets.

To help ensure that the trust remains properly funded, and to discuss any changes in circumstances or the law, some Trustors plan on a regular "check-up" meeting with the lawyer who drafted the trust. If the Trustor maintains a notebook with copies of statements, deeds and transfer documents in one place, such a meeting need not be lengthy or expensive.

B. **Beneficiary designations**

Some assets can not be titled directly to the trust (or need not be so titled). For many of those assets, the question becomes whether to name the trust as beneficiary, so that the proceeds are distributed to the trust on death of the Trustor. Among the most common assets of these types are life insurance policies, retirement accounts (including IRAs) and annuity contracts.

1. **IRAs and other retirement plans**

“Retirement plan” is a broad term. It encompasses “defined benefit” plans such as Social Security, Civil Service Retirement, Railroad Retirement, Arizona State Retirement and many other pension plans. It also includes “defined contribution” plans such as Individual Retirement Accounts, “401(k)” accounts and others. It is very difficult to imagine any circumstance in which retirement benefits should be **retitled** to the trust, since transferring ownership could trigger income taxation of the entire plan assets. Do NOT retitle retirement plan assets to the name of the trust without first consulting your accountant, lawyer and/or financial adviser. In at least some cases, however, the trust may be made the **beneficiary** (or secondary beneficiary) of such plans.

a. **Pensions**

Government pension plans (Social Security, for example) and most large-employer plans are “defined benefit” retirement programs. Although they may permit an election at the time of retirement, they usually do not include a death benefit. After the retirement and death of the employee, payments may be made to a surviving spouse but usually terminate after his or her death. In such plans, there is no need to involve the trust at all; upon the

Trustors' deaths, the benefits will cease.

b. IRAs, 401(k)s, etc.

Difficult choices face the "defined contribution" retirement plan owner when establishing a trust. On one hand, naming the trust as beneficiary helps to control the distribution of the entire estate (including retirement plan benefits), and makes it simpler to change distributions in the future. On the other hand, individual beneficiaries (especially spouses) usually have options which trusts do not have, with the result that there may be substantial income tax savings associated with naming an individual as the beneficiary.

Because each individual's circumstances may vary, it is difficult to generalize about the proper beneficiary designations for IRAs, 401(k) and 403(b) accounts and other similar retirement benefits. Usually the spouse should be named as primary beneficiary, but the choice between naming the trust or individual family members (or charities) as secondary beneficiary requires consideration of each Trustor's personal, financial and tax situation.

2. Life insurance

Usually (but not always), life insurance policies will name the trust as primary beneficiary. This may be true even for a married couple—it may be necessary to use the cash proceeds from the life insurance to make sure the deceased spouse's share of the trust reaches the maximum amount under federal estate tax law. Of course, the rules are very different for an irrevocable trust which was established precisely to hold life insurance, and that circumstance should be discussed with counsel separately.

3. Annuities

Unless annuities are “tax-sheltered,” they ordinarily will be titled to the trust and name the trust as beneficiary. For tax-sheltered annuities, the rules are similar to IRA rules, and require individual consideration after consultation with counsel.

C. Income tax returns

Once the trust is funded and operating, administrative concerns must be dealt with. The first concern is often the tax effect of establishing the trust. On this score, there is good news:

1. Filing tax returns

For the typical revocable trust, in which the Trustor(s) and Trustee(s) are the same, no special tax filing is required. Of course when the first spouse dies the rules may change, but that will be dealt with in a later section.

2. Tax ID numbers

Because no special tax filing is required, no tax ID number (TIN—though the number assigned to a trust is properly an Employer Identification Number, or EIN) is necessary. While some trust preparers routinely secure TINs for clients, there is no need to do so. Bank and brokerage accounts should continue to list the Trustor’s Social Security number, and anyone who asks for a trust TIN should also be given the Trustor’s Social Security number.

D. Trust administration

Before the death of a Trustor, the administration of the trust should be as

straightforward as the income tax issues. The Trustee(s) will ordinarily be able to deal with the property as if there were no trust; this makes sense, particularly where the Trustee(s) also established the trust, transferred assets to the trust's name, and retains the authority to revoke the trust at any time.

1. Trustees acting independently

Usually co-Trustees are given the authority to act independently of one another. This means that when a husband and wife have named themselves as co-Trustees, for example, either one of them will be able to sell trust assets, purchase new assets and sign documents for the trust. In most cases, this will be an advantage; if one spouse is temporarily unavailable, the other spouse will still be able to transact trust business. Under Arizona's community property rules, one spouse has the authority to manage almost all of the community assets for both spouses—the co-Trustee's power is essentially similar.

2. Requiring Trustees to act jointly

In some cases it may be advisable to require approval from both Trustees before permitting at least some transactions. If the power of a Trustee to act independently is to be limited, the trust document should carefully spell out that limitation. Unless the limitation is clear on the documents provided to others, it may be possible for a co-Trustee to dispose of or encumber property without both signatures.

