
Advantages of a Revocable Trust In Your Estate Plan

Lynn Hopewell

The author presents a primer on revocable trusts. A Revocable trust offers many advantages in your estate plan, with few downside costs. They save significant costs, offer privacy and have living benefits too.

Revocable trusts have been much written about and commented on in the personal finance literature. This paper presents an objective view of the suitability and use of revocable trusts in estate plans. We will also discuss common myths about revocable trusts and separate fact from fancy.

The discussion in this paper is based on the author's fifteen years of experience in assisting over 500 families in their estate planning; and in serving many of them as executor, trustee and attorney-in-fact.

A Revocable Trust Does Not Save Estate Taxes

The revocable trust has sometimes been misrepresented, so let's make one thing clear right away—the revocable trust has no unique estate tax savings. Of course, estate tax savings techniques can be and are used in revocable trusts. But, these same techniques are also used in wills.

What Is Probate?

Since one of the major advantages of revocable trusts is that it makes it possible to avoid the probate process, we define probate here.

Probate is the court supervised administration of the terms of a will. When a person dies, property that is subject to the terms of his will (later in this paper we will discuss what property is subject to a will and what property is not,) must be placed in the hands of the will's "executor."

The executor's job is to carry out the terms of the will. The executor will pay the decedent's debts, file the necessary tax returns and distribute the estate property to heirs as specified by the will.

This entire process¹ is under the supervision of a local court in the jurisdiction of the decedent. The executor must file various accountings and obtain the approval of the court to distribute the assets.

Costs. The process of court supervision has associated costs—court fees and executor time or fees. In many jurisdictions,

¹Except that property in another state must be probated in the courts there.

Lynn Hopewell is an advisor to The Monitor Group, Inc. in McLean, Virginia, investment and financial advisors to individuals and retirees. He received his MBA from Harvard Business School.

this process is very expensive and administratively complex. In some jurisdictions, the process has been simplified. Thus, it is possible to overstate the costs of probate in these instances. Where probate costs are low, the attraction of revocable trusts will have to stand on its other advantages.

Probate Can Be Lengthy. Probate is not necessarily a one-time affair. If your will sets up a trust that continues after your death (for example, for minor children,) the trust is subject to probate court accountings for its entire term, often for 30 or 40 years, depending on the ages of heirs and the specific trust terms. The costs, especially for modest estate, can consume a significant portion of the trust fund earning each year.

Except for very small estates, probate can involve considerable hassle and expense and many people who have experienced it would have preferred to avoid it.

How Property is Passed at Death

Not all property of the decedent goes through the probate process.

In order to appreciate the role of revocable trusts, it is first helpful to review how property generally passes at death.

If you asked fifty people what is the most common way property passes at death, the great majority would answer: "by will." But, wills are the least common way property passes. The most common ways are by law and by contract.

Property Passing by Law

Both married and un-married owners can own property "Joint Tenants, With Common Law Rights of Survivorship." Married couples often own real estate, brokerage accounts and many other financial assets by taking title as "Tenants By the Entirety, With Common

Law Rights of Survivorship." This special form of joint ownership for married couples has certain creditor protection advantages.²

With both these methods of ownership, state laws say that at the death of one party, the survivor instantly, and without the intervention of anyone, owns the property.³ And—guess what—you *cannot* change that in your will. Nothing you may say in your will can direct your share of the property to someone else. The joint tenant survivor will own the property.

Thus, property inherited "by law" does not pass through a will and bypasses probate.

Property Passing by Contract

Examples of property that passes by contract are life insurance proceeds and retirement accounts of all types such as IRAs, Keoghs, 401(k)s, Thrift-Savings and pension and profit sharing plans.

These instruments are trusted accounts that have "beneficiaries." At the death of the account owner, the beneficiary becomes the new owner of the property. You cannot change that result in your will. Just as property passing by law, property passing by contract is ignored by a will.⁴

You can see that for married couples who hold their property entirely in joint names, at the first death, very little property passes by will.

What Property Passes by Will?

The only property that passes by will is property in the *sole* name of the decedent (and which is not property that passes by

²TBE property cannot be divided and sold to satisfy the debts of only one of the parties.

³There are situations where a second party is added to an account as a "convenience." However, it is often difficult to establish the motives of the parties.

⁴Unless, of course, the estate is the beneficiary.

"But, wills are the least common way property passes. The most common ways are by law and by contract."

law or contract.) Of course, almost any property⁵ can be in someone's sole name.

