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REVOCABLE TRUSTS vs. WILLS

What is a Revocable Trust?

A revocable trust is a legal entity that holds title to property for the benefit of designated beneficiaries. It is created as an agreement between two parties, the grantor and the trustee, which provides for the management and distribution of the grantor's assets. The grantor creates the trust, transferring some portion or all of his or her assets to the trust by re-registering them in the name of the trustee. (See, "Funding Revocable Trusts" Article) The trustee holds title to the trust property and manages it according to the terms of the trust instrument. The beneficiaries receive the income or principal from the trust. They can be the grantor (and, if desired, one or more of the grantor's spouse and children) during his or her lifetime and the grantor's spouse and children, or anyone else the grantor chooses to name, after the grantor's death.

What makes the trust revocable is the grantor's reservation in the trust instrument of the right to amend or revoke the trust at any time during his or her life. This enables the grantor to revise or terminate the trust to take into account any change of circumstances. Upon the death of the grantor, the revocable trust becomes irrevocable.

Most commonly, the grantor retains control of his or her assets by serving as trustee during his or her lifetime, and another person, or a bank or trust company, is named to serve as successor trustee after the grantor's death or in the event of the grantor is unable to continue serving for any reason. The trust terms generally require that the trustee distribute as much of the income and principal to the grantor as the grantor requests during his or her life or as the trustee may decide in accordance with the standards contained in the trust instrument. The trust instrument may also allow the trustee to make distributions to other persons, such as members of the grantor's family.

Upon the death of the grantor, the trustee continues to hold and administer the trust property in accordance with the terms of the trust instrument. When a revocable trust is used, the trust generally contains all the provisions regarding the post-death distribution of assets (the provisions that one would place in his or her Will). In such a case, the grantor's Will is reduced to a relatively short and simple document called a "pour-over" Will, which may set forth a few specific bequests and direct that all property held in the grantor's sole name (that is, not held by the trust) be distributed to the trustee of the revocable trust, to be administered pursuant to the terms of the trust.

Revocable Trust or Will: Non-Tax Considerations

Avoidance of Probate. One of the primary reasons for using a revocable trust is the avoidance of probate proceedings. The term "probate" refers to the process, which may be very simple or complex, depending upon the circumstances and applicable state law, of getting the applicable court to determine that the Will is genuine and valid and appointing the executor or personal representative. At the grantor's death, any assets transferred to the revocable trust during the grantor's lifetime may be administered by the trustee according to the terms of the trust instrument without the supervision of the probate court, and the trustee assumes its duties without court involvement. In some states, this may avoid the complications resulting from probate procedures relating to inventories, claims periods, current and final accounts, etc.

Because property held in a revocable trust at the time of the grantor's death is not subject to probate, in some states, the value of such property may not be considered in determining the amount of fees that may be allowed under state law for the executor or personal representative (the person who is designated in the Will to administer grantor's estate) or the estate's attorney (where such fees are based on the value of the estate). Further, assets held in a revocable trust can often be distributed to the beneficiaries shortly after the grantor's death, avoiding much of the delay encountered with probate.

Probate proceedings and costs are a function of state law, however, and where simplified administration is available, probate may be neither cumbersome nor expensive. In many cases, a routine estate administration may require no court supervision at all, and the executor can collect the assets of the estate, pay the debts and taxes and distribute the estate without court approval.

Additionally, to avoid probate completely, the grantor must title nearly all assets in the name of the trustee of the revocable trust, which can be difficult, time-consuming and expensive. Simply missing one or two items of property may force a probate proceeding anyway. Also, contrary to a common misconception, avoiding probate does not mean avoiding state or federal estate taxes. The assets held in a revocable trust are fully includible in the grantor's gross estate for federal estate tax purposes. (See, "Transfer Tax System" Article).

A revocable trust may be most helpful in avoiding probate in a state other than the state in which the grantor resides (known as "ancillary administration"). If the grantor owns real estate in a state other than the state of his or her legal residence, separate probate proceedings in the second state are often required to transfer title to that property. This usually requires the estate to retain local counsel in each state. Ancillary administration can significantly increase the costs and delays involved in administering an estate. If the grantor transfers the real estate to his or her revocable trust, however, ancillary probate is avoided. The trustee may administer the property and distribute it to the beneficiaries designated under the trust instrument.

