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THE USE OF A REVOCABLE TRUST IN ESTATE PLANNING

The Revocable Trust for a number of years has been a popular estate planning device. Unfortunately, many people are reluctant to use this otherwise valuable estate planning tool because they do not fully understand what a trust is or how it can work effectively for their estate plan. It is the purpose of this outline to provide you with basic information on what a trust is, how it works, and whether you can use it comfortably in your own planning situation.

I. WHAT IS A REVOCABLE TRUST:

A Trust is a legal arrangement established by an individual, who is called either the grantor or settlor, in which the legal title to property and the right to manage it is placed in the hands of a trustee(s) and the beneficial enjoyment of the trust property is given to the trust beneficiaries. The grantor can also be the trustee.

II. THE REVOCABLE LIVING TRUST:

The most common trust used in estate planning is called a Revocable Living Trust. The living trust is "living" because it is established during the lifetime of the grantor. In many instances the trust receives assets owned by the grantor prior to the grantor's death. The living trust is called "revocable" because the grantor reserves the right to amend or terminate (revoke) the trust during the grantor's lifetime by notice to the trustee or trustees. The grantor can be one person or a married couple together.

III. THE TRUSTEE:

The person or entity that administers a trust under the arrangement established by the grantor is called the trustee or, if more than one, the trustees. If an individual is designated, that individual is called an individual trustee. If a bank or brokerage firm is named, it is known as a corporate trustee. In many instances both an individual and a corporate trustee work together as co-trustees.

It is not unusual for one person to play a number of roles in a living revocable trust. For example, the grantor may also designate himself or herself as the trustee during the grantor's lifetime. The grantor then designates a successor trustee, such as the spouse, or adult children, or another individual or a corporate trustee, to serve in the event of the grantor's death or incapacity.

IV. RESPONSIBILITIES OF A TRUSTEE:

The trustee must follow carefully the directions of the grantor which are set forth in the trust and must hold and manage the trust assets for the benefit of the beneficiaries. The trustee can be held responsible and legally liable to the beneficiaries for not following the instructions of the grantor for the benefit of the beneficiaries, as the trustee is a fiduciary.

V. USE OF SUB-TRUSTS:

Typically, the revocable living trust for married people contains several sub-trusts or separate trusts which spring into existence upon the death of a grantor. These sub-trusts are intended to maximize federal estate tax savings while at the same time providing benefits for the surviving spouse, children and any other designated beneficiary. This is often referred to as "A-B Trusts", or "A-B QTIP Trusts", depending if two or three sub-trusts are created at a Grantor's death. Since 2012, the estate tax credit of a deceased spouse is “portable” to the surviving spouse. This means that sub-trusts are not required to preserve the deceased spouse’s estate tax credit as in the past. So long as the surviving spouse files an estate tax return (a “706) even if the estate is much smaller than the estate tax credit, and does not remarry, the estate tax credit of the first spouse to die is preserved.

1. The Survivor’s Sub-Trust:

The standard survivor’s trust (also known as the “A” Trust) only comes into effect in community property states. In these states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin), married couples have one trust together. At the death of a spouse, sub-trusts are created, depending on the specific trust language, which usually include a survivor’s trust.

The survivor’s trust contains the surviving spouse’s separate property and his or her ½ of the community property. Since it is comprised of the surviving spouse’s share of assets, he or she can change the trust at any time.

2. The Bypass Sub-Trust:

The Decedent's Trust or "Bypass" Trust (also known as the “B” Trust, or Credit Shelter Trust) is usually funded at the death of a spouse in an amount which will take full advantage of the federal estate tax unified credit equivalent, which is currently $11,580,000 (which changes every year). At the death of the first grantor, this trust becomes irrevocable.

The proper use of the decedent's trust permits the assets held in this trust to pass free of the federal estate tax on the death of both the spouses. The decedent's trust obtains this tax benefit by not permitting the surviving spouse to have absolute control of the trust. However, the surviving spouse may receive income earned on the assets of this sub-trust, and the trustee (which can be the surviving spouse) can be given the right to invade the principal for the surviving spouse's benefit. In addition, the surviving spouse can act as Trustee without losing the estate tax savings if the trust contains certain provisions. During the surviving spouse's lifetime the grantor's children or other beneficiaries can also receive distributions of income and principal.