3. Trustees dealing with separate property of one Trustor

A joint trust might contain both property that is jointly owned by the Trustors and property separately owned by one Trustor. In such a case, the trust document should spell out any limitations on the co-Trustee's powers, and the separate property should be clearly identified to minimize the likelihood that a co-Trustee could effect a change in the separate property improperly. Of course, if both Trustors are prepared to permit independent management of both joint and separate property, no special steps need be taken to protect against such a result.

4. Using the Certificate of Trust Existence and Authority

From time to time banks, stockbrokers, real estate agents and others may ask for a copy of the trust itself. Usually they only need to establish that the trust is still in existence and the name of the current Trustee(s). They may ask for a copy of the first page (showing the Trustee(s)) and the last page (including signatures) of the trust document. The short "Certificate of Trust Existence and Authority" (or similar document) is designed for precisely this purpose, and most individuals and organizations will be satisfied with a copy of that document. In that way, the contents of the trust need not be divulged to others unnecessarily.

E. Accounting requirements

General trust accounting rules require that the Trustee(s) account to trust beneficiaries on a regular (usually annual) basis. When no accountings are forthcoming, a beneficiary may resort to court action to enforce the requirement. The rules are different, however, for a trust that is still revocable.

1. When Trustee and Beneficiary are the same

While a trust is still revocable, and especially where the Trustee(s) and beneficiary(ies) are the same, no formal accounting requirement is imposed. It is, of course, prudent to maintain good account records. There is no requirement, however, that accountings be filed with the court or any other agency, and remainder beneficiaries are not entitled to accountings as a matter of right during the lifetimes of the income beneficiaries.

2. When someone other than Beneficiary is Trustee

Those principles change once the trust becomes irrevocable, as well as when the Trustee is no longer a beneficiary. The beneficiaries are entitled to a reasonable accounting at least annually; the purpose of such an accounting is to give them actual information about the trust's administration. No specific form is required, though there are widely accepted formats available through accountants and lawyers. The key issue is giving the beneficiaries sufficient information; it is not usually necessary to file the accountings with the court or any other entity or organization.

For purposes of this requirement, a trust becomes irrevocable if the person who established the trust is incapacitated, even if only temporarily. When a trustee takes over an irrevocable trust, or when a trust becomes irrevocable, the trustee should notify beneficiaries of the existence of the trust, the trustee's name and address, and their right to request a copy of the document and receive annual reports. For this purpose, "beneficiaries" includes anyone who is currently entitled to receive income from the trust, plus anyone who is named as a future beneficiary and who requests notice. Some practitioners would argue (and some state laws would require) that notice should be given to every person who will be entitled to receive income or principal from the trust after the

occurrence of some future event, such as the death of another beneficiary or the passage of time.

F. Amending (and revoking) the trust

Once a revocable trust is established and funded, it will probably require little maintenance. It may occasionally occur, however, that the trust must be amended to reflect changes in the Trustor's wishes or circumstances. An amendment will probably be both simpler and less expensive to complete than the original trust preparation.

Revocation of a trust is another matter. Once the expense and trouble of establishing a living trust have been undertaken, there are extremely limited circumstances in which it makes sense to revoke the trust altogether. Put another way, having a trust is almost never a disadvantage; the only disadvantage in most cases is the expense and difficulty of establishing a trust, and once those hurdles have been crossed it is unlikely that it will ever be advisable to terminate the trust. One large exception to that rule: in Arizona (and some other states) it may be necessary to transfer assets out of the trust when an application is made for Medicaid long-term care benefits. Before taking even that step, however, consult an attorney about how to maintain your investment in trust planning to the extent possible.

1. When you need to amend

Amendment of the trust may be necessary to appoint a new or different Trustee (or Successor Trustee), to change beneficiaries (or the terms under which the beneficiaries will take their shares) or to update administrative provisions. Amendments are **not** usually required when a beneficiary changes his or her name or address, or when assets change.

2. How amendments are completed

Amendment of a trust requires a formal document, and must follow the amendment procedure spelled out in the trust document. It is not enough to simply make changes on the trust instrument itself. Usually you will want to have an attorney make any amendments to the trust, though that is not required in order for the amendment to be effective. It is possible to cause unintended consequences by changing (or attempting to change) trust provisions, so you should get competent legal advice before making any such changes.

A trust amendment usually must be signed by both (or all) of the original Trustors. Some exceptions to that rule exist; some trusts permit the surviving spouse to amend the trust after the death of one spouse, and others may permit the Trustee (or an agent under a durable power of attorney, if the permission is included in both documents) to make the amendment.