Management of Assets. A Will controls only those assets that are held in the grantor's sole name at death or assets payable to the grantor's estate at his or her death. A revocable trust controls only the assets transferred to the trust prior to the grantor's death or payable to the revocable trust as beneficiary at the grantor's death. Neither a Will nor a revocable trust applies to assets registered in joint tenancy with a spouse or a third party or assets controlled by beneficiary designations, such as life insurance, qualified plan benefits, IRAs, "transfer on death" or "payable on death" arrangements.

Where the grantor has appointed himself or herself as the initial trustee, the grantor retains control of his or her assets and continues to have the responsibility for their day-to-day management. In the alternative, a grantor may name a bank or trust company or a person other than himself or herself as the trustee, shifting to that person or the bank or trust company the responsibility for day-to-day management of his or her property. Of course, the use of a revocable trust requires ongoing monitoring to ensure that assets remain in the trust and that newly acquired assets are titled in the trust.

When an executor or personal representative is appointed, the executor must become familiar with all of the grantor's affairs and formally take possession of all of the estate's assets. This takes time. If one transfers his or her property to a revocable trust during life, and names a trustee or co-trustee other than himself or herself, some problems often faced by a new executor or personal representative can be avoided and continuous management of the assets maintained. The trustee already will have possession of the property and be familiar with the grantor's financial affairs.

Provision for Incapacity. If one does not have a funded revocable trust and becomes incapacitated, and if one lacks an appropriate power of attorney, it may be necessary to have a conservator or guardian appointed by a court to handle the incapacitated individual's financial affairs. In contrast, a funded revocable trust can provide for the management of one's property when he or she becomes disabled, incapacitated or incompetent. If the grantor has placed most of his or her property in the revocable trust and later becomes incompetent, the trustee (or successor trustee if the grantor is acting as trustee) has the power to manage the property for the benefit of the grantor and his or her family under the terms of the trust instrument.

The trust instrument can specify a method for deciding whether the grantor has become disabled and, if the grantor is acting as trustee, for the appointment for a successor trustee, without the need for any court action. Typically, the successor trustee, often with the assistance of the grantor's physician and certain members of the grantor's family, makes the determination that the grantor is incapacitated, which enables the successor trustee to manage the trust assets. Such a mechanism avoids the publicity, costs and delays involved in guardianship or conservatorship proceedings.

A durable power of attorney can achieve substantially the same results. If one is concerned about future disability but does not wish to transfer assets into a revocable trust immediately, he or she may give a power of attorney to another person that specifically authorizes the agent to transfer property to the revocable trust. The trustee can then manage those assets in accordance with the terms of the trust instrument.

Privacy Issues. Avoiding probate maintains greater privacy about one's assets and the distribution of one's estate. Upon death, a Will is filed with the clerk of the probate court. It becomes a matter of public record, available for the inspection of any interested person. This makes all of the details of one's estate plan open to the public. In some cases, the executor or personal representative must file with the court an inventory listing all the assets and their values subject to probate and an accounting showing all expenses paid and the assets distributed to each beneficiary. Inventories and accountings are also public records. If the revocable trust replaces the Will as the primary estate planning document, these details may never become public.

Depending upon applicable state law, assets transferred to the trust during the grantor's lifetime may not have to be listed on an inventory or accounting filed with the court records.

Some states, however, do require a copy of the revocable trust instrument to be filed with the probate court. Further, a copy of a revocable trust instrument will be attached to a federal estate tax return, if such a return is required, for review by the Internal Revenue Service.

Flexibility. A revocable trust may offer greater flexibility in the management and disposition of certain assets. Such assets include life insurance proceeds, annuities, death benefits under retirement plans and even certain partnership interests. These assets usually pass directly to a named beneficiary, possibly escaping the costs and delays associated with probate assets. Designating a revocable trust as the beneficiary of these assets, however, can be a helpful alternative. Many clients do not want substantial assets to pass outright to an individual, especially young children. With a revocable trust, the grantor can retain broader flexibility in providing for the administration of these assets and dividing the benefits among various family members, while at the same time, still avoiding probate.

Further, a trust instrument may give any individuals the grantor chooses the power to remove and replace an unsatisfactory trustee. In contrast, a court must approve the removal and replacement of an executor or a personal representative named in a Will.

Creditor Claims. Both present and future creditors can reach assets of revocable trusts during the grantor's lifetime, just as creditors can reach assets of an individual during lifetime. In a probate estate, certain creditors' claims are cut off after a statutory period (usually from six months to a year). If there is no probate proceeding and the trustee does not publish notice to creditors, a revocable trust could remain liable for debts to creditors for many years. Therefore, in some circumstances, it may still be appropriate to open a probate estate in order to extinguish creditor claims.

