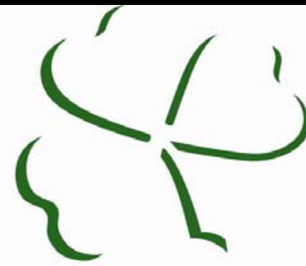

The Glynn Group, Ltd.

August 10, 2007 **Issue # 260**

When Do You Really Need Revocable (Living) Trust?

A revocable (or living) trust arrangement is one in which the creator of the trust retains the right to revoke the trust and reclaim the ownership of trust property during his lifetime. If this right isn't exercised, the trust becomes irrevocable upon the grantor's death, and the trust instrument (not the grantor's will) controls the disposition of trust property.

Living trusts have increased in popularly as more and more people have become convinced (frequently with the help of a life insurance agent or an attorney) that they need one. However, taxpayers sometimes set up such trusts without fully understanding what they're getting into or how the trust will benefit (or hurt) them.

So What Are the Benefits?

A living trust that's properly set up and funded offers several advantages as an estate planning tool. While each of these advantages is significant, they have to be viewed in light of the particular needs of the individual. Then, a decision can be made about whether a living trust is an appropriate planning tool for that client.

Avoiding Probate. Generally, the principal reason given for using a living trust is to avoid the probate process and its related costs. In states where executor fees and attorney fees are based on a percentage of the probate estate, this certainly can be a valid reason because these costs can be significant. However, in jurisdictions where a family member can serve as executor (and waive the fee) and attorney's fees are based on an hourly rate, the cost of probate typically isn't an issue. Thus, prior to recommending the use of a revocable trust as a means to reduce probate costs, it's important to compare the cost of establishing and maintaining a trust with the estimated future probate costs. Only when the latter expenses are expected to be significantly higher and a less expensive means of avoiding probate (such as using joint ownership with right of survivorship or providing named beneficiaries on life insurance or retirement benefits) is not appropriate does a living trust provide a good alternative.

For the trust to effectively reduce probate costs, it needs to be "fully funded" so that all of the decedent's assets are removed from the probate estate. This requires all assets titled in the name of the client to be re-titled into the name of the trust. As a result, deeds to real property must be prepared, and transfer agents must be contacted to transfer all securities from the name of the individual to the name of the trustee. (These transaction costs should be considered in weighing the costs of funding and administering the trust versus letting the decedent's assets go through probate.)

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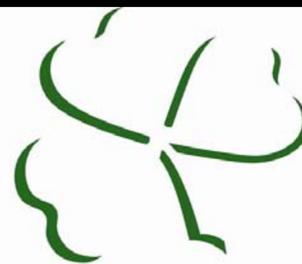

Note: The disposition of certain assets (e.g., retirement plans, IRAs, or life insurance on the decedent's life) will be determined by a separate beneficiary designation. Thus, these assets may not necessarily need to be re-titled to avoid probate costs.

It is also advisable to have anyone who sets up a living trust to execute a *pourover* will at the same time. A *pourover will* is a valid will specifying that all assets owned by the decedent at death pass directly to the living trust (which has become irrevocable as a result of the grantor's death). The *pourover* will is a precautionary measure ensuring that all assets owned by the trust creator will be distributed according to the terms of the trust. Unfortunately, the *pourover* will defeats the stated purpose of avoiding probate because it must be admitted to probate just as if the decedent had only a will and no revocable trust. However, in states that allow fees based on a percentage of the total estate, the majority of the decedent's assets will not be subject to probate costs as long as the trust is funded prior to death with the bulk of the decedent's assets. Thus, the trust may still provide significant savings in terms of probate expenses.

Asset Administration in the Event of Incompetency. Another reason for using a living trust is to avoid a court-supervised administration in the event the trust creator becomes incompetent. A living trust allows someone to transfer all of their assets to the trust and to continue managing them as long as they desire. If they later decide to give up the responsibility of managing the property, they can resign as trustee, and the person designated as successor trustee assumes management responsibility for the trust's property. The ability to transfer management responsibility may be particularly desirable to elderly individuals who are concerned about the possible future loss of their faculties and their ability to manage their assets.

Without a living trust or other appropriate documents, a guardianship proceeding is required to appoint someone to manage the assets of an incompetent individual. In a guardianship administration, the actions of the guardian must be reviewed and approved by the court. This degree of court supervision, coupled with the cost of providing a required annual accounting to the court, makes guardianship administration unattractive. Thus, a living trust can provide a viable alternative to a guardianship administration.