3. Revocation

Physically destroying an original will (by, for example, tearing it up) revokes the will's terms. The same is not true for a trust. Revocation of a trust must follow the instructions in the trust itself; if there are no instructions, the revocation should be done with substantially the same formality as the trust itself.

G. Restating the trust

After a trust has been amended several times, it can become confusing to try to figure out which amendment is current, and which has been revoked (or amended) by subsequent amendments. At some point, usually after two or three

amendments, it becomes simpler to just rewrite the trust. Such a revision is referred to as a “restatement” of the trust, but is more accurately a complete amendment. After a restatement the trust is usually referred to as, for example, “The Curti Family Trust Dated February 14, 1981, as Restated on March 15, 1999.”

H. Changing Trustee(s)

When a Trustee dies, becomes incapacitated or resigns, a vacancy in the office of Trustee occurs. It may not be necessary to fill that vacancy—a married couple, for example, might serve as co-Trustees until the death of one spouse, with the surviving spouse serving as sole Trustee thereafter. The trust instrument should provide the rules for the succession of Trustees, as well as providing for how to determine that any Trustee has become incapacitated.

1. Resigning as Trustee

When a Trustee (or co-Trustee) simply wants to give up that role, it is an easy matter to resign the position. A simple signed statement that says “I hereby resign as Trustee of the _____ Trust Dated _____” should suffice to effect the resignation once it is delivered to the other Trustee or Successor Trustee. In order to make it clear that the signer is actually the Trustee, the resignation should be acknowledged by a notary public, but even that step is not required. Remember, however, that a resignation can not be rescinded; once the Trustee has resigned, he or she can not step back into the Trustee’s position (unless, of course, the resigning Trustee still retains the power to amend the trust and name a new Trustee).

2. Incapacity of one or both Trustees

A more difficult problem is faced with the incapacity of a Trustee. When there are two co-Trustees, the problem may never arise; most trusts permit either Trustee to act independently, and it may never be necessary to firmly establish the incapacity. If, however, the sole Trustee is incapacitated, or both Trustees are incapacitated, or someone (a title insurance company, or a stock brokerage house, for example) requires signatures from all current Trustees, it may be necessary to go through the steps to prove that a Trustee is not capable.

The first step in such a case is to review the trust document itself; it probably contains language that describes what is required to terminate a Trustee's power. The trust might, for example, provide that a letter signed by the Trustee's physician indicating that he or she is unable to handle the duties of Trustee is sufficient. If so, such a letter should be obtained and the original shown to any organization holding Trust assets.

3. Changing title to reflect new Trustee

It may be necessary to actually change the title on trust assets after a change in Trustee, but do not assume that it is always so. Arizona law does require that real estate held in trust accurately reflect the current Trustee(s) and beneficiaries, so if the trust holds real property it will probably be necessary to prepare and record a simple declaration concerning the change in status. It may be a good idea, even if it is not required, to update account information with banks, brokerage houses, stock transfer agents and insurance companies. Changing the title may require assistance from a lawyer, but will usually be fairly simple and inexpensive.

III. When one spouse dies (for married couples only)

When a joint trust holds community property and names both spouses as co-Trustees, administration of the trust works very much like administration of community property under Arizona law. When one spouse dies, however, the rules change and a legal review is probably in order.

A. Estate tax returns

The first question to address on the death of a spouse is whether an estate tax return is due. It is almost never necessary to pay any estate tax on the death of the first spouse, but that does not mean that no return is required. Similarly, it is important to understand that though a trust may avoid the necessity of probate proceedings, it does not also avoid the requirement of estate tax filings. When in doubt, consult with a lawyer or accountant shortly after the death of the first spouse.

1. \$2,000,000 limit (in 2007)

Federal estate tax law exempts estates of less than \$2,000,000 (that number is scheduled to rise after 2007, and the tax may be completely eliminated). In calculating whether a given estate exceeds that amount, remember that the deceased spouse only owned one-half of the community property in the trust. On the other hand, life insurance proceeds, personal effects and IRAs and other retirement accounts, along with all other assets the decedent (or his or her trust) had control over must be included.

If an estate tax return is required, it does not follow that any tax is due. In fact, filing an estate tax return can actually be beneficial, since it establishes the trust's new income tax basis in property—which may help

document the substantial capital gains tax savings if the property is later sold.

2. Timing

Estate tax returns are due nine months after the death of the decedent. There is a provision for an extension of time to file the return, but any tax due must be paid within the nine-month period in most cases.

3. Arizona and other state estate tax rules

Arizona does impose a state estate tax, but it can usually be ignored (until the actual filing, that is). If the estate is not large enough to require a federal estate tax return, there will not be a state return, either. If there is an Arizona estate tax paid, it will almost always be a credit on the federal estate tax payment, so that Arizona's state tax does not increase the total tax burden. Nonetheless, a return may be necessary, and so consideration should be given to filing an Arizona estate tax return shortly after the death of the spouse.

