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Living Trusts—Making a Wise Decision

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A discussion of the estate planning considerations and ramifications of living trusts, focusing on:

- Potential benefits
- Potential difficulties

INTRODUCTION

An inter vivos trust is a trust created during the settlor's lifetime that becomes effective while the settlor is still alive, as contrasted with a testamentary trust that takes effect upon the settlor's death. Because an inter vivos trust operates during the lifetime of the settlor, it is commonly referred to as a "living trust."

The settlor may want to create a living trust but may also desire to retain considerable interests in the trust property and control over its management, such as serving as trustee, receiving all income, retaining the power to revoke the trust, and keeping the right to change the beneficiary.

Revocable living trusts under which the settlor, trustee, and lifetime beneficiary are the same person are sometimes called *Dacey trusts* based on a book entitled *How to Avoid Probate* authored by Norman Dacey. This book touted the advantages of this type of trust, which permits a person to retain total control over the property while alive and then have the property pass to the designated remainder beneficiaries upon the person's death. Mr. Dacey argued that most people would be better served by placing their property in these trusts, rather than having their property pass under a will, which would necessitate a potentially time-consuming and expensive probate process. The book, originally published in 1966, contained approximately 55 pages of text and 310 pages of forms and instructions. Because Mr. Dacey was not an attorney, he got in trouble for allegedly practicing law without a license. However, a New York court later found in Mr. Dacey's favor.[1]

Mr. Dacey's "radical" ideas have now been incorporated into mainstream estate planning. Living trusts are still being pitched as the panacea that avoids lawyers, taxes, and probate.[2] Living trusts are often the focus of advertisements, free seminars, and media coverage. However, living trusts are not for everyone. They must be used wisely after obtaining professional guidance to thoroughly evaluate the potential benefits and disadvantages.

ADVANTAGES OF LIVING TRUSTS

Provide for and protect beneficiaries

The settlor's desire to provide for and protect someone is probably the most common reason for creating an inter vivos trust. Although a donor could make a quick, convenient, and uncomplicated outright gift, there are many situations in which such an outright gift would not effectuate the

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donor's true intent.

Minors. Minors lack legal capacity to manage property and usually have insufficient maturity to do so as well. A trust permits the settlor to make a gift for the benefit of a minor without giving the minor control over the property or triggering the necessity for the minor to have a court-appointed guardian to manage that property. A trust is also more flexible and allows a settlor to have greater control over how the property is used when contrasted with other methods, such as a transfer to a guardian of the minor's estate or to a custodian under the Uniform Transfers to Minors Act.

Individuals who lack management skills. An individual may lack the skills necessary to properly manage the trust property. This deficiency could be the result of mental or physical incompetence or a lack of experience in the rigors of making prudent investment decisions. For example, persons who suddenly obtain large amounts of money, such as performers, professional athletes, lottery winners, or personal injury plaintiffs, tend to deplete these windfalls rapidly because they have never learned how to manage their money wisely. By putting the money under the control of a trustee with investment experience, the settlor increases the likelihood that the beneficiary's interests are served for a longer period of time.

Spendthrifts. Some individuals may be competent to manage property but are prone to use it in an excessive or frivolous manner. By using a carefully drafted trust, a settlor can protect the trust property from the beneficiary's own excesses as well as the beneficiary's creditors.

Persons susceptible to influence. When a person suddenly acquires a significant amount of property, that person may be under pressure from family, friends, charities, investment advisors, and opportunistic scam artists who wish to share in the windfall. An inter vivos trust can make it virtually impossible for the beneficiary to transfer trust property to these people.

Protect Assets From Beneficiary's Creditors

Under the law of most states, the settlor may protect trust assets by including a spendthrift provision. A spendthrift clause does two things. First, it prohibits the beneficiary from selling, giving away, or otherwise transferring the beneficiary's interest. Second, a spendthrift clause prevents the beneficiary's creditors from reaching the beneficiary's interest in the trust. The provision permits the settlor to carry out the settlor's intent of benefiting the designated beneficiary but not the beneficiary's assignees or creditors. Unless prohibited by state law, settlors include spendthrift restrictions in practically every trust because they protect beneficiaries from their own improvidence and their personal creditors. Note that neither the settlor nor the beneficiary must show that a beneficiary is actually incapable of prudently managing property to obtain spendthrift protection.

An important exception exists to the enforceability of spendthrift provisions in most states. Spendthrift protection is not available if the beneficiary is also the settlor of the trust. It has been traditionally against public policy for a person to shield the person's own property from creditors with a spendthrift restriction. However, a growing number of states, including Alaska, Arkansas, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming, enforce spendthrift provisions to varying extents even if the trust is self-settled, giving rise to the *domestic asset protection trust* or DAPT technique.

