Estate Planning Insights

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REVISITING LIVING TRUSTS

Over the years, we have assisted many clients with the creation of their estate plan. In the vast majority of cases, we have used a "good, old-fashioned" Texas Will, coupled with "impaired judgement" documents to address the issue of incapacity. Due to the increased mobility of people, multi-state property ownership, and the fact that every state has its own unique probate process, publicity about an alternative estate planing device called a "Living Trust" has proliferated. Like all estate planning "tools", the Living Trust has both advantages and disadvantages. It is a better choice for some people and not worth the additional expense and effort for other people. Now that some of the Living Trust "hype" has died down, it is probably time to examine the Living Trust again.

Those of you who have heard me on the radio and read my articles in the Houston Chronicle over the years know that I have spent a fair amount of time rebutting the exaggerated sales pitches made by "Living Trust promoters". I have never been opposed to the use of Living Trusts, just opposed to "slick salespeople" purposely misleading the public regarding the advantages of Living Trusts. Some of the more irresponsible statements that have been made by Living Trust promoters over the years have been that (i) the probate process is always lengthy, cumbersome and expensive, (ii) probate lawyers take 4% - 6% of a person's estate in attorneys' fees, and (iii) using a Living Trust "avoids estate taxes". None of these statements are true.

In recent years, however, I have started to appreciate new and different reasons for using Living Trusts and have determined that Living Trusts should be used more often. People who might be better off using a Living Trust include those who have (i) a "large" estate, (ii) "large" qualified retirement plans and IRAs, (iii) "complicated" assets (such as a small business), (iv) non Texas real property, and/or (v) an "unusual" estate plan.

<u>Some General Estate Planning Principles</u>. Every person who owns assets of any type should create an "estate plan", indicating "who is in charge" and "who gets what" after the person's death. The best way to memorialize this estate plan is in a legally effective, written document that addresses various circumstances and contingencies. Because this document will be "transporting" the person's assets after his death, it can be viewed as a "vehicle". The after-death process will be more efficient (and less costly) if all (or most) of a person's assets are transported by that one vehicle.

There are two alternative vehicles that can be used for transferring assets at death: a Will and a Living Trust. Neither vehicle is necessarily better than the other. Both have advantages and disadvantages. Some things are the same no matter which vehicle is chosen as the "master estate planning document": both can name a "person in charge" after death (called an "Independent Executor" in a Will and a "Trustee" in a Living Trust), both can be used to transport assets after death, both can include the same type of tax savings and asset protection devices, both can provide various trusts for beneficiaries, etc.

<u>Other Forms of Transfer at Death</u>. Certain forms of titling used on bank accounts, brokerage accounts, stocks, bonds and other assets result in those particular assets "flying off" on their own, and perhaps in a different direction from the assets being transported by the estate planning vehicle. Forms of titling in this category include "Joint Tenants With Right of Survivorship" ("JTWROS"), "Pay on Death" ("POD"), "Transfer on Death" ("TOD") and accounts listing the owner "as Trustee for" a named beneficiary. Accounts set up in this way are sometimes collectively referred to as "multi-party accounts". Multi-party accounts and other assets titled in one of the forms above are not part of the written estate plan set out in the estate planning document. In other words, this form of titling *overrides the estate plan* in the Will or Living Trust as to the assets involved, which can cause many problems (including unexpected tax results and litigation

among the beneficiaries). For this reason, this form of titling should be avoided in most cases.

Other assets will be transferred at death pursuant to a "contractual arrangement" evidenced by a beneficiary designation form. Assets in this category include life insurance, qualified retirement plans (such as profit-sharing plans, 401(k) plans, thrift plans, etc.), IRAs and annuities. These assets always pass outside the estate planning vehicle. Unlike the multi-party accounts, which can be avoided entirely, we cannot change the post-death transfer mechanism applicable to these assets. Instead, however, we can carefully word the beneficiary designation form submitted for each of these assets, so that the disposition of these assets can be coordinated with the "master" estate plan set out in the Will or Living Trust vehicle.

Considerations Regarding Use of the Living Trust. While the three reasons listed in the first paragraph of the newsletter are not good reasons to use the Living Trust vehicle instead of a Will (since they are untrue), there are some good reasons to consider using a Living Trust as the "master estate planning document".