Other states may not apply the same rules as Arizona. Particularly if there is real estate in another state, there may be different filing requirements and even, in some cases, a state estate tax despite the estate not being large enough to require a federal estate tax return. If there is out-of-state property, you should discuss it with your lawyer and/or accountant. Several states are reviewing their estate tax rules because of the changes in federal estate tax law, and so this part of estate planning is currently in flux. No serious move has been initiated to reinstate Arizona's estate tax, but that might well change in the future.

B. Is probate necessary?

One of the principal purposes behind establishing a living trust is usually to avoid the expense and difficulty of the probate process. While a fully-funded living trust will usually accomplish that purpose, it sometimes happens that assets did not get moved into the trust, or accidentally (or otherwise) got moved back out of the trust after funding. In such cases, it may still be necessary to probate the deceased spouse's estate.

There may even be some circumstances in which probate is viewed in a positive light. Because probate proceedings can trigger a shortened "statute of limitations" (after which no lawsuit may be brought against the decedent's estate), sometimes the surviving spouse will be glad to initiate a probate proceeding. This is especially the case if the deceased spouse was a professional person (a lawyer, doctor or architect, for example), since the lingering possibility of professional malpractice actions can be unsettling to the survivor. Other potential creditors who may be cut off by a probate proceeding include contractors, landlords, and even parties injured in an accident involving the decedent.

C. The importance of "A/B" ("Survivor's" and "Decedent's") trusts

For married couples worth more than the federal estate tax exemption amount (\$2,000,000 in 2007), another primary purpose of the trust may be to minimize estate taxes on the second death. This is not an inherent feature of trusts, but requires that the trust contain special provisions. Those provisions are disadvantageous for most married couples who do not have estate tax concerns, so they will not be found in every trust for a married couple. Usually the estate tax provisions of a joint living trust for a married couple are referred to as "A/B" provisions. They may also be identified by reference to the trust itself; if the trust

provides for a split into two separate trusts on the death of the first spouse, it is probably intended to handle estate tax issues as well as probate avoidance and the other benefits available through trust planning.

An “A/B” trust document may refer to the two trusts as the “A Trust” and the “B Trust” or use other names altogether. Common terms include the “Marital Trust” and “Family Trust,” or the language usually used in FLEMING & CURTI, P.L.C., trusts: “Survivor’s Trust” and “Decedent’s Trust.” If any of those terms exist in the trust, the surviving spouse may want to seek legal help in deciding how to handle the administration of the trust after the death of the first spouse. With relatively new Arizona rules governing the administration of the “Decedent’s Trust,” the need for counsel has grown larger in recent years, and regular consultation with an attorney is recommended in this situation.

1. Separating assets

After the first spouse’s death, the division of an “A/B” trust into two (or more, in some cases) shares must be accomplished according to the terms of the trust itself. While these directions may serve as a helpful guide, the first task is to look at the document and take appropriate steps. Generally (but not always), the trust’s assets will be split fairly evenly between the two trusts, though the Decedent’s Trust will usually be limited to the federal estate tax exemption amount (\$2,000,000 in 2007). It may actually be to the heirs’ benefit to increase the size of the Decedent’s Trust, even though that may result in estate tax being paid by the surviving spouse; the trust may permit the surviving spouse to make this choice depending on his or her comfort level and personal wishes. Interpretation of the trust document (and discussion of the surviving spouse’s choices) will probably require a meeting with your lawyer.

a. **Determining which assets go where**

Again, it is difficult and dangerous to try to predict every circumstance, but there may be good reasons to try to move some kinds of assets into the Decedent's Trust, leaving others to the Survivor's Trust. Particularly in very large estates, for example, it may be advantageous to the ultimate heirs for the Decedent's Trust to hold those assets most likely to substantially appreciate before the death of the surviving spouse. The planned gradual reduction and possible elimination of the estate tax makes this selection more difficult; it may actually make more sense to put appreciating assets in the Survivor's Trust in order to maximize the stepped-up income tax basis on the second death.

b. **Physically making the division**

It is not sufficient to simply list those assets which will belong to the Decedent's Trust—they must be retitled in that trust's name. The proper name for the trust may be something like "The Curti Family Trust—Decedent's Trust" or similar title. Transfers of real estate to the Decedent's Trust will require a deed, and other assets will require retitling with the bank, brokerage house, insurance or mutual fund company.

c. **Timing**

The actual transfer of assets to the Decedent's Trust should occur as quickly as possible, especially since there may be income tax consequences from any delay. In essence, income and growth credited to the Decedent's Trust assets may be taxed as ordinary

income as of the time of transfer (from the date of death of the deceased spouse), so it is important not to delay the transfer. On the other hand, it may be impossible to determine which assets should be transferred until about the time an estate tax return is filed.