Spousal Rights. If a surviving spouse would receive more under state law than he or she will receive under the grantor's Will, the surviving spouse may elect to take the larger amount despite the provisions of grantor's Will. This means that the spouse will receive what he or she is entitled to by statute instead of what was provided for under the grantor's Will. In some states, a surviving spouse may not be able to reach assets in a revocable trust, however, unless it can be shown that assets were transferred to the revocable trust in fraud of marital rights.

Will provisions for a former spouse are revoked by operation of law upon divorce. Revocable trust provisions for a spouse are not automatically revoked by operation of law. Accordingly, a trust amendment may be necessary to eliminate provisions for a former spouse. Alternatively, the revocable trust can define the term "spouse" to include only a spouse who is married to the grantor at the time of the grantor's death.

Costs. Legal fees for the preparation of a revocable trust may be higher than those for a Will. A cost comparison must also consider lifetime expenses of operating a revocable trust, including the costs of retitling assets in the trust's name, recording fees and trustees' fees, versus probate court costs and executor's fees and attorney's fees for a future probate estate. The availability of simplified administration under state law will affect the cost and time required for probate. Costs also depend on the nature of the assets. For example, transferring real property or units of a limited partnership involve more expense and legal costs than transferring stock.

Contests. Revocable trusts may be challenged for the mental incompetence or undue influence of the grantor. This is difficult to allege if the revocable trust operated under the grantor's control during his or her lifetime. Further, there may be a different standard regarding competency for the transfer of assets to a revocable trust than for transfers under the Will. There is also greater procedural difficulty for challenging a revocable trust because a separate legal action is required rather than probate court intervention. On the other hand, the Will contest procedure is well established by statute and case law.

Tax Considerations

Income Tax. During the grantor's lifetime, a revocable trust has no effect on the income tax that the grantor will owe. In fact, all income earned on assets held in the trust is reported directly on the grantor's income tax return, and the trust is not required to file a separate income tax return.

After the grantor's death, some of the income tax rules applicable to a revocable trust are not as liberal as those available to a probate estate, although changes in the law in recent years have made the income tax rules that in the past were more favorable to estates applicable to certain types of trusts.

Gift Tax. Because the grantor can amend or revoke a revocable trust, the grantor's initial transfer of assets to the revocable trust is not a completed gift for gift tax purposes. If assets are distributed from the trust to a person other than the grantor, a gift of the amount actually distributed is then made. The gift tax consequences generally are the same as if the grantor had made the gifts directly. So, for example, gifts to the grantor's spouse are not taxable; gifts to other individuals may qualify for the $13,000 annual exclusion from gift tax.

Estate Tax. Because the grantor retains the right to amend or revoke a revocable trust, all the assets of the trust at the grantor's death are included in the grantor's estate for estate tax purposes. All estate tax planning techniques used in Wills are also available to those using a revocable trust.

Conclusion

The revocable trust offers many benefits that are not available in an estate plan based solely on a Will, but a trust is not necessarily appropriate for everyone. The revocable trust can provide easily for capable and continuous management of property after the grantor's disability or death. It also may avoid certain costs, delays and publicity involved in some probate court proceedings.

The primary disadvantages of the revocable trust arise in implementing and maintaining the trust before its real benefits begin to accrue. The full benefits of a revocable trust will be realized only if substantially all of the grantor's assets are transferred to the trust during his or her lifetime or automatically pass to named beneficiaries when the grantor dies. Therefore, to be effective, an estate plan based on a revocable trust requires the additional effort and cost involved in actually transferring assets to the trust. Post-mortem income tax planning also may be limited because different rules apply to estates than to revocable trusts after the death of the grantor.

A revocable trust does not totally replace the need for a Will, because often there are some assets that are not transferred to a revocable trust during a grantor's lifetime or that are changed or acquired over time. A "pour-over" Will is needed in combination with a revocable trust, and these two documents must be carefully coordinated. In any event, each individual situation must be examined carefully to determine whether the benefits of the revocable trust outweigh the costs and complications involved.

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Please contact Albertson & Davidson, LLP at (951) 686-5296, on the web at www.aldavlaw.com, or read our Blog at www.californiatrustestateandprobatelitigation.com, for further information regarding Wills or revocable trusts or any other estate planning options.