THE FUNDING OF LIVING TRUSTS

by

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Excerpt from Chapter I

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2. Revocable Living Trusts

In a trust-centered estate plan, the estate planning client's basic package includes a revocable living trust, a pour-over will, and a durable power of attorney. The revocable living trust is the core of the client's estate plan. The trust contains provisions for use of the income and principal during the settlor's lifetime and directions for disposition of the trust property upon the settlor's death. All or most of the client's assets are funded into the revocable living trust upon its creation. The revocable living trust is accompanied by a pour-over will. The will directs that any probate assets owned by the client at death are given to the acting trustee of the revocable trust. A durable power of attorney authorizes an attorney-in-fact to act on behalf of the client during his or her lifetime. The power of the attorney-in-fact survives the client's disability but terminates upon the client's death. The estate planning documents dealing with the client's property are typically supplemented by a health care directive and a living will, under which the client appoints individuals who can make health care decisions on his or her behalf under various circumstances.

The terms of a revocable living trust depend on the client's individual circumstances. If the client is an unmarried individual, the client is typically the settlor, trustee, and current beneficiary. In the capacity of trustee, the client is authorized to use the income and principal of the trust for his or her own benefit. The trust agreement nominates successor trustees to serve upon the client's incapacity or death and directs the disposition of the property remaining in the trust upon the client's death. The property can be distributed outright to the designated beneficiaries or held in further trust for their benefit. A husband and wife who do not require estate tax planning typically create a joint revocable living trust into which they transfer their individually and jointly owned assets. The husband and wife are the settlors, co-trustees, and beneficiaries during their joint lifetimes and the lifetime of the survivor. If one spouse becomes incapacitated or dies, the other spouse continues serving as the sole trustee. As in the case of an unmarried individual, the settlors of a joint trust nominate successor trustees and provide for the disposition of the trust property upon the death of the survivor. If a married couple requires estate tax planning, the customary approach is for the couple to divide their property between two revocable living trusts. The husband is the settlor of one trust, and the husband and wife are the co-trustees and beneficiaries of the trust during the husband's lifetime. The wife is the settlor of the other trust, and the wife and husband are the co-trustees and beneficiaries of the trust during the wife's lifetime. Upon the death of the first spouse to die, the property in the trust can be split between a credit shelter trust to maximize use of the deceased spouse's applicable exclusion amount and a marital gift in trust or outright. In all cases, the settlor or co-settlors of the trust retain the right to amend or revoke the trust.

Revocable living trusts serve two important functions in an estate plan, one of which applies during the settlor's lifetime and the other of which transpires at death. A living trust eases the burdens on the settlor and his or her family in the event of the settlor's incapacity. If a person becomes incapacitated, *i.e.*, unable to transact business on his or her behalf, and no precautions have been taken in advance of the incapacity, then it is likely that a guardianship will have to be established under which a guardian is appointed by a court to manage the person's affairs. The rules for establishing and maintaining a guardianship of property depend on the applicable state law, but they have traditionally been regarded as rigid and costly to the guardianship estate. Moreover, the legal procedure required to determine incompetency inevitably exacts a personal cost on family members. Although a durable power of attorney can be useful upon incapacity of the principal, a living trust is the best method for handling potential incapacity. The settlor can serve as the trustee and beneficiary of the living trust during his or her lifetime for so long as the settlor remains competent. If incapacity occurs, the successor trustee named in the trust agreement assumes the management of the trust property for the benefit of the settlor-beneficiary without necessity for a formal guardianship.

