Most people come to estate planning with a single hope: "I just want to make things simple and avoid taxes for my family." Trusts often get sold as a magic key that unlocks tax-free inheritances, Medicaid protection, and probate avoidance in one neat package.

Reality is more nuanced. Trusts are powerful tools, but they do not automatically eliminate inheritance tax, and they can create unintended tax or legal problems if they are drafted or funded carelessly.

I work with California families who have a mix of assets: a primary home, retirement accounts, a family business or rental property, and sometimes aging parents who may need long term care. The same questions surface again and again. Is it better to have a will or a trust in California? Do all wills in California have to go through probate? Can a nursing home take your house if it is in a trust? How much tax do you pay if you inherit 100,000 dollars?

Let us walk through how trusts really interact with federal taxes, California rules, and practical family dynamics, using plain language and real trade offs.

Start with the right question: estate tax, inheritance tax, or income tax?

When someone asks, "Do trusts avoid inheritance tax?" they are usually mixing three different tax concepts.

Federal law uses an estate tax system, not an inheritance tax. The estate tax applies to the value of what you own at death. A handful of states impose inheritance tax directly on the recipient. California currently imposes neither a state estate tax nor a state inheritance tax.

On top of that, there is income tax on what the heirs or the trust itself earn after death. Many of the biggest surprises happen here, not with estate tax.

For context, as of 2024, the federal estate tax exemption is in the ballpark of 13 million dollars per person, or roughly 26 million for a married couple with proper planning. That number is scheduled to be cut roughly in half after 2025 if Congress does nothing. Even after that reduction, the majority of Californians will still not pay federal estate tax, but high real estate values mean more “middle class millionaires” will be closer to the line than they think.

So the right starting question in most California cases is not “Do trusts avoid inheritance tax?” but rather:

1. Do we have a realistic estate tax exposure at federal level now or after 2025?
2. How will income tax, capital gains, and property tax affect what my kids actually keep?
3. Can we avoid or shorten probate, and what happens if we do not?

Trusts can help with all three, but in different ways.

What taxes do trusts actually avoid?

There is no single, universal rule that “trusts avoid taxes.” The answer depends on the type of trust.

A standard California living trust, also called a revocable trust, usually avoids probate but does not avoid federal estate tax or income tax during your lifetime. For tax purposes you are treated as still owning the assets. The upside is flexibility and a full step up in basis at death for most appreciated assets.

Irrevocable trusts are a different animal. Depending on how they are drafted, they can:

- Remove appreciating assets from your taxable estate over time.
- Shift future income to beneficiaries in lower tax brackets.
- Protect assets from certain creditors or long term care spend down, if done well in advance and consistent with federal and state rules.

However, irrevocable trusts often pay income tax at very compressed brackets if they accumulate income rather than distribute it. They can also lose the basis step up if you are not careful.

From a federal tax standpoint, the most common benefits of trusts are:

1. Estate tax reduction for very large estates, through lifetime gifting into irrevocable trusts.
2. Income tax planning, for example, sprinkling distributions among children in lower brackets or using charitable remainder or lead trusts.
3. Capital gains planning, particularly around whether assets get a step up at death versus carryover basis.

From a California standpoint, the trust’s main “tax” benefit in most middle class estates is not actually a tax, but the avoidance of full probate with its statutory fees.

Probate in California: why people use living trusts

A big part of the “trusts avoid tax” myth in California comes from confusion between tax and probate.

California probate is court supervised, very public, and can be slow and expensive. Do all wills in California have to go through probate? No. Small estates under a certain threshold can use simplified procedures, and certain assets pass outside probate no matter what a will says.

But if you die with only a will and you own a home or other assets in your name alone that exceed the small estate threshold, a formal probate is usually required. The statutory fees run on a sliding scale based on gross value, not net equity. For a 1 million dollar house with a 700,000 dollar mortgage, the court looks at 1 million, not 300,000.

That is why most California homeowners are advised to use a revocable living trust. Properly funded, a living trust can:

- Avoid formal probate for assets titled in the trust.
- Keep basic family financial details out of the public record.
- Make administration smoother when dealing with banks and title companies.

