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The Revocable Living Trust – Is It Right For You?

Revocable, or "living" trusts have become popular for purposes from probate avoidance to protection of private information about assets and loved ones. This planning technique does not, however, offer any estate tax or income tax advantage and generally also does not offer enhanced protection from creditors. A revocable trust involves some work after the trust agreement is signed; the trust is only effective with respect to property actually transferred to the trust. The appropriateness of revocable trusts depends in part upon the age and stage of the client, the laws of the state where the client makes a permanent home, and the family and business situation of the client. While not a one-size-fits-all solution, revocable trusts are worthy of consideration for many people. Even where a revocable trust is used, a Will is still needed.

Many people wonder whether this popular technique is appropriate for them. Some have heard from friends or financial advisors that living trusts are the answer. Some have read that living trusts avoid the problems and expenses commonly believed to be associated with probate of their estates. Some believe (erroneously) that living trusts will save estate or income taxes. Here are some of the issues to consider in evaluating whether this planning approach is an appropriate fit.

What is a living trust and how is it created?

A living trust is a trust that is created while the person who creates it (known as the "grantor" or "settlor") is still living. The trust is created by the simple act of signing an instrument sometimes referred to as a "Declaration" or "Agreement of Trust." However, no property is governed by the terms of the trust until ownership of that property is transferred formally from the grantor to the trustee. Often, the grantor will act as the initial trustee for as long as he or she wishes, with the result that he or she continues to control property transferred to the trust. The grantor may also name one or more co-trustees to act with him, as well as one or more successor trustees to serve after him. Alternatively, the grantor may wish to name another person or a corporate trustee, such as a bank or trust company, to be the original trustee.

Most living trusts can be revoked or amended whenever the grantor so desires. While people do create irrevocable trusts during their lifetimes, these are usually set up for specific tax reasons and are not the kind of trust people think of when they hear about living trusts.

The trust agreement provides directions for how the trust assets are to be managed for the grantor's benefit and perhaps also for the benefit of certain family members during the grantor's lifetime. The agreement also specifies how the trust assets are to be handled after the grantor's death (when the trust will become "irrevocable"), either by distributing the assets to the beneficiaries named in the trust agreement or by continuing to hold some or all of the assets in the trust and administering them for the benefit of the specified beneficiaries.

The provisions of the trust agreement are of great importance. While the grantor throughout her lifetime may change them, the provisions will govern disposition of the trust assets after the grantor's death, when no further changes are possible. Accordingly, the many choices and decisions involved in designing a living trust are worthy of close attention.

How does property become part of a trust?

The grantor "funds" the trust by transferring to the trustee ownership of whatever assets he or she chooses to include in the trust. A trustee may hold title to most kinds of property, although some assets are less suitable or desirable than others. For example, if a bank or other corporate entity is acting as the trustee, it may not wish to accept title to a car which the grantor or someone else is still driving, or silverware or jewelry not in the trustee's physical custody, for obvious reasons of liability.

The manner in which property becomes part of the trust depends upon the nature of each asset, and whether title to that asset is a matter of public record. Securities are re-registered in the trustee's name: if the shares are held in certificate form, each stock certificate must be transferred, by means of a stock power presented to the transfer agent for each company, on the records of the company in question. If shares are held in street name, in a brokerage or other agency account, then the account must be re-titled in the name of the trustee, usually by means of opening a new account for that purpose. Bank accounts are re-titled in the trustee's name, and title to real estate is transferred to the trustee by means of a deed recorded in the county where the real estate is located. Untitled property, such as artwork, jewelry or other tangible items, is transferred by means of an unrecorded assignment document signed by the grantor and "accepted" by the trustee.

What becomes of income received by the trust?

During the lifetime of the grantor, income of the trust is fully available to the grantor and is taxed to him or her as if earned directly. In fact, during lifetime the revocable trust generally will use the grantor's social security number rather than a separately assigned "employer identification number" for income tax purposes. No separate income tax return need be completed for the trust, regardless of whether the grantor is acting as trustee.

Does a living trust "avoid probate" and is it a good idea?

Probate and estate administration is the process by which the assets which were owned in a decedent's name alone are legally transferred to the persons named in his or her Will or, if there is no Will, as provided in intestacy laws of the decedent's state of residence. This distribution generally cannot occur until a waiting period has elapsed, during which time creditors may come forward to present claims against the estate. In addition, distribution generally does not occur until after the decedent's debts (including medical costs not covered by insurance), expenses of estate administration (including executors' commission and the fees of lawyers and accountants) and any estate or inheritance taxes are paid.