The other main purpose of a living trust is to avoid probate of the assets owned by the trust upon the death of the settlor. Probate is the process by which assets owned by a decedent at death are formally transferred to the beneficiaries under the will. Typically, the personal representative appointed under the will identifies and collects the decedent's assets, pays the decedent's debts, expenses of administration, and taxes, and distributes the remaining assets to the intended beneficiaries. The probate process is generally supervised at each stage by a probate court and has traditionally been considered to be cumbersome and costly.[1] In contrast, when the settlor of a living trust dies, the successor trustee is already familiar with the trust assets because they are identified on the trust property schedule. The successor trustee pays the decedent's debts, expenses of administration, and taxes, and distributes the remaining trust assets to the beneficiaries. Although a trust administration parallels a probate, the trust administration is generally regarded as less costly and time consuming than a probate.[2]

Other advantages of a revocable living trust over a will may be important in particular contexts. For example, a revocable living trust affords privacy to a settlor and family because of the absence of court supervision of a trust administration. In contrast, the personal representative of an estate is required to offer the will for probate and file an inventory identifying the probate assets and their values. The probated will and the inventory become public records. In addition, use of a revocable living trust is often recommended when it is anticipated that a client's dispositive scheme will be contested. Whereas a will does not operate until the testator dies, a revocable living trust takes effect immediately upon execution and funding and the trustee may be serving for years until the settlor dies. Because the trust is already in existence at the settlor's death, there is a sense that the validity of the trust is more difficult to challenge than the validity of a will. Moreover, a state statute of limitations may limit the time period within which the validity of a trust can be challenged.[3]

The creation of a revocable living trust does not in and of itself achieve tax savings for federal income, gift, or estate tax purposes. Because the settlor of a revocable living trust retains the right to revoke the trust, the trust is considered a grantor trust for federal income tax purposes.[4] The income and other tax items of a grantor trust are included in the grantor's gross income as if the trust did not exist.[5] Transfers of property to a revocable living trust do not constitute taxable gifts for federal gift tax purposes.[6] When the settlor of a revocable living trust dies, the value of the property in the trust is included in his or her gross estate.[7] If estate tax planning is required, however, revocable living trusts, like wills, can incorporate estate tax savings measures, such as credit shelter trusts and gifts to charity.

1.Various procedures are available to reduce the time and expense involved in a typical probate proceeding. For examples, an expedited probate for relatively small estates may be available. *E.g.*, TEX. PROB. CODE ANN. §137 (collection of small estates by affidavit); §143 (summary proceedings for small estates). Some states have an unsupervised probate that a person making a will may choose that will minimize the court's involvement in the process. *E.g.*, CAL. PROB. CODE §10500(a) (independent administration); D.C. CODE ANN. §20-406 (unsupervised personal representative); MONT. CODE ANN. §§72-3-201 - 72-3-225 (informal probate); TEX. PROB. CODE ANN. §145 (independent administration).

2.The estate planner should take care not to overemphasize the cost savings to be achieved by using a revocable living trust rather than a will. Some clients have the mistaken impression that, because a revocable trust avoids probate, there is little to do and few costs to pay when a settlor dies. In practice, while a trust avoids the expense and delay associated with the probate court's involvement in supervising an estate administration, in other respects a trust administration parallels the administration of an estate. Both a personal representative and a successor trustee must locate and value the assets, pay the debts and administration expenses, file any applicable tax returns, and distribute the remainder as provided in the will or trust. In Florida, the base statutory attorneys fee for a trust administration is 75% of the base statutory fee for a probate. FLA. STAT. ANN. §737.2041(2). While the fee for representing a trustee is less than the fee for handling a probate, the fee for the trust administration is certainly not negligible.

3.*E.g.*, KAN. STAT. ANN. §58a-604 (a proceeding to contest the validity of a revocable trust must be commenced within the earlier of: one year after the settlor's death; or four months after the trustee sent the contestant with a copy of the trust instrument and of a notice containing specified information).

4.Under Internal Revenue Code (I.R.C.) §676(a), a grantor is treated as the owner of any portion of a trust over which the grantor has the power to revest title to such portion in himself or herself.

5.I.R.C. §671.

6.A gift of property is complete when the donor has parted with dominion and control over the property and does not have the power to change its disposition, whether for the benefit of the donor or another. Treas. Reg. §25.2511-2(b). If the donor of property reserves the power to revest title to the property in himself or herself, the gift is incomplete. Treas. Reg. §25.2511-2(c).

7.I.R.C. §2038(a).