Note that for a single person who does not own property jointly, almost *all* property will pass by will. (Except life insurance, IRAs and other contracts that have a named beneficiary other than the owner's estate.)

Mistakes by Married Couples

Many married couples think that probate is not a problem because so much of their property is jointly titled. They are correct for the *first* death. But, at the *second* death⁶, *all* property that was jointly titled will pass through the will and will be subject to probate and its attendant costs.

What Is A Revocable Trust?

When you invested money in a mutual fund for your IRA, or put money in your employer 401(k) retirement plan you specified a "beneficiary," who would own the funds at your death.

You can name one or two people as beneficiaries, but this is usually inadequate because none of these accounts and assets allow a *complex* arrangement of beneficiaries with payouts at various ages, discretionary payments, and other complex and varying terms for young children, handicapped heirs, charities, etc.

Many assets aren't contracts and don't even have the capability of specifying a beneficiary. You can't do this for real estate, business interests, brokerage accounts and many other types of property.

Wouldn't it be nice if you could have a private contract where you appointed

someone (a trustee) to own all your property, and to whom you could give as elaborate instructions as you desire for its disposition at your death? It sure would be handy. Then all the property titled to your trustee under such arrangements would not pass by your will and would avoid probate.

Well, such a private contract is available. It is called a revocable trust. That's right, a revocable trust is just a private contract. It is an ancient legal device longed sanctioned in American law.

Parties to the Revocable Trust

Who are the parties to this contract—this revocable trust? There are three.

The **Grantor/Trustor/Settlor** (all three terms are used interchangeably,) is the party who sets up the trust and specifies all the other parties and the terms of the trust. Think of this party as the *owner*.

The **Trustee** is the party who is charged with carrying out the terms of the trust. Think of this party as the *administrator*.

The **Beneficiaries** are the parties who are the *object* of the contract. It is for the beneficiaries that the contract is initiated in the first place. The beneficiaries can be one person or many. The terms can be simple (e.g., they receive the property at your death, outright,) or complex (e.g., they receive the property in various amounts depending on their ages.)

The first reaction of many people upon hearing about a revocable trust is that they don't like the idea of having to title all their property to some other person who acts as the trustee. Here is the surprising good news about a revocable trust: *you* can be the trustee! Yes, no third party has to be involved. You are the grantor (owner,) you are the trustee (administrator) and you are the beneficiary while you are alive, and you say who the beneficiaries are at your death, just like you do in a will.

In other words, setting up a revocable trust (private contract,) need involve no

⁵Except, of course, in those states where community property concepts apply to married couples.

⁶Most people think of the second death as occurring many years after the first. There is, however, the possibility of both spouses dying within a short time of each other, particularly if the deaths are accidental.

other party except *yourself*. Of course, you will appoint others to take your place if you cannot serve.

“Revocable” Means You Can Change Everything

Remember that you have all the rights of “ownership” over your trust, so that means—just like your will—you can change any or all of it anytime you wish. You give up absolutely no control over your assets.

You have complete, 100% control of your property and its disposition, just like you do now. The only difference is that now you can enjoy the benefits of the revocable trust.

“Probate involves considerable hassle and most people who have experienced it would have preferred to avoid it.”

Who Supervises A Trust?

You are your own trustee until you become incapacitated or die. At that point someone else must step into your shoes.

The purpose of the revocable trust (and powers of attorney) is to avoid the expense and administrative hassle of court involvement. But, what about the issue of supervision. Who looks over the shoulders of the trustee?

When Is Supervision Required? Here are typical situations where a trustee will be acting:

You are incapacitated. Your spouse or an alternate will usually be the successor trustee. The job lasts until you recover.

You die. The successor trustee must pass your property to heirs. If your heirs are young, the job lasts until they fully receive their inheritance outright, often 30 or 40 years for very young children.

Does Probate Really Offer Supervision? We are comparing revocable trusts with the traditional will. The essential question is: in using a trust, are we giving up an essential element—“supervision?” After

all, it would be comforting to know that someone was “looking over the shoulder” of your trustee.

In practice, the answer is mostly, no. True, the probate court will make sure the arithmetic of your accounting is correct. However, there is little or no supervision of the “judgment” of the trustee in carrying out his many duties.

Is A Trustee Of A Revocable Trust Unsupervised? Normally, the trustee renders regular accountings to all beneficiaries (or in the case of minor children, to their guardians.)