When a living trust is used to avoid a guardianship proceeding, it is usually best to fully fund it at the time of its creation. This ensures that the successor trustee has control over all of the person's property in the event the person is incapacitated. If it's impractical for the trust to be fully funded, the establishment of the living trust should be coupled with

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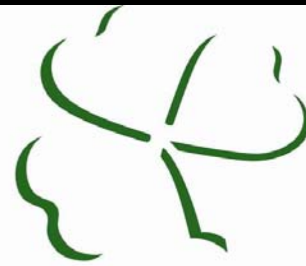
Slinger, WI 53086



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When a living trust is used to avoid a guardianship proceeding, it is usually best to fully fund it at the time of its creation. This ensures that the successor trustee has control over all of the person's property in the event the person is incapacitated. If it's impractical for the trust to be fully funded, the establishment of the living trust should be coupled with the granting of a durable power of attorney to the person who will ultimately serve as trustee in the event of incapacity. Under the terms of the power of attorney, the designated person should have the authority to transfer assets to the trust after the grantor suffers an incapacitating disability. If this funding method is desired, it is imperative that the durable power of attorney comply with the specific provisions of state law authorizing the attorney-in-fact to act as agent on the grantor's behalf after the grantor becomes disabled, incapacitated, or incompetent.

Observation: If the only reason for creating the living trust is to avoid a guardianship proceeding, it may be simpler (and cheaper) to grant a durable power of attorney over all of one's assets to a trusted relative or friend, rather than to establish the trust. Because many people are uncomfortable giving even a family member a general power of attorney over their assets, some states provide for a "springing" power of attorney, which doesn't become effective *until* the grantor becomes disabled. Thus, grantors can retain sole control over their assets unless they become disabled.

Multistate Administration. An *ancillary administration* (or administration of the decedent's estate in more than one state) is necessary when decedents own real property located outside of their state of domicile. As with regular probate administration, the expense associated with an ancillary administration is directly related to the specific requirements of the state in which the real property is located. If an ancillary proceeding is fairly simple, it may not be cost effective to establish a living trust to avoid the additional administrative expenses. However, an ancillary administration usually requires the same degree of cost and involvement as a regular administration. In addition, another attorney will normally be required to handle an ancillary administration when the attorney handling the probate administration in the state of domicile isn't licensed in the other state. Thus, as an alternative to an ancillary administration, a living trust can be established to hold title to the property located in another state.

A living trust established solely to avoid an ancillary administration doesn't need to be fully funded to serve its purpose. Instead, it's only necessary to transfer title

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to the out-of-state real property to the revocable living trust. The transfer of title is what makes this trust an appropriate planning tool. If the real property is titled in the name of the living trust, there's no need to transfer title to the property at the death of the trust grantor (trustee). The title will already be vested in the trust, and administration of the decedent's estate in the other state will be avoided.

Other Advantages. Privacy is another benefit of using a revocable living trust. An inventory of assets must be filed in a probate administration. This document becomes a matter of public record, subject to inspection by anyone who expresses an interest. Individuals concerned about the privacy of their financial affairs can use a fully funded living trust to prevent public disclosure of their assets. With the availability of information over the Internet, this may become a greater concern than in the past.

A revocable living trust can also be used to minimize the risk associated with a will contested on the grounds of incompetency. When the competency of individuals is in question, it may be better for them to establish a living trust to dispose of their assets. Generally, it is easier to challenge a will than a trust. If the trust is later challenged on the grounds that the grantor was incompetent at the time of creation, the previous will should still be valid. Conversely, if a person whose competency is in question executes a new will, the new will may be deemed effective to revoke the prior will even though it is not effective to transfer the property to the persons named in the later will. This could force the decedent's property to pass as if he or she died without a will.

Possible Pitfalls of a Revocable Living Trust

Although a revocable living trust can be a valuable estate planning tool, it's certainly not for everyone. Issues that can make such a trust inappropriate for a particular individual include the following:

Failing to Fully Fund the Trust. If the goal of the revocable living trust is to avoid probate, this goal will not be met if the trust is not fully funded. If any titled property isn't transferred to the trust prior to the death of the trust creator, a probate administration may still be required. Even if the trust is fully funded at the time of its creation, subsequently acquired property must be titled in the name of the trust. If for any reason this fails to occur, it will be necessary to have a will admitted to probate (even if it's a *pourover* will), and what was perhaps the primary purpose for establishing the trust will have been defeated.