2. Income tax reporting and Tax ID Numbers

Though the Survivor's Trust share of the joint trust remains revocable after the death of one spouse, the Decedent's Trust becomes irrevocable. That fact, plus the surviving spouse's limited ability to change the ultimate beneficiaries, means that a separate income tax return will be required. Although the trust will usually not pay any income tax (the income is passed through to the surviving spouse, who pays all the tax), returns must still be filed. This means the trust will have to have its own Employer Identification Number (EIN). There is no need (and no advantage) to apply for this number before the death of the first spouse, but it will be required for the Decedent's Trust share of any "A/B" trust thereafter.

3. Administering the Decedent's Trust

The Decedent's Trust is irrevocable, and remainder beneficiaries are set (even though the surviving spouse may have some discretion to change the beneficiaries, or their shares). This means that the Trustee of the Decedent's Trust (frequently, but not always, the surviving spouse) must account to the beneficiaries, maintain appropriate investment standards and follow the rules governing trustees generally. The Trustee has some obligation to notify the **beneficiaries** of their right to receive a copy of the trust document and annual reports, and should keep the beneficiaries

updated on the Trustee's address.

a. **Requirements**

The Trustee of the Decedent's Trust must not:

- (1) Self-deal (for example, hire himself or herself to sell Trust real estate),
- (2) Commingle assets with his or her own assets, or with the Survivor's Trust (except that the two trusts might own separate shares in the same asset),
- (3) Charge an unreasonable fee for administering the Trust,
- (4) Invest imprudently (for example, highly speculative stock may not be appropriate).

The Trustee of the Decedent's Trust must:

- (5) Provide **beneficiaries** with the Trustee's name and address, and the name of the trust, and let them know that they are entitled to a copy of the trust document and annual reports,
- (6) Provide information to other beneficiaries on request,
- (7) Report to beneficiaries annually, keeping them reasonably informed about Trust investments, income and expenditures,
- (8) Exercise careful judgment in investment strategies, and follow the "Prudent Investor

Rule,”

- (9) Balance the interests of the remainder beneficiaries and those of the income beneficiary (for example, it would be inappropriate to invest a substantial trust estate solely in bonds just to maximize the income at the cost of future growth, just as it would be inappropriate to invest solely in growth stocks with little or no current or future income).

b. Goals

Despite those formidable-sounding requirements and limitations, the usual goal for the Decedent’s Trust is to minimize current income and maximize future growth. Although this may seem counterintuitive to the surviving spouse, it should be apparent that there is no gain (and substantial tax loss) associated with building up the surviving spouse’s estate only to have it taxed at a higher rate in the future. In the unlikely event that the Survivor’s Trust is later reduced or exhausted, the investments in the Decedent’s Trust can be switched to appropriate income-producing assets. In the meantime, it is often (but not always) beneficial to have most of the combined estate’s growth-oriented assets in the Decedent’s Trust.

D. Disclaimers

In some cases, it may be desirable to actually increase the value of the Decedent’s Trust on the first spouse’s death. This may be accomplished by the surviving spouse disclaiming some portion of the trust. Such an approach may

result in some estate tax being paid on the first death, but with significant tax savings on the second death.

Similarly, the surviving spouse may elect to disclaim property in such a way that it flows outright to children, grandchildren or other heirs. This may be attractive from a personal or tax perspective, or both. Disclaimers, if they are to be used, must be signed within nine months of the death of the first spouse and before the surviving spouse has received any benefit from the property. Use of disclaimers will almost certainly require consultation with an attorney.

E. Amending the trust(s)

When a married couple has an “A/B” or “QTIP” trust, some or all of the trust may become irrevocable (and unamendable) on the first death. For most joint trusts which do not contain “A/B” provisions, however, it is common for the surviving spouse to retain full power to amend or revoke the trust. Even if the trust does divide into two shares, the surviving spouse will usually retain the power to revoke or amend the “Survivor’s Trust” share. Because the issues are more complex, and have potential tax implications, it is even more important to consult your attorney if you wish to make changes in your trust after the death of one spouse.

F. Powers of appointment

Although the Decedent’s Trust must be irrevocable, the surviving spouse may be given a “limited power of appointment” over the trust. Such a power may permit the surviving spouse to change the shares to be distributed to the Trustors’ children and grandchildren, or to establish trusts for the benefit of those descendants. The power of appointment will not usually permit the surviving spouse to designate a non-family member as beneficiary, or to simply

withdraw the trust's assets—such a provision would defeat the estate tax planning purposes of the trust. Exercise of a power of appointment usually requires special language in the surviving spouse's will, and should not be attempted without legal advice.

IV. Death of the sole or surviving Trustor

Upon the death of the surviving spouse (or upon the death of the sole Trustor in the circumstance where the trust was established by a single individual), the rules for trust administration, accounting and taxes change yet again. The trust may continue for a period of time (for example, until a beneficiary reaches a certain age, or until a certain number of years after the Trustor's death) or dissolve on the death. In either event, some administration of the trust will be required, and it is unlikely that final distributions will be made for some months after the date of death.