1. Beneficiary Designation Forms. Qualified plan administrators and IRA custodians seem more willing to accept a contingent (secondary) beneficiary designation for retirement plans and IRAs worded: "To Mary Jones, Trustee of the John Jones Living Trust, u/t/a dated May 8, 2004, as amended (or her successor)". On the other hand, they are becoming more resistant (and hostile) to beneficiary designations worded: "To the Trustee named in the Will of John Jones" or "To Mary Jones, Trustee named in the Will of John Jones". This may have to do with the perception that the Living Trust is an already existing trust and has an identifiable person who is already serving as Trustee (although the creator of the Living Trust [the "Trustor"] is usually serving as the Trustee [or Co-Trustee] of the Living Trust while living and, obviously, the Trustor will not be serving as the Trustee of the Living Trust after his death). Plan administrators and IRA custodians have sometimes explained their refusal to accept the "Trustee in the Will" as a contingent beneficiary by saying that: (i) a Will is a revocable document that is not yet effective and, therefore, no trust created in the Will is currently in existence, and (ii) even if a person is appointed in the Will to serve as Trustee after the Will writer's ["Testator's"] death, it cannot be known now if that person will actually turn out to be the Trustee at the time of the Testator's death. While all of this is true, the same complaint can be made regarding the identity of the Trustee in the Living Trust because it cannot be known now who, in fact, will take over as the Trustee of the Living Trust on the Trustor's death. Nevertheless, it is easier to get plan administrators and IRA custodians to accept a contingent/secondary beneficiary designation listing the Trustee of a Living Trust as the beneficiary versus the Trustee in the Will.

2. Use Can Avoid "Bad" Forms of Titling. As noted above, many banks, brokerage firms, stock transfer agents, investment companies and other financial institutions "automatically" title accounts and other assets in the name of two or more "owners" (such as an account in both spouses' names) as "Joint Tenants With Right of Survivorship" ("JTWROS"). Again, as noted previously, this form of titling overrides the estate plan in the Will or Living Trust of the account owner, often resulting in unintended consequences. For example, if the Will or Living Trust contains a Bypass Trust, having accounts pass outside the Will or Living Trust by "right of survivorship" can potentially cause large unnecessary estate taxes to be paid on the second spouse's death due to under-funding the Bypass Trust. Unfortunately, it's not always easy to get out of the JTWROS form of titling–some institutions will not allow any other type of designation for accounts set up in the names of two or more individuals. If a married couple uses a joint Living Trust as their estate planning vehicle, all of their joint accounts can be re-titled in the name of their Living Trust as part of their estate plan, thereby preserving their estate plan, including the tax benefits they are seeking.

3. Privacy. Another advantage of re-titling joint accounts (and other assets) in the name of the Living Trust prior to death has to do with one part of the probate process. Assets already titled as part of a Living Trust prior to the death of the owner will not "pass through probate" and, therefore, will not need to be disclosed in an Inventory filed for the deceased owner's estate in the Probate Court records. Thus, both the existence of the account and the amount held in the account as of the date of death will remain private. Note that I am not listing "Avoiding Texas Probate" as one of the advantages of the Living Trust (although the Living Trust can facilitate that goal, if desired). As explained in our July 31, 2004 Newsletter, the probate process in Texas (unlike other states) is fairly simple.

4. Asset Management During Incapacity. When a person with a "large" or "complicated" estate becomes incapacitated and the incapacity is likely to last for a long period of time, it will be easier to deal with title companies, stock transfer agents, banks, brokerage firms and other "third parties" if the person's assets and affairs are being handled by the Trustee of his Living Trust (versus an agent appointed in a Power of Attorney). Two differences make the Living Trust work better in this

situation: (i) a Trustee holds legal title to the assets in the trust, while an agent under a Power of Attorney does not hold legal title to the assets, and (ii) the Trustee's powers are usually spelled out in great detail in the trust instrument, while the agent's powers are listed very summarily in the Power of Attorney. Further, a guardianship "of the estate" (a court-supervised administration of a person's assets) can still be opened for an incapacitated person whose assets/affairs are being handled by an agent under a Power of Attorney, while a guardianship generally cannot be obtained with respect to assets already held in a Living Trust. In addition, people who want a corporate fiduciary (a bank having trust powers or a private trust company) to manage their assets and financial affairs for them while they are incapacitated must use a Living Trust (most corporate fiduciaries will not serve as the agent of an incapacitated person under a Power of Attorney).

5. Avoiding Ancillary Probate. People who own any real estate or minerals in other states can often avoid an "ancillary" probate process upon death by transferring that real property into their Texas Living Trust now. Unlike Texas, many states have a "bad" probate process, one that is cumbersome, expensive and lengthy. By transferring title to real property and minerals located outside Texas to a Living Trust, a person domiciled in Texas should be able to provide for a smooth transition of ownership of those out of state assets and avoid the probate process in those other states.