Only those assets owned solely in the decedent's name or payable to his or her estate (such as a final paycheck or an income tax refund) are subject to probate, in any event, as property titled in joint names "with right of survivorship" or as tenants by the entireties passes directly to the surviving owner by operation of law. Assets subject to a contract, such as retirement accounts and life insurance proceeds are payable directly to the beneficiaries named by the decedent and are not controlled by the Will, so they are not subject to probate - unless there is no named beneficiary surviving or unless the beneficiary designation reads "to my estate" or words to that effect.

Why seek to avoid probate? While probate laws vary from one state to another, at least historically, the probate process has been perceived as a cause of delay and additional expense to the estate. Estates may be required to file inventories listing and valuing all of the assets in the decedent's sole name, as well as accountings describing in minute detail every penny received into or paid out of the estate. Probate court personnel then audit these accountings, and may require documentation for all transactions.

Many states now have simplified probate proceedings that permit an estate to bypass some or all of the court filings previously required. The District of Columbia has "unsupervised probate" which allows the estate administration to go forward without the filing in court of inventories and accountings. Maryland has "modified administration," which for an estate whose beneficiaries and personal representatives qualify, permits the filing of only a simplified final report instead of an inventory and an accounting of all estate transactions.

One situation where a living trust may be particularly useful occurs when the grantor owns real property in more than one state in his or her sole name. In this circumstance, probate would be conducted in the decedent's state of domicile, but an additional ("ancillary") probate proceeding would also probably be necessary in each other state in which the decedent owned real estate in order to transfer ownership to the beneficiaries named in the decedent's Will. Each of these ancillary administration proceedings would entail court costs and likely additional fees for a local attorney. In some states, a similar proceeding is needed for mineral rights such as interests in oil and gas partnerships. These interests may be very small and may have little or no value;

nonetheless, to complete transfer of their ownership in the orderly administration of a decedent's estate, it may be necessary to open ancillary probate in several states.

If, however, the same decedent had created a living trust during his or her lifetime and deeded title to all of the real property to the trustee, ancillary administration would not be needed in the states where the real property was located because title to the real property would not have been in the decedent's name at the time of death. It should be noted, nevertheless, that transferring title to the real property to the trustee during the grantor's lifetime might incur transfer and/or recordation taxes in each jurisdiction, in addition to the cost of deed preparation.

Protection of confidential information

Living trusts are sometimes recommended on the basis that the records of a probate administration are a matter of public record that anyone who wishes to may inspect, while the terms of a living trust agreement and the records of a trust's assets are private. While some jurisdictions require that the trust instrument be filed as part of a public record, this occurs only in a diminishing minority of states. While the privacy afforded by the use of a funded living trust is easy to appreciate for public figures, it may also apply to business owners and to individuals who may not wish to benefit each family member equally.

Finally, avoiding probate is often recommended as a cost-saving technique. It is true that if courts costs and other administration expenses, such as personal representatives' and attorneys' fees, are computed as a percentage of the value of the assets subject to probate, then those assets owned by a living trust and, therefore, not subject to probate, will not be included as part of the calculation of such administration expenses. However, much of the expense involved in settling a decedent's affairs is related to preparing the decedent's final income tax return and U.S. and any state estate tax returns (if the total assets are large enough to require estate tax returns).

For purposes of the estate tax returns, all assets, including those owned in joint names, in a living trust, or in a retirement account or life insurance policy, must be valued or appraised, and this cost is the same whether the assets are part of the probate estate or not. While some legal and accounting fees are attributable to complying with probate requirements, they are more often largely related to income and estate tax return preparation and tax planning and are a function of the amount of time required to complete the work rather than of the dollar value of the assets.

Where there's a Will ...

While the use of a living trust can greatly reduce the number and value of assets subject to probate, everyone should still have a valid Will because it is fairly common for individuals to have at least one asset that will require probate. A simple example might be a significant tax refund. Less common, and more dramatic, are assets such as a

winning lottery ticket not presented during lifetime, or a favorable judgment in a lawsuit. Even if a decedent diligently transferred everything he or she owned into a revocable trust during lifetime, assets such as these, which arise or which are issued to the decedent after death, may require probate. The Will of a decedent who had most of his or her assets in a living trust can be very simple and merely provide that any property subject to probate should be distributed, or "poured over," to his or her living trust.

Are there any reasons not to avoid probate by using a living trust?

The probate laws of each state provide a deadline by which all creditors must file any claims they have against the decedent or the estate. Once this deadline has passed, any claim that was not filed is "barred" -- that is, the creditor may not collect it from the estate, the personal representative or the estate's beneficiaries. This protection is especially useful if the decedent's debts are difficult to determine or if it is possible that there may be significant outstanding claims against the decedent, such as malpractice actions not yet filed against a professional. This statutory protection against creditors is generally not available to shield assets held in a decedent's living trust.