3. **The Marital Trust**:

The standard marital trust usually receives the balance of assets not funded into the Bypass Trust or Survivor's Trust. Usually the deceased spouse's one-half of community property and separate property which exceed his estate credit are funded to this sub-trust. It allows the surviving spouse to control the marital trust (known as a "general power of appointment"), which means the surviving spouse can change the trust terms, including changing the beneficiaries. The sub-trust qualifies for the unlimited marital deduction which ensures that no estate tax will be due until nine months after the death of the surviving spouse. Thus, the marital trust must benefit only the surviving spouse during his or her life, and all of the income generated from the investment of the assets within this trust must be paid out to the surviving spouse. Additionally, the surviving spouse can choose to receive distributions of principal if needed for his or her health, education, maintenance or support.

At the death of the surviving spouse, the trust will be distributed to the ultimate named beneficiaries (usually the children).

4. **QTIP Trust:**

Since January 1, 1982, there is a type of marital trust known as a Qualified Terminable Interest Property Trust, or QTIP. The major difference between the QTIP and the standard marital trust is that the QTIP qualifies for the martial deduction without giving the surviving spouse a general power of appointment exercisable upon the death of the surviving spouse. This means the spouse cannot change the ultimate beneficiaries.

Consequently, under a QTIP arrangement, the grantor can designate to whom the remaining assets go upon the surviving spouse's death. Thus, changes in family circumstances such as the remarriage of the surviving spouse will not affect the ultimate disposition. This type of trust (used in combination with the other types of trusts which come into being after the death of the first spouse), is preferred where there may be children from a former marriage that the grantor wants to ensure an inheritance of at least a portion of the estate.

VI. **TRUST FOR CHILDREN:**

At the death of the surviving spouse, the sub-trust is no longer needed. Then, the trust is usually set up to continue after the death of both spouses until the children have completed their schooling and/or have reached a specified age at which they can handle the management of the assets. The trust assets can be held in a single trust for all children or can be divided into separate trusts in equal or unequal shares. There is great flexibility in structuring the dispositive provisions for children. Special provisions can also be included for children or relatives with special needs or alcohol/drug dependency issues.

There are significant planning alternatives available which will vary for each person's family. As your children age, the type of distribution plan also changes.

1. **Pot Trust:**

Ideal for young children. In case both parents die while the children are minors, the trust holds all the assets in a single "pot" until the youngest reaches an arbitrary age when you think he

or she should have completed school. This concept is important for younger children because you really can't anticipate differences in each child's educational or health needs. The single pot of assets is used according the each child's needs until the stated age (usually 20's) is reached.

2. Adult Children Options:

(a) Outright distribution to adult children can be fine so long as the child (now an adult) has no issues in life. I have met a few lucky parents where this is true. However, once the child inherits his or her share, the funds can be spent unwisely or lost to creditors, or due to the child's divorce.

(b) Staged distributions - upon attaining defined ages, each child can obtain a percentage of his or her share. For example, 1/3 at 28, 1/3 at 30, and the rest at 35. You can pick any ages or fractions. This gives your child a chance to learn from his or her investment mistakes, but not blow the whole share at once.

(c) Lifetime Distributions for HEMS or distributions at the discretion of the trustee. This distribution plan may protect your children from divorce, creditors or themselves. The trustee can dole out the money over the child's life for health, education, maintenance or support (HEMS) or as the trustee allows. This can vary for each child according to his or her needs. At the child's death, the grandchildren can continue receiving distributions of amounts left from the child's share. Because this distribution method means a lifetime relationship with the successor trustee, it may be a good idea to give the children the ability to fire the trustee every three years and pick a new corporate trustee or have a trust protector have the ability to remove and replace the trustee.

(d) Special Needs Trusts. If a beneficiary may be incompetent, incapacitated or on any type of government aid, like SSI, that persons' share must be held according to very restricted terms, known as "Special Needs Trust" to prevent the beneficiary's inheritance to ruin his or her aid. Sometimes, the government entity can even take back part or all of the inherited share to reimburse for aid previously paid on the beneficiary's behalf. This can be avoided with the proper trust terms.

