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REVOCABLE LIVING TRUST PLANNING BENEFITS

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Overview

Traditionally, most individuals are familiar with the Will as their major estate planning document. The Will, among other matters, contains the individual's instructions as to how his or her property is to pass at death. The problem with a Will is that it must be admitted to probate to be effective. Additionally, the "Will only" estate plan does not avoid the need for a guardianship proceeding (sometimes referred to as "living probate") in the event the individual becomes incompetent or not able to properly care for himself or herself.

Objections to the use of a "Will only" plan include the expense and delay of the probate process and the loss of privacy. Once the Will is filed for probate, it is a public document and generally may be examined by anyone. During one's life, it is unlikely that anyone would want to publish his or her financial and personal affairs for the whole world to view. Yet, that is exactly what happens when a Will is the primary estate planning document.

Another objection is that an unhappy relative may, at little personal expense to him or her, but at great inconvenience, delay and expense to the decedent's estate and family, frustrate the probate process by filing objections to the probate of the Will.

The Living Trust is a Better Way

To avoid the detriments of the probate process, more and more people are turning to the Revocable Living Trust (the "**RevTrust**") as an alternative to the Will. Although both the Will and **RevTrust** are used for estate planning purposes, the basic difference between the two is when the document takes effect. The Will does not take effect until death, while the trust is effective immediately and continues without interruption notwithstanding the grantor's incapacity or death.

Structuring the Living Trust

The person creating a living trust is known as the "grantor," "settlor," "trustor," or "creator." The grantor creates a **RevTrust** usually naming himself or herself as trustee and as the sole beneficiary during his or her lifetime. The spouse or other close relative is often named as a co-trustee. Most states now permit the grantor to be the sole trustee thereby avoiding the merger doctrine (which results in a legal life estate terminating the trust when the trustee and beneficiary are the same person). On the grantor's death, the trust becomes irrevocable. Each spouse should have his or her own **RevTrust**. It is usually recommended that both spouses be named as trustees of each trust and provision be made in each trust for naming successor trustees, such as adult children.

The **RevTrust** includes all the provisions typically found in a Will, including use of all the mechanisms designed to reduce death taxes, such as the unlimited marital deduction and the credit shelter (by-pass) trust which avoids estate tax on the applicable exclusion amount: $625,000 in 1998, $650,000 in 1999 and increasing in increments to $1 million in 2006. (The applicable exclusion amount was previously referred to as credit shelter exemption equivalent.)

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Pour-Over Will

Since it is possible that not all of the grantor's assets will have been transferred to the **RevTrust** at the time of death, it is common practice for the grantor to execute what is referred to as a "Pour-Over Will." The Pour-Over Will states that any property owned at death which had not been previously transferred to the **RevTrust** shall be transferred by the executor to the **RevTrust**. If there are such omitted assets, then only those assets are subject to probate.

On the other hand, the assets in the **RevTrust** are not subject to probate and they may be managed as provided in the **RevTrust**. This means, for example, that the trustee may buy and sell assets and make distributions to beneficiaries before applying to court to probate the Will, and before the expiration of any statutory minimum time periods.

Grantor Retains Control

With a Will, the individual always keeps control of his or her property. The grantor of a **RevTrust** retains the same control. The grantor's control of the trust property is as complete as if title in the individual's property had never been transferred to the **RevTrust**, but with the additional benefit that since title is in fact transferred, the grantor and his or her survivors need not be concerned about probate.

Control is maintained by simply so providing in the trust document. Although the grantor usually names himself or herself as trustee along with other family members, the grantor will reserve the right to name new trustees and to remove or replace any trustee at any time. Since the **RevTrust** is revocable, the grantor may make any desired changes at any time and from time to time. These include adding property to the trust, withdrawing property from the trust, changing the dispositive provisions (i.e., who gets what), changing the trustees, and even terminating the trust.

The Grantor's Subsequent Incapacity— Living Probate

If the grantor becomes incapacitated, the trust continues with the other trustees managing the trust property without interruption. In the absence of a living revocable trust or a durable power of attorney, court proceedings — or what many practitioners refer to as "living probate" — is required for the purpose of appointing a conservator or guardian of the person and property of the incapacitated person. Living probate may only be expensive and time consuming, but could be messy if there are disagreements among family members concerning the appointment.