The trade off is ongoing responsibility. A trust that is not funded is a very expensive stack of paper. Which bank accounts avoid probate? In practice, any account correctly titled in the name of the trust, or with a valid pay on death or transfer on death designation, usually bypasses probate. If you forget to move accounts or update titles, your estate can still end up in court.

What happens if you do not file probate in California when one is required? The estate can stall. Title companies may refuse to transfer real estate. Banks may block access to accounts. Beneficiaries can go to court to force action, and in the meantime property taxes, insurance, and mortgage payments still need to be handled.

This is where I see one of the most common inheritance mistakes: people assume the existence of a will or trust is enough, and do not follow through on funding, titling, or basic administration.

Will or trust in California: which is better?

“Is it better to have a will or a trust in California?” is like asking whether it is better to have a car or a bike. It depends on the trip.

A simple will can work for renters with modest financial assets and clear beneficiaries, particularly if their estate will fall under the small estate threshold. The average cost for estate planning in California for a straightforward will package might range from a few hundred to around 1,500 dollars, depending on complexity and the attorney’s experience.

For homeowners or people with blended families, a living trust is often worth the additional cost. A solid revocable trust based plan in California frequently runs in the range of 2,000 to 5,000 dollars for a couple, again varying with complexity, tax planning, and the experience of the lawyer. If you are seeing numbers far below that for a customized plan, ask what is being included and what is not.

The downside of a living trust in California is not usually taxes but maintenance. You need to:

- Retitle assets into the trust, including the house, and follow up with lenders and insurers.
- Keep beneficiary designations on retirement accounts and insurance coordinated with the trust terms.
- Review the plan after remarriage, divorce, births, or significant changes in net worth.

If you do not, the trust can fail to accomplish what you paid for. That is why some people later ask, “What is better than a trust?” The answer is not a different document, but a simpler, maintained plan that fits your life. For some, that is a will plus beneficiary designations. For many California homeowners, it is a well drafted, properly funded living trust.

Trusts and long term care: the 5 year and 2 year “rules”

A huge amount of myth swirls around Medicaid, nursing homes, and trusts.

The federal Medicaid program has a 5 year California Estate Planning lookback on asset transfers in most states. People often ask how to avoid Medicaid 5 year lookback, or "What is the 5 year rule on trusts?" The rule is not that putting your house in a trust magically protects it after 5 years. The rule is that certain transfers for less than fair value, including gifts into some kinds of irrevocable trusts, may trigger a penalty period if you apply for Medicaid within 5 years.

California's Medi Cal rules have been evolving, and there are nuances about which assets are countable and which are not. A basic revocable living trust does not protect assets from Medi Cal. For eligibility purposes, you are still treated as owning what your revocable trust owns.

Can a nursing home take your house if it is in a trust? A nursing facility itself does not usually "take" anything, but the state can, in some circumstances, seek reimbursement from your estate or recovery against assets after death. Whether your home is in your name or your revocable trust often does not change that.

Irrevocable trusts may help with long term care planning in some situations, but they must be carefully structured and done well in advance. That brings up the 2 year rule for trusts and the 2 year rule after death, phrases that sometimes surface in discussions of creditor claims, claim periods after death, or special state statutes. In California, most creditor claims and estate tax audits have specific time windows, but it is not a universal "2 year rule" across all trusts. If you are seeing generic references to a 2 year rule for trusts, be cautious. These are typically oversimplifications, or they may be drawing from other states' rules.

The 7 year rule for trusts and the 7 year rule on inheritance usually refers to United Kingdom inheritance tax rules, not US or California law. I sometimes see clients who read about those online and worry they have missed a 7 year deadline. They have not, at least not under US federal or California law.

Key distribution rules: 5 by 5 and "5 of 5000"

High net worth families sometimes see language in older trusts about the "5 by 5 rule in estate planning" or the "5 of 5000 rule in trust" documents and wonder if something is wrong.

The so called 5 by 5 power allows a beneficiary to withdraw the greater of 5 percent of the trust principal or 5,000 dollars per year. It is a way to give a beneficiary some access to trust funds while limiting inclusion in the beneficiary's own estate for tax purposes. When drafted correctly and managed prudently, it can balance control and flexibility.