(e) Complete Discretion to Trustee. This is even tighter than item (c) HEMS, because the trustee has the sole discretion to distribute or hold back whatever amounts the trustee decides. This is the strongest protection from all classes of potential creditors of the beneficiaries, including alimony and other claims from divorce. Again, there should be checks and balances to allow for removal and replacement of the trustee if necessary.

3. Special Assets:

Specific assets in the trust can be dealt with by special instructions. For example, a child involved in the business could be given the right to receive as part of his share of the trust a specific

business interest or could be given specific rights to purchase the business held in trust on terms and conditions spelled out under the trust document.

There are many other goals that can be accomplished in the trust document that would otherwise be difficult or impractical to cover in any other document. The nice thing about a revocable trust is that the plan can be readily amended by the grantor during his or her lifetime, should a change in circumstances develop.

VII. FUNDING THE TRUST WITH ASSETS:

It is important to remember, that not all assets will necessarily end up in the grantor's revocable living trust, even though there is a will set up by the grantor which leaves all of his or her assets to the trust at the grantor's death. For example, property held jointly with rights of survivorship, or real estate held between a husband and wife as tenants by the entirety, will pass directly to the surviving joint tenant, not to the trust. This is also true for life insurance policies and most retirement plans. Those amounts go directly to the named beneficiaries without probate. It is important to realize that the legal title of assets such as IRAs, Retirement Plans or life insurance, is determined by its ownership or the beneficiary designation. Thus, it may be important to rearrange the ownership of assets or beneficiary designations as part of the effective use of a trust as an estate planing tool. However, usually IRAs or retirement plans should not list your normal revocable trust as beneficiary. This is because the IRS rules regarding retirement assets are complex and most revocable trusts are not drafted with these goals in mind. Be careful. If you still want to use a trust in order to protect your children, consult an attorney who specializes in estate planning for retirement assets.

Funding your revocable living trust prior to your death avoids probating the assets that have been transferred to the trust. It is very important to follow through and transfer your assets, such as real estate or investment accounts, to the trust before you die, otherwise the assets not transferred may be subject to probate. Since you have the power to withdraw the trust assets from your trust at any time, you will not lose any control of those assets. A separate tax return will not have to be filed for the trust until the time of your death. All of the trust income will be reported under your social security number and reported on your personal return. It is very important to follow through and make sure that all of your assets, such as real property and investment accounts, are transferred to the trust. If you die before this process is completed, the assets that have not been transferred to the trust may be subject to probate.

For most married couples, your spouse, not the trust, should be the designated beneficiary of your retirement plan or IRA. Be sure to name a contingent beneficiary in case you and your spouse both die in an accident. If you have perfect adult children, name them as contingent beneficiaries. If you have minor children or adult children that may need creditor or divorce protection, use a specially drafted IBRAT^{SM}.

It is usually better to name children or an Irrevocable Insurance Trust as direct beneficiaries of a life insurance policy, instead of a revocable living trust. This may be relevant because the named beneficiaries obtain the proceeds directly without probate. This is because the policy proceeds

become theirs directly, without a probate. There may be exceptions if you, the insured, retain an incident of ownership in the policy or die within three (3) years of purchasing the policy. Alternatively, an irrevocable insurance trust may suit your needs.

The form of the transfer of any particular asset into your trust depends on the nature of that asset. For real estate, a deed transferring title to your trust is required. For personal property, usually a bill of sale or an assignment is required. For certificates of deposit or bank accounts, the name on the account or certificate of deposit must be changed to the trustee of your trust. Almost any asset can be transferred to your trust if the proper transfer documents are completed. It is important to remember that in order to transfer an asset to your trust, the trustee must be listed as the owner of that asset in his or her capacity as trustee.

VIII. CONCLUSION:

The Living Revocable Trust is an extremely effective and flexible estate planning tool which can accomplish many objectives that are impossible to do by any other means. It is the primary tool for effecting an estate plan to provide for specific family distributions, avoid probate, and minimize federal estate taxes.