Power of Attorney Not a Viable Substitute

A power of attorney may not be a viable substitute for the living trust, even if the power continues in the event of the principal's incapacity (known as a "durable power"). If after the principal becomes incapacitated, the power holder dies or becomes incompetent, then there is no one authorized to act and a court proceeding is required.

Although several states mandate that the statutory power of attorney must be accepted in that state, the principal may own property in a state without such a mandate, in which event it may be necessary to obtain a court order in the other state if the other party refuses to recognize the power. None of these problems exist with a living trust. Additionally, the **RevTrust** has the advantage that it continues after death without interruption and without any court intervention. The power of attorney ends on the principal's death.

Summary of RevTrust Benefits

- **Takes Effect Immediately.** Although both the Will and the **RevTrust** may be structured so as to minimize death transfer taxes and to direct the distribution of the client's assets, the similarity ends at that point since the Will does not take effect until death while the **RevTrust** takes effect immediately upon being funded.

- **Incapacity.** In the absence of a **RevTrust** or adequate durable power of attorney, a guardianship (or similar) proceeding is usually required in the event of incapacity or incompetence. Such a proceeding is expensive, time consuming, demeaning to the individual, and may split the family members into opposing (sometimes warring) camps if they cannot agree on the appointment of a guardian. Additionally, the individual and the family lose control of the individual's assets which become subject to court supervision.

- **Privacy and Confidentiality.** While the Will must go through the probate process after death, the **RevTrust** avoids probate and all the pitfalls and additional expense associated with the probate process. Since there is no probate, generally, the **RevTrust** remains a confidential document and is not subject to public scrutiny.

• **Will Contests.** Unhappy relatives have a much more difficult and expensive route to follow if they wish to overturn **RevTrust** provisions since they are forced to sue the trustee. The Will and probate process present a simpler cost efficient (from the challenger's point of view) method to challenge the decedent's disposition of his or her property.

• **Continuity.** The **RevTrust** means continuity. In the event of the incompetency of the grantor/beneficiary, the co-trustee or successor trustee assume management of the trust. Prior to death, the trust is managed for the sole benefit of the grantor/beneficiary. Upon death, the trustees carry out the wishes of the grantor in the same manner as an executor, although without many of the restrictions that burden an executor.

• **Ease to Administer.** After death, the trustees, although they will want to reserve sufficient assets to cover creditor claims, income taxes and estate taxes, are free to administer the **RevTrust** without interruption in a time- and cost-efficient manner. For example, the trustees may create the credit shelter and marital deduction (QTIP) trusts, provide funds as needed for the family, arrange for an orderly sale or transfer to family members of family or other closely held business interests, and enforce the decedent's rights under business or other agreements. Although executors (and their attorneys) typically devote much time, effort and expense in marshaling a decedent's assets, this is less so than with a **RevTrust.**

• **Training Co-Trustee.** Whether the co-trustee is the spouse or another family member, the grantor is in a position to observe and train the co-trustee. This would occur, for example, if the grantor is temporarily unable to manage the trust for whatever reason (i.e., out of the country for a long period, an illness or retirement). The co-trustee must then assume the trustee's duties and manage the trust, for the grantor's benefit, for the period or periods that the grantor is not able to do so. The grantor may also assign duties to the co-trustee. The grantor is therefore able to observe the co-trustee and satisfy himself or herself that the co-trustee is capable of performing the duties of a trustee when the grantor is no longer able to perform or in the event of death. If the grantor is not satisfied with the co-trustee's performance, then the grantor may want to name another person for the position. The training period does not exist when the estate plan is based on a Will. When the co-trustee eventually assumes the duties of trustee, the learning period is minimized because of the co-trustee's prior experience.

• **Marshaling Trust Assets.** A funded **RevTrust** (as distinguished from an unfunded trust) means that the assets that require marshaling are those not in the trust. If the **RevTrust** has been properly administered, all of the decedent's assets should be in the **RevTrust,** except for those assets which may have been acquired shortly before death or those assets which could not be transferred to the **RevTrust.**

• **Omitted Assets.** Even if an asset has not been transferred to the **RevTrust,** in many jurisdictions, if the language of the **RevTrust** is broad enough, the asset may be deemed to be owned by the trust so as to avoid the need for probate of the omitted asset. Even if omitted assets require probate, often the probate may be accomplished under simplified procedures if the dollar amount is low enough.