You might see this as a right to withdraw up to "5 of 5000" or "5 or 5,000" each year. The trust may grant the power but expect that most beneficiaries will not exercise it annually. This is one of those technical tax concepts that lives in the fine print, but it has real consequences if the trust swells in value. A 10 million dollar trust with a 5 percent power theoretically lets the beneficiary pull 500,000 dollars per year. If your goal is long term asset protection for a child with poor money habits, that is a problem.

This is why boilerplate trust language, copied across generations, can lead to outcomes the original family never intended.

"Worst" assets to inherit, tax wise

People sometimes ask, "What are the six worst assets to inherit?" The exact list varies by family, but certain patterns repeat in California.

Non Roth retirement accounts like traditional IRAs and 401(k)s are often at or near the top. When a non spouse inherits a traditional IRA, the new 10 year distribution rule usually applies. The beneficiary often must empty the account within 10 years, paying income tax at their own marginal rates. For a high earning adult child, inheriting a 1 million dollar traditional IRA can feel like taking on a tax time bomb.

Other candidates for the worst assets to inherit include low basis rental property in another state with difficult probate, closely held businesses with poor records, timeshares with ongoing fees but little market value, and heavily leveraged properties with tax issues.

Here is a short, practical snapshot of frequently problematic inheritances:

1. Large traditional IRAs or 401(k)s for high bracket heirs.
2. Out of state real estate held individually, not in a trust or entity.
3. Assets with big built in gains but no step up, such as some irrevocable trust assets.
4. Partnerships or LLCs with messy or missing operating agreements.
5. Timeshares and fractional interests with recurring costs.

These are not always bad, but they require more planning both before and after death.

Who should not be a beneficiary or what should not go in the trust?

People sometimes fixate on strange questions, like “Can I sell my house to my son for 1 dollar?” Technically you can transfer for less than fair value, but you may trigger gift tax reporting, property tax reassessment issues in California, and conflict among siblings who feel shortchanged. It is usually cleaner, from an estate planning perspective, to use a trust or transfer on death arrangement and equalize gifts across children.

A more important question is “Who should I not name as a beneficiary?” and “What should you not put in a trust?” Missteps here cause long lasting family fractures.

I have seen trusts that name a minor child outright, with no backup provisions if the child struggles with substance abuse, disability, or serious debt. I have seen ex spouses left as beneficiaries on old retirement accounts, long after the divorce. And I have seen people try to put everything they own into the trust, including retirement accounts that are better handled by beneficiary designation to an individual or specially designed see through trust.

A short, focused list can help clarify common red flags:

1. Avoid naming minor children directly on beneficiary forms without a trust or custodial structure.
2. Be cautious about naming financially troubled adults or those on needs based benefits without protective trust terms.
3. Think twice before naming your estate as beneficiary of life insurance or retirement accounts, which can cause unnecessary tax and probate exposure.
4. Coordinate retirement accounts with qualified trust provisions, rather than retitling them into the trust during life.
5. Revisit any designation that gives an ex spouse or estranged relative a windfall that does not match your current intent.

As for what are three things to avoid putting in a will, retirement account distributions, detailed instructions about digital accounts that belong in a separate memorandum, and complex business succession terms that conflict with your operating agreement are frequent culprits. The principle is simple: do not force an asset that already passes cleanly by contract into the slower, more public will based process if you can help it.

Practical tax perspective: “How much tax do you pay if you inherit 100,000 dollars?”

Many Californians are relieved to learn that there is no California inheritance tax at the moment. If you inherit 100,000 dollars in cash from a US citizen or resident, there is typically no federal inheritance tax either. The estate may have had an estate tax issue at death if it was very large, but the recipient does not file an inheritance return.

The real question is what kind of 100,000 dollars you receive.

If it comes as cash from a checking account, there is generally no income tax. If it comes as 100,000 dollars of traditional IRA, you will likely owe income tax as you withdraw it, subject to the 10 year rule. If it comes as appreciated stock outside a retirement account, you often receive a basis step up to the value as of the date of death. You then pay capital gains tax only on growth after that date.

Some families ask about the 10,000 dollar death benefit they heard about, thinking it is automatic. In reality, particular pensions, union plans, or veteran’s benefits may offer specific death benefits, and some older state inheritance tax regimes had small exemptions for funeral costs or modest cash. There is no universal federal 10,000 dollar death benefit that applies across the board.