In many states, Virginia for example, beneficiaries who are unhappy with their trustee’s accountings can, by a simple court filing⁷, require the trustee to have all accountings processed in the probate court. Thus, beneficiaries have the right to cause the trust to be under the same supervision as it would have been if it had been created by a will (but, of course, the usual probate expenses will be then incurred. But, in some cases, it may be worth it.)

Husband and Wife Each Need A Trust

Just as both a husband and wife need a will, both will need a trust. So-called “joint” trusts should be avoided. While they are not prohibited by law, they require quite complex drafting and are easy to misuse.

The best approach for a married couple is for each person to have a will and a revocable trust—four documents.

⁷Code of Virginia, Section 26-1.1

What About Powers of Attorney?

An extended discussion of the features of powers of attorney are beyond the scope of this article.

However, a durable⁸ power of attorney is advisable for many reasons. One reason is, if you are incapacitated, you can authorize the person helping you to use your power of attorney to transfer assets to your trust.

This might be done because you forgot to transfer some asset. Or perhaps you decided for some reason not to fully fund your trust, but now your family believes it would be a good idea. The power of attorney will be necessary to accomplish the transfers.

Benefits of a Revocable Trust

Here are the primary benefits of a revocable trust.

Probate Avoided. We have already noted that the revocable trust avoids probate of the property it owns. An important point to remember is that to avoid probate, the trust must actually own the property at the moment of death. Your survivors cannot run around after your death transferring property to your trust—it's too late then.

Probate Supervision For Minor Children Avoided. Minor children cannot inherit property directly, so wills usually specify that if a minor inherits, the property must be held in trust until the child reaches legal age.

In fact, for inheritances of substance, it is not uncommon for heirs to receive the property over a span of years, up to age 35 or 40. For property passing by a will this “testamentary” trust will be under the courts

supervision for the life of the trust—as much as 35 or 40 years for a young heir.

Yet, if the heir receives his inheritance via a revocable trust, this entire probate supervision process and its attendant costs are avoided.

Privacy Ensured. Many people do not know that the probate process is public. All the documents are available to anyone at the courthouse. Anyone can find out the details of your estate—how much money as involved—who got your property—what was each person's share—who received his share outright and whose property came with supervisory strings that kept it from them until they were “mature.”

For many families the prospects of this public display of the most intimate details of their estate is very unsettling and is to be avoided, especially if they are familiar with the uses such public records are put to by scam artists and others who prey on the bereaved.

The revocable trust becomes, in effect, a will substitute. But, the trust also has benefits while you are alive.

Property Management Is Easier. You will need someone to manage your property under several sets of circumstances—if you are absent for an extended length of time (on your round-the-world cruise, of course,) or if you are incapacitated by illness or accident.

In both these cases, a general power of attorney can also be useful in managing your affairs. With a general power of attorney, you appoint someone to act as your agent when necessary.

But, powers of attorney are not foolproof. Sometimes people resist doing business with the agent of a principal. But, no one refuses to do business with the legal owner of property (your trustee.)

The trust offers improved mechanisms for management succession. The power of attorney is useless if the named attorney-in-fact or his successors are not available. The trust, in contrast, provides a mechanism for open-ended succession of trustees.

Protect Your Estate From Disgruntled Relatives. A will is relatively

⁸A type of power of attorney that stays in effect if you are incapacitated.

easy to challenge. Sometimes disgruntled heirs are paid off just because of the trouble they can make, not because their claims have merit. A revocable trust is much harder to challenge.

Test Drive Your Trustee. Many estate plans call for someone to step into your shoes—as a trustee if you are incapacitated—if you die and minor children inherit. Many people would like to “test-drive” their chosen trustee to see if he performs as expected. If not, you can appoint a new trustee.

Limited Creditor Protection. A revocable trust does not provide true creditor protection. The assets of the trust will ultimately be available to creditors. But, the fact that the creditors may have to chase down a trustee⁹ who is not the debtor does put an added burden on the creditor. They have been known to be more amenable to settling the debt at a discount when they run into a trust. But, not always.

Never *depend* on a revocable trust for creditor protection. Real creditor protection requires other techniques.

Are There Any Negatives To A Revocable Trust?

The revocable trust is remarkably free of negatives, but using a trust is not 100% painless. Whether you regard the following as negatives depends to a great degree on your personality and disposition. Here is a catalogue of negatives collected over a fifteen year period of using revocable trusts.