A. Administration of Trust

Whether the trust will continue or terminate, the Trustee is required to administer the trust in accordance with fiduciary principles. This means that the Trustee is held to the same sort of standards described in an earlier section as applying to the Trustee of the Decedent's Trust: the Trustee must invest carefully, account fully, complete all tax returns and consider the needs and interests of the beneficiaries.

1. Successor Trustee's powers and duties

The Successor Trustee (named in the trust document) immediately takes over as Trustee on the death of the last named original Trustee. In fact, the trust document might even provide that the Successor Trustee

becomes a full Trustee on the death or incapacity of one of the original Trustees. Of course, the Successor Trustee might also already have taken on the role of Trustee if the original Trustee(s) became incapacitated or resigned.

a. Powers

Once the Successor Trustee becomes Trustee, he or she (or they) has all the power previously held by the Trustee(s). Remember, though, that the power to amend or revoke the trust was held by the Trustor(s), not the Trustee(s); the Successor Trustee will not usually be given that authority. The Successor Trustee will be able to liquidate stocks, bonds and mutual funds, pay the Trustor(s) debts, sell real estate, protect property and generally handle the trust's assets immediately after the death of the last original Trustee.

b. Duties

Just as with any trustee, the Successor Trustee must account to beneficiaries, file tax returns and faithfully administer the estate. The same rules against commingling funds, self-dealing and imprudent investments as applied to the Trustee of any irrevocable portion of the trust now control the Successor Trustee. When taking over from someone other than the Trustor, the Successor Trustee may also have a duty to inquire into the administration of the trust by the previous Trustee.

A Successor Trustee also has an affirmative duty to give notice of the fact that he or she has taken over administration of the Trust. Within sixty days, the Successor Trustee must give written

notice to **beneficiaries** (and note that the death of the Surviving Spouse may have changed the identities of beneficiaries) of the Trustee's name and address, and the name of the Trust.

Beneficiaries should also be advised of their right to receive a copy of the Trust document, and that they will receive annual reports on the Trust's financial status.

2. Notifying and dealing with depositories, brokers, etc.

In order to effect the change of trustees, the Successor Trustee must communicate the fact of the Trustee's death to financial institutions and other account holders. This is usually done by submitting death certificates, though they may not be available for some days (or weeks) after death. In practice, most banks will permit the Successor Trustee to have access to trust bank accounts more quickly, and few other decisions need to be made before death certificates are available. In rare situations, it might be necessary to file a court proceeding to document the death for access to assets.

Remember that Arizona law requires notice of the change of trustee to be recorded if the trust holds real property. Once again, the mechanics of transferring control to the Successor Trustee may require some legal assistance.

B. Is probate necessary?

Once immediate concerns have been answered, it will be time to consider whether any court proceedings are required. Usually the combination of trust funding and designating the trust as beneficiary on some accounts will avoid any need for probate proceedings. Assets may have been overlooked, or

inadvertently transferred out of the trust's name; in that case, a probate may be required. Usually when a trust is executed the Trustors also sign "pourover" wills, leaving their estates to the trust. If everything works as planned, those wills should not be necessary.

As with the death of the first spouse, there may be some circumstances in which the probate proceeding is helpful to heirs, though this is less likely to be an issue for the children (or other beneficiaries) than it was for a surviving spouse. The creditor-protection value of probate, for example, is usually only important if the deceased Trustor was a professional (doctor, lawyer, architect, etc.).

C. Income tax returns

Even though the trust may avoid any need for probate proceedings, income tax returns will still be required. After the death of the Trustor(s), two different kinds of income tax returns (at least) are necessary:

1. Decedent's income taxes for final year

Income earned by the trust while the Trustor was still alive is ordinarily taxed directly to the Trustor. After the Trustor's death, a final income tax return needs to be prepared for the portion of the year until the date of death. Ordinarily the personal representative (executor) is responsible for preparing that tax return, but if no probate proceedings are required there will be no personal representative. The Trustor's final income tax return will usually be signed and filed by the Trustee. It will not be due until April 15 of the year following the Trustor's death, even if the date of death is early in the year.