Are there other benefits to a living trust in addition to avoiding probate?

Living trusts can provide other benefits in addition to probate avoidance. First, they permit continuity of asset management. Assets held in a living trust can continue to be held and invested as the grantor wishes even after the original trustee (often the grantor) has been replaced by a successor trustee. A change of trustee due to the original trustee's death, incapacity or resignation does not cause a delay in the successor trustee's authority to manage the trust assets.

A related benefit is the grantor's ability, by naming co-trustees and successor trustees, to choose those who will manage the trust assets and make other discretionary decisions in the grantor's stead.

Finally, a living trust allows the grantor to plan for the possibility of his or her own disability or incapacity. A person who becomes unable to manage his or her own assets and make financial decisions on his own behalf may need to have a court appoint a conservator or guardian of his property to act for him. Not only is this a clumsy and comparatively expensive process, but it may even result in the court's appointment of a stranger as the conservator or legal guardian if the court is not satisfied that any of the incapacitated person's relatives would make a suitable fiduciary. In such cases, courts often make these appointments from lists of local attorneys who have signed up and indicated their willingness to accept this work. The result is that the property owner's assets will be managed (1) by someone who does not know the owner, his investment preferences, his values or what his relationship with various family members may be, and (2) by someone whose level of investment ability is an unknown quantity. Such a conservator is legally required to administer the assets conservatively for the ward's benefit, and may be unable or unwilling to make discretionary decisions about spending

conservatorship funds as the ward might otherwise have done; for example, for the benefit of the ward's grandchildren.

Does every one need a power of attorney?

It may be possible to avoid the need for a conservatorship of an incapacitated person's assets if the property owner (prior to becoming incapacitated) signs a legally enforceable durable general power of attorney that names someone else to manage his or her assets. However, the use of a durable general power of attorney does not solve all problems. Many financial institutions will not honor a general power of attorney unless it is on their own forms and, by the time the attorney-in-fact learns this, the property owner may no longer be able to sign new power of attorney forms. Even worse, some attorneys-in-fact have recently reported that, even if the powers of attorney are on the financial institutions' own forms, some banks are refusing to honor them if they are more than six months or a year old, thus rendering a "durable power of attorney" not durable at all.

Powers of attorney give an agent (generally referred to as the "attorney-in-fact") power to act on behalf of a principal with respect to assets held in the principal's individual name. While a person who has a revocable trust should not discard a power of attorney, assets transferred to the revocable trust during lifetime will be managed and controlled by the trustee named in the trust instrument, whether that is the grantor or a named successor. Unless specifically so provided in the trust instrument, the agent generally would have no right to act with respect to property held in a revocable trust.

What if a court declares the grantor incapacitated?

In a similar manner, even if a grantor is declared legally incapacitated in a judicial proceeding, the person named to act as guardian, conservator, next friend or committee generally would not become empowered to act with respect to assets held in a revocable trust. The grantor would cease to be the trustee by the terms of the instrument, and the named successor would take his or her place.

Who should act as trustee of the living trust?

There is no single answer that is best for all people. Some individuals wish to manage their assets as long as possible; others are eager to transfer that responsibility. Some will prefer an institution or unrelated individual such as a trusted advisor. Others will look to children or other family members to act as trustee. In selecting a trustee, the most important factor to consider is whether a person will act in accordance with the grantor's wishes and in the best interest of the trust and those it benefits. Some of the most important judgment calls in designing a revocable trust arise in connection with the selection of a trustee or successor trustee, and these issues should be discussed carefully with the lawyer who prepares the trust instrument.

If the grantor expects to use a professional trustee, such as a bank or trust

company, at some time in the future, naming that trustee as a co-trustee during the grantor's lifetime may allow the grantor a sort of "test drive," an advance look at how well the corporate co-trustee manages investments, how well the grantor likes the co-trustee's investment style, and in general how smoothly and satisfactorily the co-trustee and its officers work with and for the grantor and the grantor's family.

What objectives will not be accomplished by a living trust?

While assets placed in a living trust by the grantor will avoid probate, the living trust will not reduce either the grantor's income taxes or his or her estate taxes. Because the grantor has the right to revoke or amend the trust at any time, for income tax purposes the grantor is treated as the owner of all of the assets, and all of the income produced by the assets continues to be treated as his or her personal income. In the same way, living trusts also achieve no estate tax savings. The grantor's retained right to revoke or amend the trust agreement and take back any or all of the trust assets makes these assets part of the grantor's estate for purposes of calculating estate taxes (not, however, a part of his or her probate estate).