This is why the best way to leave inheritance to your children is not a fixed template, but a matching of asset type to child’s situation. A high earning child may prefer more Roth assets and stepped up brokerage accounts, and less pre tax retirement money. A financially unstable child may need a fully discretionary trust. A child with special needs may require a supplemental needs trust, not an outright gift.

Real world downsides and common mistakes with trusts and wills

Every planning tool has a downside. The downside of having a trust is not just cost. It is the false sense of security that can come when you sign a stack of documents, put them in a drawer, and never review them again.

Common mistakes people make with trusts include:

- Failing to fund the trust, leaving real estate or key accounts in their own name.
- Naming co trustees who cannot work together.
- Ignoring successor trustee choices for decades, so all named people are deceased or infirm when needed.
- Drafting overly rigid distribution standards that do not age well as children grow from toddlers to adults to retirees.

On the will side, the biggest mistakes people make with their will are often psychological, not legal. They avoid hard conversations about unequal inheritances. They make optimistic assumptions about a child’s sobriety or stability. Or they rely on a handwritten form without considering state formalities, leading to costly litigation. The most common inheritance mistake I see in California is leaving real estate to multiple children equally, with no guidance on whether the property should be sold, rented, or used by one child with a buyout structure. Conflict inevitably follows.

A related issue is what not to do immediately after someone dies. Grief and paperwork do not mix well. Families sometimes rush to clean out the house, change locks, and start selling assets without understanding their legal authority. Others delay everything, letting property taxes fall behind and insurance lapse. There is a practical middle ground: secure the property, order death certificates, notify key institutions, but hold off on big financial moves until you understand the plan and your role.

The question “Why do you have to wait 10 months after probate?” usually stems from hearing that executors often wait many months before making final distributions. In California, creditors have a limited period to file claims. Tax authorities can review returns. The executor or trustee needs time to inventory assets, pay bills, and resolve disputes. Partial distributions during administration are common, but responsible fiduciaries keep a cushion until the dust settles.

Property, children, and the “house question”

For many California families, the house is the emotional and financial center of the estate. What is the best way to leave your house to your children? There is rarely a one size fits all answer.

Putting the house into a living trust while you are alive is often wise. Is it wise to put your house in a living trust? For probate avoidance and smoother transition, in most California homeowner situations, yes. The more nuanced questions are whether to leave it equally to all children, to a specific child, or to the trust with instructions to sell and divide the proceeds.

What are the disadvantages of putting your house in a trust? For a typical revocable living trust, the disadvantages are minor: you must retitle the deed and ensure your insurer recognizes the trust. For some types of irrevocable trusts, disadvantages include loss of control, difficulty refinancing, and potential loss of property tax benefits if not structured carefully.

Can I lose my home if my husband goes into a nursing home? Under Medi Cal rules, a primary residence is often treated differently from other assets, but estate recovery and post death claims can still be a concern. A revocable trust alone will not solve that.

The best approach is to integrate the house into the broader plan. If one child has been living there and contributing to care, it may make sense for that child to receive the home subject to a mortgage or equalization. If no child wants to live there, instructing the trustee to sell within a reasonable time and divide net proceeds can prevent lingering disputes.

Pulling it together: strategy, not superstition

Trusts do not magically avoid inheritance tax, especially in California where the more pressing issues are probate, income tax, and property tax. The choice between will and trust, revocable and irrevocable, is less about trendy rules like the “5 year rule for a trust” and more about aligning tools with your actual assets, family, and risk tolerance.

A thoughtful California estate plan tends to share a few traits:

It accepts that probate rules exist and works with them by using a living trust for major assets, especially real estate, rather than pretending a simple will can always avoid court. It understands that not all assets are equal, and it pays special attention to the worst assets to inherit, like large pre tax retirement accounts or messy business interests. It respects that tax rules shift, such as the scheduled changes in federal exemption and the 10 year rule for inherited IRAs, and it builds in some flexibility through powers of appointment or discretionary trusts. And most important, it keeps documents, beneficiary designations, and asset titles consistent and updated, instead of treating the signing date as the end of the process.

If you view trusts as one tool among many, instead of as a tax magic trick, you are far more likely to leave your children something more valuable than dollars: clarity, reduced conflict, and a structure that actually works when they need it.