2. Trust's income taxes for each year of administration

After the Trustor's date of death, all income earned by the trust is taxed to the trust itself (or, if benefits are paid to the remainder beneficiaries, to those beneficiaries). Even though the income may be "passed through" to beneficiaries, the trust must file an annual return until it is dissolved. In many cases, the trust will terminate on the death of the Trustor; nonetheless, it will probably earn income during the period of administration before final distribution can be made, and at least one income tax return will probably be necessary.

a. Filing returns

Trust income tax returns are based on calendar years and due on April 15 of each year. In many cases, the trust will have been concluded before December 31, but a trust income tax return will still be due on the following April 15. Trust income taxes are filed on federal Form 1041 (and Arizona State Form 141) and are referred to as Fiduciary Income Tax returns.

b. Tax ID Numbers

After the death of the last Trustor it will almost always be necessary to secure an Employer Identification Number (EIN) for the trust. If a Decedent's Trust has been operating and filing income tax returns, its EIN may be sufficient if the Survivor's Trust is added to the Decedent's Trust on the surviving spouse's death. Shortly after the death of the Trustor, the Successor Trustee should consult an accountant or lawyer about establishing the appropriate EIN so that there is no need to later revise information improperly reported

under the Trustor's Social Security number.

c. Paying the income taxes

The trust is liable for income taxes on income earned by trust assets. Distributions to beneficiaries, however, are deducted from income before tax is calculated. This means that in most cases the trust will not actually pay any income taxes. When the trust does pay income taxes, the tax structure is very aggressive; trusts pay at higher marginal rates than individuals with similar income, so it is advantageous (for tax purposes) to make distributions from the trust.

The other side of that issue is that income distributed to beneficiaries will be taxable to them. The trust will need to provide a federal Form K-1 for each beneficiary who has received money from the trust. Not all distributions are taxed to the beneficiary. Tax is due on trust distributions only to the extent that the trust itself had taxable income. The income thus passed through to beneficiaries retains its character, so that municipal bond income remains tax-free, for example.

d. State income tax returns

In addition to federal tax returns, state returns must be filed for the trust after the death of the Trustor. As with the federal tax liability, state taxes will be due from the trust only on undistributed income. Beneficiaries who receive distributions will pay income tax to the extent that the trust received taxable income. Distributions to out-of-state beneficiaries may require that they file an Arizona State

income tax return.

3. IRAs and qualified retirement plans

If the trust has been named as beneficiary of a tax-qualified retirement plan (such as an IRA, a 401(k) or a 403(b)), the deferred income tax liability could all be due in the year the Trustor dies. The same result would be reached if an individual plan beneficiary chose to withdraw all the funds shortly after the owner's death, but the flexibility to extend the tax liability is lost if the Trust is named as beneficiary of the plan—unless the Trust has specifically been constructed to qualify as a beneficiary of tax-qualified plans.

D. Estate tax returns

If the Trustor's estate (including all trust assets but excluding any assets held as part of a Decedent's Trust) exceeds the federal exemption amount (\$2,000,000 in 2007), both a federal and state estate tax return will be due. In calculating the value of the Trustor's estate, assume that life insurance, personal property, joint tenancy property and anything purchased by the Trustor during life will be included in the computation. In fact, careful planning may have removed some of those assets from the taxable estate, but begin with the assumption that the estate is larger before deciding no tax return is required.

1. Federal vs. State taxes

If an estate tax return is due, both a federal and Arizona state return will be required. In addition, if the Trustor (or the trust) owned any real estate in another state, a third estate tax return may be necessary.

Although Arizona does impose an estate tax, there is a 100% credit on the

federal estate tax return for any tax paid, so the Arizona return will not increase the total tax liability.

2. Due dates

Both federal and state estate tax returns must be filed nine months after the Trustor's death. Because tax law permits the Trustee to value assets as of either the date of death or the six-month anniversary of the death, the Trustee will not usually want to file the return for six months. In other words, a taxable trust will ordinarily be maintained for at least six to twelve months after the death of the Trustor, even if it provides for immediate distribution to beneficiaries.

E. Wrapping up the Trust

Once all tax liabilities have been settled and the Trustor's debts paid (assuming the trust provides for payment of those debts), it is time to close the administrative phase of the trust. If the trust provides for distribution to beneficiaries, this is the time for the Trustee to make distributions and dissolve the trust itself. If an estate tax return was filed, the Trustee should usually retain at least some funds until that return has been accepted by the IRS—a process that usually takes about nine months from the filing of the return. If the trust provides that it will continue (or a portion of it will continue) for the benefit of one or more beneficiaries, the Trustee will now shift focus to managing the trust for those purposes.

1. Distributions and timing

No court approval or government action is necessary before distributions can be made. The Successor Trustee has an obligation to

adequately account to beneficiaries, but there is no formal proceeding or specific format in which to deliver that accounting. It is probably prudent for the Successor Trustee to prepare some sort of formal accounting and have beneficiaries acknowledge receipt, waive any further accounting and consent to dissolution of the trust.