Retain flexibility

An outright gift, either inter vivos or testamentary, gives the donee total control over the way the property is used. With a trust, the settlor may restrict the beneficiary's control over the property in any manner the settlor desires as long as the restrictions are not illegal or in violation of public policy. This flexibility allows the settlor to determine how the trustee distributes trust benefits, such as by spreading the benefits over time, giving the trustee discretion to select who receives distributions and in what amounts, requiring the beneficiary to meet certain criteria to receive or continue receiving benefits, or limiting the purposes for which trust property may be used such as health care or education.

Easy to revoke or amend

Many formalities are required to execute a valid

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will as well as to amend an already existing will. Changing an existing will is a hassle and may require as much effort as making the will in the first place. On the other hand, the settlor may update and revise, or even revoke, a revocable inter vivos trust with a minimum of effort thus avoiding extended procedures and technicalities.[3]

Avoid probate

Property in an inter vivos trust is not part of the probate estate upon the settlor's death. The property remaining in the trust when the settlor dies is administered and distributed according to the terms of the trust; it does not pass under the settlor's will nor by intestate succession.

The probate process creates a gap between the time a decedent dies and the time the heirs or beneficiaries physically receive the decedent's property. This delay may range from months, to years, and even to decades, especially if the decedent's will is contested. This delay is potentially damaging from three perspectives.

First, the heirs and beneficiaries are unable to use the property. During the delay period, the educational, medical, or other needs of the survivors may go unmet because they cannot reach the decedent's property.

Second, the decedent's property may not be able to withstand a gap in management. Some types of property require constant monitoring to maintain value. Corporate securities need to be traded as the market dictates; crops need to be timely harvested and then processed or sold; and foreign investments must be evaluated in light of the constantly changing world political scene. If the decedent owned a business operation in which the decedent was actively involved, time may be of the essence in the transfer of control of the business after the death of the decedent. Any delay in the transfer of control may hinder or disrupt the business activity, as well as cause the loss of customers.

Third, the decedent's survivors may have to endure the emotional impact of a prolonged administration. The constant reminder of a loved one's death that results from a drawn-out administration may prevent closure and keep the survivors from moving on with their lives.

Reduce administration expenses

Estate planning and administration are relatively expensive procedures. The costs are based on a variety of factors such as the size of the decedent's estate and its composition. For example, planning for cash, bank deposits, and other relatively liquid assets is usually inexpensive, while businesses often require more complex and sophisticated planning. Another key factor is the law of the state in which the estate is administered. Some states have expensive, cumbersome, and lengthy probate procedures while others have procedures that are relatively inexpensive and efficient. Expenses incurred during estate administration include attorney's fees, personal representative fees, and court costs. The use of an inter vivos trust may be effective to reduce these expenses because less of the decedent's property would pass through the decedent's estate.

Increase privacy

Most people like to keep their financial and family matters private. During life, it is relatively easy to keep these matters confidential, unless the person is a celebrity or politician. However, an entirely different situation exists when the person dies. All estate proceedings are on the public record. Typical documents filed in an administration include inventories of all of the decedent's assets, the appraised value of each asset, and the names of the new owners, be they intestate heirs or will beneficiaries. Of course, the will itself is public record. A reporter, marketer, creditor, or merely curious person needs no excuse to view, copy, distribute, or publish the documents. Used properly, however, inter vivos trusts that do not involve real property can usually escape conspicuous notation on the public record or in other readily available sources. The settlor can thus keep private the extent of the settlor's assets and their disposition.

Avoid ancillary probate of out-of-state real property

If a decedent owned out-of-state real property, the decedent's will is usually probated in the state of the decedent's residence with some type of ancillary administration being necessary in the state or country in which the real property is located. This potentially expensive, inconvenient, and time-con-

suming "double-probate" process may be avoided if the property passes by way of an inter vivos trust.[4]

Protect from estate creditors

Most property that passes through a decedent's probate estate is subject to the claims of the decedent's creditors. The primary reason for having an estate administration is to make certain the decedent does not escape the decedent's obligations merely by dying before paying them in full. If the property does not pass through the probate estate, however, it may escape liability for the decedent's debts.

The use of some non-probate transfers to avoid creditors is very controversial. Creditors generally accept that they cannot reach certain non-probate assets such as the proceeds of a life insurance policy that is payable to a named beneficiary. This makes sense because the creditors did not have the ability to reach the proceeds while the insured was alive. However, creditors are reluctant to agree that they cannot pursue other non-probate transfers to satisfy their claims, such as property passing via an inter vivos trust, which the decedent could have revoked while alive. The creditors do not think that the death of a debtor should protect assets that were not protected during the debtor's life.