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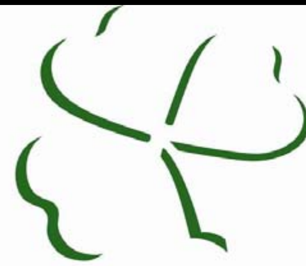
The Glynn Group, Ltd.

August 10, 2007 **Issue #260**

Observation: Some people will find that the inconvenience of having their assets (such as cars, boats, homes, checking accounts, etc.) titled in the name of the trust rather their own name is simply too much to deal with on a day-to-day basis. Thus, they'll either not bother to properly fund the trust when it is set up or as the years go by they'll become remiss in maintaining the proper paperwork.

A concept known as magic wand funding can be used to resolve this dilemma, whereby the creator of the trust executes an instrument stating that he or she no longer owns any property individually, but rather all property currently owned or that may be acquired in the future belongs to the revocable trust. The instrument is recordable (that is, it is acknowledged and meets the formalities for filing in the deed records), but is not actually recorded.

Although magic wand funding may work in theory, it has significant problems from a practical standpoint. The theory is that if the grantor of the power is also the trustee, and the trustee is authorized to hold trust property in nominee form, then executing the magic wand instrument effectively provides for full funding of the revocable trust. However, in deed records the property is still titled in the name of the trust's grantor. If, after the grantor's death, there is an attempt to transfer the property, a title company may not be willing to accept the magic wand funding instrument. If it is not accepted, the intent has been defeated, and the estate must still be probated.

Costs That Exceed the Benefits. Besides the time and effort required to set up and maintain a living trust, there's also some fairly significant (at least for many people) costs involved. If the individual owns a large number of assets, changing the title on all the assets (especially if multiple parcels of real estate are involved) can be time-consuming and costly. Title to the assets needs to be changed twice, initially upon funding to the revocable trust by the grantor during lifetime, and then again upon transfer to the beneficiaries during the post-death administration. Additionally, it can be cumbersome to deal with third parties regarding assets that have been retitled to the trust. These and any other expenses involved have to be weighed against the hoped for benefits of the trust to determine if it appears to be worthwhile. Some individuals will decide that it's not.

Property That's Less Appropriate for Ownership by a Living Trust. Certain property is more appropriate than other for ownership by a living trust. For example, S corporation stock may not be a desirable asset for such a trust because of the restrictions on trust ownership that could apply after the S corporation shareholder's death (i.e., ownership is generally limited to two years unless the trust meets the requirements of a qualified

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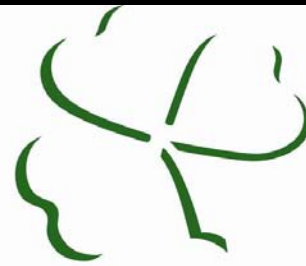

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Subchapter S trust or electing small business trust). In addition, the $25,000 rental real estate allowance available to individuals under the passive loss rules is not available to trusts. Therefore, funding a revocable trust with rental real estate generating losses may create adverse income tax consequences after the death of the grantor when the trust becomes irrevocable and is not entitled to the special allowance.

Tax Consequences of a Revocable Living Trust

It's important for individuals who want to set up a living trust to realize that for estate tax purposes, all of the assets in the trust are included in their gross estate (IRC Secs. 2036 and 2038). Thus, by themselves, living trusts do nothing to reduce an individual's taxable estate.

For income tax purposes, a revocable living trust is treated as a grantor trust. Accordingly, all items of income and deductions generated by the trust pass through directly to the grantor of the trust. Due to the compressed income tax rate structure for estates and trusts, with the 35% marginal tax bracket beginning (in 2007) at $10,450 of taxable income, this is actually good news in most cases because the grantor's tax rate will typically be lower than what the rate would be if the trust income were taxed inside of the trust.

Selecting an Appropriate Trustee

Initial Trustee. The initial trustee of a living trust is normally the grantor. For married couples, both husband and wife are usually named as co-trustees. The intention is to allow them to continue to handle the property as in the past, although they now hold the property in a fiduciary capacity subject to the terms of the trust instrument.

Successor Trustee. It is important to designate a successor trustee for the trust. This is particularly true if one of the purposes for the trust is to provide for the possibility of incapacity of the grantor, or professional management for a surviving grantor. Careful consideration should be given to the selection of a successor trustee because this person will be responsible for investing the assets and making distributions at the death or incapacity of the grantor.

For more information on the following article, please contact The Glynn Group, Ltd.