2. Continuing trusts

When the trust (or a portion of the trust) will continue for the benefit of one or more beneficiaries, no court involvement is required. The Trustee of the continuing trust will be obligated to file annual tax returns, to account to the beneficiaries and to invest prudently. Any beneficiary has the right to ask an appropriate court to supervise administration of the trust, but in the absence of any controversy the trust should be easy to manage. One interesting point—the “situs” of the trust (that is, the state in which the trust “lives” for tax and administrative purposes) is usually the state of residence of the Trustee. This means that an Arizona trust established with Arizona property and administered for the benefit of your Arizona child can actually become a California (or Illinois or Florida) trust if the Successor Trustee is from that state.

V. Miscellaneous Issues

A number of specific issues regularly arise in trust administration and estate planning, including these:

A. Safe deposit boxes

Under current Arizona law, a safe deposit box is no longer “frozen” on the death of one owner. It is no longer necessary to inventory the box’s contents and

secure state tax authority approval before removing those contents. It is still necessary to get some supervision to open the box if you are acting solely as personal representative or trustee, however, so it is a good idea to have your trustee named as a joint owner of the box if you want them to be able to get into the box after your death.

B. Where should I keep my trust?

Even though getting into the safety deposit box is no longer as difficult as it once was, the bank is a usually a poor place to keep your original estate planning documents. We recommend that the originals remain in your home; in the event of an emergency, that is where they will be available to your Trustee and the agent named in your power of attorney. Those individuals may need the original documents on the weekend or late at night, and even during the daytime a trip to the bank to open the safe deposit box may be a nuisance or, worse, a life-threatening delay.

C. Who should get copies of my trust, will and powers of attorney?

At least as it applies to your trust and will, there is no right answer to this question. Some of our clients prefer not to discuss their estate plans with children and others, while some clients want to have the information available to the whole family. Either course is proper, though if you decide not to share the documents you should at least notify the Successor Trustee of his or her role, so that he or she knows it is important to step in when an emergency arises.

With regard to your power of attorney for health care, the answer is completely different. This one document (including a living will, if you have executed a separate document) needs to be widely shared and discussed. Copies should be provided to every family member (**particularly** any family member

who is likely to disagree), your physician(s), your clergy, rabbi or other religious advisor, involved friends and neighbors and the local bartender. Wide distribution and family discussion of this document is the best way to ensure that your wishes will actually be carried out.

D. Personal property lists

Arizona law permits you to include a provision in your will referring to a list of personal property and who you wish to receive individual items. This list is particularly useful for distributing family heirlooms and keepsakes (it is not as useful for larger items, like cars or valuable collections). When we prepare a will, we almost always include reference to such a list; even your trust may refer to the list described in your will. We encourage everyone to make such a list, as our experience is that family members are much happier when individual items have been left to them. The personal property list need not be prepared by a lawyer; in fact, most lists are handwritten and evolve over time.

E. Will my trust protect me against future creditors?

In a word, no. Although there are means to protect against future creditors (but not currently known creditors—that would be a civil fraud in the law's eyes), they require much more elaborate and expensive steps than a simple trust. If you wish to discuss asset-protection techniques, we will be happy to explain your options. In the meantime, the ordinary revocable trust provides no such protection.

A trust you establish (with your assets) for the benefit of your children **will** be protected against **their** creditors, at least until the Trustee makes distribution of trust assets or income. This makes the trust very useful if you have children with checkered financial experience. The important protection in such a trust is

usually referred to as the “spendthrift” clause.

F. Will my trust help if I require nursing home placement in the future?

Again, the short answer is no. As with protection against creditors, the trust is simply ineffective at sheltering your assets from being used for your needs.

Under Arizona law, however, there is a quirk that modifies this answer somewhat. For a married couple, there may be a slight advantage to having a trust well in advance of any nursing home placement, particularly if the trust expressly permits transfer of assets out of the trust into the name of only one spouse. This may make it possible to secure Medicaid coverage for long-term care placement somewhat more quickly, but is not by itself a sufficient reason to establish a trust in most cases.

G. Using a Certificate of Trust Existence

The “Certificate of Trust Existence and Authority” prepared by FLEMING & CURTI, P.L.C. at the same time as any trust (or any significant amendment or restatement) is intended to provide information about the Trustor(s), Trustee(s) and beneficiaries of the trust. This short (one or two page) document is ideal for recording (it complies with Arizona law requiring disclosure of the Trustee, Trustor and beneficiary) or delivery to banks, brokerage houses and other asset holders. Sometimes individual institutions do not accept the Certificate; they may require a photocopy of the first and last pages of the trust document itself. For most purposes, however, the Certificate provides a simple way of giving the Recorder’s office and institutions all the information they need to permit trust assets to be titled to the trust. For most purposes (but not for recording) a copy

of the Certificate will be sufficient.

H. Does the Trust have to be recorded?

No. Arizona law does not provide for recording of trusts. While there is nothing preventing recording of the entire trust with the County Recorder's office, there is nothing to be gained from doing so. Meanwhile a substantial recording fee will be incurred, and the public will have access to the content of your trust.