• **Pour-Over Will.** Even when probate is required, it is accomplished through a special form of Will known as a "Pour-Over Will," since the only dispositive provision in the Will is that the probate estate is transferred (poured over) to the trustees under the **RevTrust.**

• **Ancillary Probate.** Ancillary probate is avoided. If real property is owned in more than one state, it is necessary to probate the Will in each jurisdiction where real property is owned by the decedent so that the property may either be sold or transferred to the intended beneficiary. This is called "ancillary probate." Ancillary probate means additional expense and delays for the estate. When real property is owned by a **RevTrust,** there is no need for any ancillary probate since the decedent does not own the real property in his or her name. The property is owned by the trust which is not affected by the death of the grantor. With a **RevTrust,** the property may be retained, sold or conveyed to heirs or beneficiaries (as directed in the trust) without any court intervention.

• **Avoiding Notice.** With **RevTrust** planning, there is no requirement (as there is with probate in many states) to locate and give notice

to those persons who would inherit the decedent's property if he or she died intestate. Such proceedings can be extremely time consuming and expensive, especially for those who have relatives living outside the United States or relatives whose whereabouts are unknown or whom the deceased did not want notified in the event of his or her death. With probate, in the case of a relative who cannot be located, the probate court may require appointment of a guardian ad litem and/or a kinship proceeding. The estate may have to retain an investigator and there may be numerous court hearings. The end result may be that if an heir cannot be located, there may be an indefinite delay in distribution of estate assets to other family members.

Probate Savings — Real or Imagined

The probate savings are not only real but they are also significant. The savings arise in several respects, some obvious and others not so obvious. The most obvious savings are probate fees paid to the probate court. These are not significant for most estates. Even in a high tax state such as New York, filing fees amount to a maximum of $2,000, plus incidental court costs associated with probate such as fees for special court proceedings and obtaining certificates of appointment that may be required from time to time. Typically these fees and other costs may amount to about $3,000 or more. Though small, these fees are probably adequate to cover the additional legal fees usually involved for creating a **RevTrust** plan. Of course, these court costs will significantly increase if ancillary proceedings are required in other states where the decedent owns real property, or if a construction, kinship or other special purpose proceeding is necessary.

The most significant cost savings are the executor's commissions and legal fees incurred in connection with the probate process. Every time a probate document has to be prepared, reviewed, corrected and filed, every time a court appearance is required, every time a conference is required (with the probate clerk or the probate judge), every time research is necessary with respect to a probate matter, legal fees will be incurred. Executor fees are usually fixed by statute as a percentage of the estate. These fees vary from state to state, but usually average from 3% to 5% of the value of the probate estate.

With a **RevTrust**, all of the probate expense is usually avoided if there are no probate assets. (There are some exceptions, such as Connecticut for example, which requires payment of its fees even if there is no probate estate.) It is not even necessary to file the Pour-Over Will. Of course, if there are probate assets, then executor's commissions and legal fees will be incurred for probating those assets, although even in such situations, the estate may be able to take advantage of the small estate exception to the probate process. For example, in New York, a small estate, up to $20,000 in value, is administered under a simple procedure supervised by a clerk that may not require the services of an attorney.

Marshaling of Assets

Another expense factor relates to the marshaling of assets. Since a Will does not take effect until death, the executor has the responsibility for marshaling the decedent's assets, with the estate attorneys often performing most of the services. This means determining, locating, collecting and safeguarding the assets. This can sometimes be a difficult and time-consuming process, especially if the decedent was secretive, did not maintain good records, or was involved in many businesses or had numerous widespread interests. With **RevTrust** planning, marshaling assets is minimized rather than maximized. With a well-managed **RevTrust**, there may not be any marshaling needed since all the assets are owned by the **RevTrust**.