Isolate from contest

Inter vivos trusts are often more resilient to contest than wills, although individuals dissatisfied with trusts may attack them on many of the same grounds that may be used to contest a will, such as the settlor's lack of mental capacity or that the transfer was the result of undue influence or fraud. The settlor may make arrangements for inter vivos trusts long before the settlor's death. Trust creation and subsequent trust activities may require the settlor to engage in ongoing transactions with people who can testify to the settlor's capacity, such as bank officials, insurance agents, business associates, and trust officers. Thus, individuals who wish to uphold an inter vivos trust have a greater likelihood of locating evidence to rebut a contestant's claims.

Reduce family disputes

Unlike a will, the settlor of an inter vivos trust is not required to give notice of the existence of the trust to any family members. Upon the death of the settlor, the inter vivos trust simply continues without notice to family members. An inter vivos trust that has been in existence for a lengthy period of time is less likely to be subject to claims of undue influence or fraud by family members who are unhappy with the trust provisions. A will, on the other hand, is admitted to probate upon the death of the decedent, and family members are given an opportunity to dispute the validity of the will. Thus, a will is easier to attack on the grounds of undue influence or fraud.

Avoid the need for a guardian

Once an individual is incompetent due to illness, injury, or other cause, the person cannot manage the person's own property. The court then needs to appoint a guardian of the estate to manage the property. The process of judicially determining a person's incompetency may cause the person considerable private and public embarrassment, and there is no guarantee the incompetent person will be happy with the guardian's decisions. Guardianships are also inconvenient and costly because guardians act under court supervision and are typically required to submit detailed reports on a regular basis.

An inter vivos trust can be used to avoid the need for a guardian. The settlor may create a trust and maintain considerable control over the trust property by, for example, serving as the trustee, retaining the power to revoke the trust, and keeping a beneficial life interest. However, upon incompetency, the settlor's designated successor trustee would take over the administration of the trust property in accordance with the directions the settlor expressed in the trust instrument. This type of arrangement is often called a *stand-by trust*. The trust should provide in detail the event(s) and the burden of proof required to trigger a shift in the management of the trust (e.g., the settlor's doctor declaring that the settlor is unable to manage business affairs).

Provide professional management of property

The settlor may create a trust to obtain the services of a professional asset manager, either for the benefit of third party beneficiaries or for the settlor as the beneficiary. Professional trustees, such as

banks and trust companies, have more expertise and experience with various types of investments than most individuals. Assume that your client has just inherited a wheat farm located in Kansas, an office building in New York City, an apartment building in San Francisco, United States government savings bonds, corporate stock in a dozen domestic corporations, oil and gas property in Texas, and an import-export business in Italy. Would your client have the skill to handle all of these different types of assets? If not, placing the assets in trust would be one way of obtaining professional management. And, there is another. If the client negligently manages the client's own property and suffers financially as a result, there is not much the client can do about it; the client cannot successfully bring a law suit against himself or herself. However, if a trustee is negligent, the client can bring suit for breach of fiduciary duties.

Professional trustees also have greater investment opportunities. For example, a bank may combine funds from several trusts into one common trust fund to take advantage of opportunities that require a large investment and to diversify, thus reducing the damage to the value of the trust when one investment turns sour.

Minimize income taxes

Another popular reason for utilizing living trusts is tax reduction. Income taxes can be saved by transferring income-producing property to a trust that has a beneficiary who is in a lower tax bracket than the settlor.

Property passing through an inter vivos trust to pay the income for life to or on the order or direction of the settlor, with the right reserved to the settlor at all times before his or her death to revoke the trust, receives a step-up in basis, thereby reducing the capital gains tax burden on the beneficiaries [IRC §1014(b)(2)].

DISADVANTAGES OF LIVING TRUSTS

Despite the tremendous potential benefits of inter vivos trusts, a trust may not be the best tool to accomplish a client's intent. A person should not create a trust until the person carefully balances the benefits against the trust's creation, administration, and transfer costs. For example, assume that the client's main goal is to plan for disability. Although a properly drafted trust would do the job, it will entail additional time and money to establish the trust and transfer title to the property to the trust. Perhaps a durable power of attorney for property management, which can be quickly and economically prepared, is all the client needs. This section reviews the major concerns that a settlor should consider before electing to create a living trust.