6. Non Pro Rata Distributions. The Living Trust is a better device for supporting the practice of post-death "swapping" of assets. Swapping is often done after the death of the first spouse so that "more appropriate" assets can be placed in a Bypass Trust. Technically, swapping refers to a "non pro rata distribution", something that must be authorized in the document to be available as a post-death technique. An additional goal of the non pro rata distribution is to avoid "sale or exchange" treatment on the swap. Based on certain tax rulings and Texas marital property law, income-tax free "swapping" is probably more defendable against IRS attack in the situation involving a funded Living Trust containing both spouses' assets than in the situation involving a decedent's Will and a surviving spouse.

7. Sophisticated Estate Tax Exemption Planning. A recently authorized approach for taking full advantage of estate tax exemptions of both spouses in situations where one spouse is much wealthier than the other spouse (due to owning valuable separate property) can only be done using a funded Living Trust. This is a highly technical technique that is not right for everyone, but those who do want to use it must create a Living Trust.

8. Contest of the Estate Plan. With one caveat, an estate plan set out in a Living Trust is more difficult to challenge than an estate plan contained in a Will. A person who is concerned that certain heirs might contest her estate plan can establish that plan in a fully funded Living Trust, and then administer the trust for a lengthy period of time before she dies. Due to the fact that the person's assets were part of a Trust that "was operated" for a long time, it will be harder for the disgruntled heirs to challenge the estate plan. On the other hand, the degree of mental capacity required to make a Will is somewhat lower than that required to set up a trust, so that a person who already has significant mental impairment and who expects that his estate plan will be challenged may be better advised to establish the plan in a Will (containing a "no contest" clause). If a person of sound mental capacity and relatively good health believes that his/her estate plan will likely be challenged after death, it is probably better to create and fully fund a Living Trust now, and operate it (with or without assistance) until death.

9. Coordinated Estate Plan. Many couples want to have a "coordinated" estate plan, with a mutual disposition on the second spouse's death. This goal is sometimes easier to achieve using a joint Living Trust versus separate "mutual" Wills. There can be some tax "trade-offs" in these situations, however (which are the same regardless of whether the plan is contained in a joint Living Trust or in mutual Wills).

The next two items are not necessarily advantages of Living Trusts, just "features" of Living Trusts.

10. Tax Neutral. A Living Trust is "tax neutral". While the Trustor is living, a Living Trust is a "grantor trust" for income tax purposes, meaning that the income in the trust is reported by the Trustor. A Living Trust does not have to file its own income tax return if the Trustor is serving as the Trustee. If the Trustor ceases to serve as Trustee of the trust, then a taxpayer identification number will be obtained for the trust and a separate income tax return will be filed for the trust by the Trustee. All of the trust's income, however, is still reported by the Trustor until the Trustor dies. Because a Living Trust is a grantor trust, and because all of the trust's assets are considered to be owned by the Trustor, those assets are part of the Trustor's "estate" for federal estate tax purposes. That is why the Living Trust promoters' claim that use of a Living Trust avoids estate taxes is not true. If avoidance or deferral of estate taxes is desired, then tax planning devices will need to be included in the Living Trust (note that these are the same devices that can be included in a Will).

11. No Asset Protection. Because the Trustor is still considered the owner of the assets in the Living Trust, placing assets in a Living Trust does not provide the Trustor with asset protection (i.e., protection from the claims of creditors). Creditors of the Trustor can reach the assets in the Living Trust as long as the Trustor is living. This is true even if someone else is the Trustee. Asset protection devices can be included in a Living Trust to protect beneficiaries after the Trustor's death.

Disadvantages of Living Trusts. What are the disadvantages of Living Trusts? Creating a Living Trust estate plan is usually more expensive than creating a comparable estate plan in a Will. On the other hand, if any of the Living Trust advantages are important in a particular case (and save time, trouble and/or money in the future), then the additional estate planning cost may well be worth it. In addition, if avoidance of probate and/or ancillary probate is a goal, meaning that assets must be placed in the Living Trust prior to death, there will be additional asset transfer expenses, such as the cost of preparing and filing deeds to transfer title to real property to the trust.

Overall, there is really not much difference between using a Living Trust and using a Will as the primary estate planning vehicle. Both are good vehicles for transferring assets at death.

Contact Us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

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