Suitable Candidates for RevTrust Planning

Some practitioners are of the opinion that Revocable Living Trust ("**RevTrust**") planning is not suitable for all clients. They sometimes quantify those clients suitable for **RevTrust** planning in terms of a dollar amount (i.e., assets in excess of the applicable exclusion amount) or by the types of assets the client owns (i.e., real property in several states). Attempting to determine suitability based on such criteria only causes confusion for the client.

RevTrust planning should be suitable for anyone who needs a Will to pass his or her property, unless it is clear that the client's estate will qualify for an exception to regular probate under a small estate exception (as discussed in Part One of this Article). Once the benefits of **RevTrust** planning are explained, the client may then determine whether the those benefits compensate for the additional legal fees incurred for the planning. Individuals should not be discouraged from **RevTrust** planning simply because they do not have large estates. In fact, people with modest estates may be more motivated to save as much as possible of those es-

tates for their loved ones. They usually find that eliminating the probate expense more than pays for the added legal fees involved with **RevTrust** planning.

Income Tax Consequences to the Grantor

The living trust is taxed as a grantor trust under the Internal Revenue Code (IRC). (IRC §§ 671-679.) This simply means that all the income of the trust is taxed directly to the grantor in the same manner as if the trust had never been created. It is not necessary to obtain a tax identification number for the trust. The trust uses the grantor's Social Security number as its tax ID number. The **RevTrust** is not required to file fiduciary income tax returns during the grantor's lifetime. Therefore, the creation of a living trust should not cause any additional expense for preparation of income tax returns or inconvenience.

Gift Tax Consequences of the Living Trust

There are no gift tax consequences since the transfer does not become effective until death. Gift tax returns do not have to be filed since the gifts are incomplete due to the grantor's retained control and beneficial enjoyment. (IRC §§ 2036 and 2038.).

Estate Tax Consequences of the Living Trust

There is no difference in the estate tax consequences with **RevTrust** planning or with probate. Whether property passes under a **RevTrust** or through the probate process, the estate tax consequences are the same.

Revocable Transfers

Prior to the Taxpayer Relief Act of 1997 (TRA97), there was a split in the cases on whether certain transfers from revocable trusts within three years of death are includible in the estate. TRA97 resolved this split by providing that transfers from a **RevTrust** are treated as if made by the grantor, so that they will not be included in the estate. This change means that $10,000 annual exclusion gifts made by a co-trustee of a revocable trust or a person holding a power of attorney from the grantor will not be included in the estate if made within three years of death. This allows the trustee or power holder to commence a gifting program to reduce the grantor's estate when the grantor is no longer competent to act. (IRC § 2035(e).)

Income Tax Consequences of the Living Trust

The differences in the manner in which **RevTrusts** and estates were treated for income tax purposes were eliminated under TRA97. TRA97 provides that a **RevTrust** may be treated and taxed in the same manner as an estate. (IRC § 645.) If this election is made, then it is no longer necessary for a decedent's estate and a **RevTrust** to file separate fiduciary income tax returns. The **RevTrust** is treated as part of the decedent's estate so that only one income tax return is required. The election applies to estates of decedents dying after August 8, 1997.

There is, however, a significant difference for estate income tax purposes. When there are assets in the probate estate, the estate may not be able to distribute any assets before the expiration of certain minimum time periods in order to allow estate creditors adequate time to file claims. Since the estate and trust income tax brackets are more compressed than individual income tax brackets, the estate may incur significant income tax liability on its income. For example, the 39.6% rate applies when estate taxable income exceeds $8,350 in 1998. For 1998, the 39.6% rate doesn't apply to personal income on a joint return until taxable income exceeds $278,450.

With a **RevTrust**, the trustee may distribute the income and avoid the high estate and trust income tax brackets. The estate would have to obtain probate court permission to distribute income before the expiration of the time period. This involves an expense which reduces the income tax savings, but without any guarantee that permission will be granted, and with continuous potential exposure to liability to creditors.

Concerns About the Living Trust

The **RevTrust** may not be used to accomplish all family objectives. For example, the trust may not be used to name guardians for minor children. In most states, that may only be accomplished with a Will. Additionally, some people may object to the additional expense involved in creating a **RevTrust** plan (documentation and funding).

The **RevTrust** must be funded if it is to be effective. The lawyer, the financial advisor and the grantor should work together in making certain that the grantor's assets are transferred to the trust.