Loss of control over trust assets

The settlor must make the trust irrevocable in order to obtain many of the benefits of inter vivos trusts, such as tax reduction and creditor protection. Some settlors are not willing to release control over their assets. For example, the settlor may wish to have the power to terminate the trust at any time or to make changes as the settlor's financial circumstances change and the needs and responsibilities of the beneficiaries evolve.

Trust must be funded

A trust does not exist unless there is trust property. Thus, the settlor must be certain to transfer legal title to trust property to the trustee. Legal title to the trust property must reach the hands of the trustee. It is not enough for the settlor to sign a trust instrument, own assets that would make good trust property, and intend for that property to be in the trust. The settlor must consummate this intent by actually transferring the property. For example, the settlor should deed real property to the trustee and deliver personal property to the trustee. A formal transfer is needed even if the settlor and the trustee are the same person. A deed from the client as an individual owner and to the client as the trustee of the trust is needed. Personal property should be separated from all of the client's other property and then be marked in such a way that the trust property can be easily distinguished from the client's other property. A formal deed of gift is highly recommended.

Probate required for assets not transferred to trust

To completely avoid probate, all assets the settlor owns must be transferred to the trust or be held in some other non-probate form (e.g., in a joint tenancy with survivorship rights). If the settlor fails to transfer every single one of the settlor's assets to the

trust or make other non-probate arrangements for every non-trust asset, probate will still be required. Settlors often do not realize that every asset from the major (real property, securities, certificates of deposit) to the minor (e.g., photograph albums, clothes, and dishes) must be handled via a non-probate technique to totally avoid probate. Thus, although inter vivos trusts avoid probate of the property transferred to the trust, it is highly likely that probate will be necessary to handle the settlor's other property.

Costly to create and maintain trusts

Inter vivos trusts may have significant creation and maintenance costs. The settlor will typically incur legal fees to create the trust, fees that can exceed $2,000, especially if the estate is relatively complex. These fees may be much greater than those for a will that accomplishes the same goals. The settlor will also incur the cost of transferring property to the inter vivos trust. For example, if real property is involved, a deed needs to be prepared and properly recorded. If the settlor is the trustee, the settlor may incur the expense of professional advisors to advise the trustee regarding the settlor's fiduciary obligations. If the trustee is a third party, then the trust may incur trustee fees for the trustee's fiduciary services. In addition, the settlor may incur substantial expense to modify the trust when circumstances change (e.g., the birth of a new child, divorce, etc.).

The time-value of money must also be considered. "In real economic terms, the initial costs may be greater than any savings that ultimately are achieved. For example, if a person pays $2,000 for a living trust at age 50 and dies at age 75, the real cost of the trust is what an investment of $2,000 would have earned during the intervening 25 years. Assuming a modest five per cent rate of return, the initial $2,000 would have grown to more than $6,700. Thus, the person's beneficiaries would have to save $6,700 in probate costs just to break even."[5]

Beneficiaries have right to demand accounting

The trustee must keep accurate trust records and render detailed accountings upon a beneficiary's written demand. The time and cost associated with these accountings may be significant.

Trust termination expenses

When the trust ends, title to the trust assets must be conveyed from the trust to the ultimate beneficiaries. This extra set of transfers, when compared to an outright disposition by will, adds to the expense of an inter vivos trust, especially because legal assistance is usually needed to be certain the transfers are done correctly.

Privacy potentially compromised

Although inter vivos trusts do not automatically become a matter of public record, there are numerous situations where the trust terms must be revealed. Many times a third party (e.g., a bank or brokerage firm) will require the trustee to produce the trust instrument so as to establish that the trustee has the legal authority to act for the trust. Although the terms of the trust instrument are not disclosed to the public in general, the privacy sought by many settlors is weakened when a third party requires production of the trust instrument.[6] Further, if a dispute arises from the trust instrument, the trust instrument may be disclosed in a court proceeding, which, again, defeats the settlor's desire for privacy. If the trust contains real property, the trust may need to be recorded in the real property records. Consequently, the settlor must accept that there will be some disclosure, albeit not as much disclosure as incurred in probate, as well as a risk of full disclosure, when an inter vivos trust is created and managed.

More difficult for client to understand

Most clients already understand how a will works before consulting an estate planner. In other words, clients know that a will is a document that specifies who gets the client's property upon death. Trusts, on the other hand, are not really understood by most people, even if they have a general idea that they operate to give benefits to selected individuals. The estate planner needs to spend time explaining how trusts operate, such as the split of legal and equitable title, the imposition of fiduciary duties on the trustee, and the liability of the trustee for breaches of trust.