The **RevTrust** should provide that the trustees must accept all of the grantor's assets, whether existing at the time the trust is created or thereafter acquired. This permits assets subsequently acquired by the grantor to be included in the trust. The **RevTrust** should also

provide that the trustees are given the power to transfer to the trust any assets of the grantor. It may be desirable to include a power of attorney to a co-trustee to facilitate such transfers in the event the grantor becomes incompetent before the transfer process has been completed. Property acquisitions after the **RevTrust** has been created should be transacted in the name of the **RevTrust** rather than in the grantor's name. There is no need for the grantor to first acquire title and then transfer title to the trust.

Individuals typically have several different types of assets. These might include real estate, securities, brokerage and bank accounts, art collections, automobiles, and other types of personal property. Property transfers raise several concerns. Many financial institutions require a copy of the **RevTrust** document before they will open accounts. This is an objectionable practice and, hopefully over time, will be eliminated as these institutions become accustomed to the process. The only documentation necessary (aside from the usual signature cards) is a certification from the grantor as to the creation of the **RevTrust**. The practice followed by The Chase Manhattan Bank is instructive. To open a **RevTrust** account at Chase requires completion of a one page (large type, easy to read) certification. The only information that has to be inserted on the form is the name and date of the trust, the type of trust (check a box for revocable, irrevocable, testamentary, pension, etc.), and the names of the trustees. The certification is signed and dated by the grantor. Citibank has a similar form, but requires that the signatures be acknowledged.

Transfers of real property to **RevTrusts** are more complicated. Unless the real property is the grantor's principal residence, the consent of the mortgagee is usually required if so provided in the mortgage. With respect to the principal residence, a federal statute prohibits financial institutions from requiring prior consent by denying to them the right to accelerate the mortgage for an unauthorized transfer. (12 USCA § 1701j-3.) If the residence is owned in the form of a condominium or through ownership of shares of stock and a proprietary lease issued by a cooperative corporation, additional problems may arise. With respect to condominiums, the condominium declaration usually extends to the condominium association the right of first refusal. Although obtaining a waiver of this right is a simple process, it is an annoyance.

Cooperative corporations are more challenging, especially those in the New York metropolitan area. For reasons which are neither clear nor logical, until recent years, most cooperative boards have prohibited the transfer of cooperative shares and proprietary leases to **RevTrusts**. As the volume of requests increases, some boards are becoming more amenable to the process, especially if a board member is the person requesting the transfer. Hopefully, over time, transfer requests will be granted as routine matters. In the meantime, the process is frustrating for clients and their advisors. When consent for the transfer is not obtainable, it may be a good idea to include language in the **RevTrust** that in such situations, the asset is deemed to be owned by the trust and the grantor is holding title on behalf of the trust.

Another concern with real property transfers is the effect the transfer has on title insurance that may have been issued to the grantor when the property was acquired. For a nominal cost, this is often handled through an additional insured endorsement to the original policy. (For a complete discussion of the title problems, see Riven and Stikker, *Title Insurance for Estate Planning Transfers*, Property & Probate Journal, May/June 1998).

The transfer of assets is not a one time event. It is a continuing task. All assets of the grantor must be titled in the name of the **RevTrust** as they are acquired. The **RevTrust** should provide that it is the grantor's intention that all of the grantor's assets, no matter when or where acquired, are to be included in the trust and that the trustees must accept all of the grantor's assets. This permits assets subsequently acquired by the grantor to be transferred to the trust.

Joint Trusts

The usual type of **RevTrust** is one created by one person. Usually, each spouse will create his and her own trust. A joint trust is a single trust executed by both spouses to which they transfer their assets. If it is not anticipated that the joint estate will ever exceed the applicable exclusion amount (credit shelter exemption equivalent) of $625,000 in 1998 (and increasing in increments to $1 million in 2006), a joint trust may be suitable. If the estate is taxable, then the use of a joint trust raises additional issues which require careful analysis and drafting.

Conclusion

The Revocable Living Trust is an excellent alternative to a Will. It has most of the advantages of the Will but none of its disadvantages, primarily the disadvantages associated with the time and expense involved with death probate and living probate. As with any legal document, the services of a competent attorney are required to ensure that the individual's estate plan is properly structured.

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