Tax savings difficulties

Income tax savings is touted to be one of the more

significant benefits of an inter vivos trust. However, a revocable inter vivos trust generally does not provide any current personal income tax savings for the settlor. To obtain relief from personal income taxation, the settlor must not derive any benefit of the income or corpus of the trust [IRC §§671 et seq.]. If the settlor retains too much control, including the power to revoke, the settlor will be considered the owner of the trust and hence taxed on the income.

A revocable inter vivos trust does not avoid estate or gift taxes. No gift tax is incurred when the settlor transfers property to a revocable inter vivos trust because the gift is not complete—the settlor can reacquire the property at any time. Thus, none of the transfer can qualify for the annual exclusion. In addition, the settlor's estate will incur an estate tax liability based on the value of the assets held in the trust at the date of the settlor's death. [IRC §2038] On the other hand, an irrevocable trust may be structured to reduce transfer taxes.

Trustee owes fiduciary duties to trust beneficiaries

A trustee owes numerous fiduciary duties to the beneficiaries of a trust, including the beneficiaries of an inter vivos trust. As a fiduciary, the trustee may be personally liable for breaches of the fiduciary duties. Therefore, a client who creates an inter vivos trust and appoints himself or herself as the trustee must understand that the client is now subject to a higher standard of care with respect to the trust property and must avoid self-dealing and conflicts of interest. If the settlor appoints a family member or a friend as the trustee, this individual will also be subject to the fiduciary duties and potential personal liability. If the settlor desires, the trust may include an exculpatory clause that will operate to protect the trustee from liability for mere negligent breaches of duty. The trustee must exercise caution in relying on exculpatory clauses because courts construe them strictly and hold that it is against public policy to exculpate reckless, knowing, or intentional conduct.

Creditor protection problematic

Settlors often wish to use inter vivos trusts to protect their assets from creditors. This protection, however, may be hard to obtain. If the settlor can revoke the trust, no creditor protection exists.[7] Even if the trust is irrevocable, a spendthrift clause in favor of the settlor will not protect the settlor's interest in the trust in most states. Further, a transfer by the settlor to an inter vivos trust may be set aside by creditors as a fraudulent conveyance.

Homestead and exempt personal property protection jeopardized

Many states provide special creditor protection for a homestead and certain items of personal property. These protections may be jeopardized if the exempt property is held in trust form rather than by the individual outright.

Title insurance at risk

The transfer of real property into a revocable inter vivos trust "may result in loss of owners' title insurance coverage. The trust may be treated as an entity, separate and distinct from the transferor."[8]

Rights of ex-spouse as beneficiary

Unless state law provides to the contrary, an ex-spouse will continue as a beneficiary of a revocable trust if the settlor failed to change the beneficiary designation. To avoid this unintended result, the trust instrument should be drafted to require that the marriage remain in effect for the spouse to receive trust distributions.

Probate may be more efficient and economical

An inter vivos trust may not be the most efficient or economical method to transfer an estate. If the decedent dies domiciled in a state that provides for non-court supervised or independent administration, transferring property via probate may actually be faster and cheaper than via an inter vivos trust.

CONCLUSION

Before an inter vivos trust is recommended to a client, the estate of the client, the status of the intended beneficiaries, and the goals of the client must be considered. An inter vivos trust may be an extremely useful and effective part of the client's estate plan. However, living trusts are not appropriate in all cases. A careful review of the potential

benefits and drawbacks must be made before deciding whether the client should include an inter vivos trust as part of the estate plan.

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FOOTNOTES

1 *New York County Lawyers' Ass'n v. Dacey*, 21 N.Y.2d 694, 234 N.E.2d 459 (1967).
2 See, e.g., Jon W. DeMoss, *The Living Trust Scam*, 81 Ill. B. J. 234-35 (May 1993).
3 Because states have different presumptions regarding the revocability of trusts, all trusts should clearly state whether the settlor has the power to amend or revoke the trust.
4 Some states permit a will that is probated in the decedent's domiciliary jurisdiction to be "probated" simply by recording a certified copy of the will along with a certified copy of the judge's order admitting the will to probate.
5 Edwin G. Fee, Jr., *Living Trusts: Debunking the Myths*, PRAC. LAW., June 1997, at 27, 31.
6 Some firms may be satisfied with a copy of the first page and signature page.
7 In addition, "[r]evocable trusts do not protect a Medicaid beneficiary's assets held in such a trust from estate recovery laws and regulations." Clifton B. Kruse, Jr., *Critical Differences in Estate Planning Strategies Between Revocable Trusts and Wills*, 23 ACTEC NOTES 145, 145 (1997).
8 Id. at 148.

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