Costs. Revocable trusts are not free. You must incur legal fees to obtain one. The correct cost question is what is the difference in costs between the traditional way—having a long will—or the modern way—having a short will and a revocable trust. Under most circumstances, the cost difference can be very modest, amounting to

⁹In this case, you would have resigned as trustee and appointed another.

a few hundred dollars at most. Setup cost is rarely an objection to using a revocable trust¹⁰.

Retitling Costs. Remember that to ensure probate avoidance, the trust must own your assets at death. And, of course, in order to be used to manage your assets during your lifetime, the trust must also own the assets.

So, to insure that the trust benefits are available when you need them, you should title assets to your trust.

Retitling costs are surprisingly modest. How do you transfer title to your trust? Exactly as you transfer title to anyone. Transferring real estate requires a deed. Costs are usually \$75 to \$150 a deed, depending on individual circumstances.

Transfer Taxes. Caution: almost all jurisdictions allow individuals to retitle property to their revocable trusts without imposing the typical transfer taxes of 1%-2%. However, be sure to check this out with your local courthouse. Local practices do vary.

Transferring ownership of most other assets simply requires filling out some forms. For someone with lots of assets, the administrative process can be time consuming, but it only has to be done once. (Of course, if you fail to do the transfers, you may lose the probate avoidance advantage of revocable trusts.)

Administrative Hassle. When you go into your bank and tell the clerk that you want to open an account in the name of your trust, you may get a blank stare because it is not a common transaction. A supervisor may have to be called. Expect some annoying delays.

You will also need a copy of a few of your trust pages. Institutions will want assurance that you are authorized to act for the trust. Usually you have to provide only the first page, the pages citing the trustee's powers and the signature page. Expect to make copies and keep them handy.

Loss of Some Creditor Protection for Married Couples. When married couples

¹⁰Although there are exceptions to this generalization.

“The revocable trust is remarkably free of negatives, but using a trust is not 100% painless. Whether you regard the following as negatives depends to a great degree on your personality and disposition.”

hold property as Tenants By The Entirety, most states' law specify that the property may not be sold to satisfy the debts of *one* of the parties.

Of course, this is why, if one party of a married couple wishes a loan, institutions will always require the signature of the spouse as well, so the loan becomes the obligation of both. Thus, Tenants By The Entirety provides no protection under these circumstances.

But, the protection provided by Tenants By the Entirety ownership can be important for those types of liabilities that arise unexpectedly such as malpractice suits for professionals or liability from auto accidents and the like.

Titling the property in the name of your trust (or of your and your spouse's trust, jointly,) will not give the creditor protection that Tenants By the Entirety titling gives.

Each individual will have to judge the importance of this tradeoff, and for some couples where one of them is engaged in risky businesses or activities, the advantages of creditor protection may outweigh the advantages of titling to the revocable trust.

Refinancing Mortgages. If you finance or refinance a mortgage, most lenders want to record their lien against a property in your name rather than in the name of your trust.

That means the closing attorney for the loan will have to take the extra steps of taking the property out of the name of your trust, putting it in your own name, recording the mortgage lien, and then putting the property back into your trust.

This paperwork is all done at settlement, it will be just a few more papers to sign. It may increase your refinancing costs by \$100 or so.

Note that new federal regulations¹¹ are forthcoming that establish standards for allowing living trusts to stand as borrowers on mortgage loans. As these regulations become effective, the "in and out" process noted above will mitigated.

Most mortgages have a "due-on-sale" clause whereby the full balance of the

mortgage must be paid if the property is "transferred." Federal law¹² prohibits the enforcement of due-on-sale clauses in *residential* mortgages, however, not for non-residential property. For non-residential property, always obtain the lender's permission for a transfer to a revocable trust.

Lack of Confidence in Your Trustee.

If you have no one in whom you have confidence; if you definitely want a court to "look over the shoulder" of your trustee rather than make it an optional choice of the beneficiaries; if probate has been simplified in your jurisdiction; all or some of these factors could make you decided that probate court supervision of your trustee or executor is warranted.

No Income Tax Return is Required For a Revocable Trust

Since you have complete control over your trust, the IRS will not even permit you to obtain a tax ID number for it. You use your own social security number on all trust accounts.

As long as you (the grantor) are one of the trustees, the funding of your trust will not change the income tax reporting of interest, dividends, gains and losses on your annual Form 1040. It is as if your revocable trusts are "invisible" for income tax purposes. Therefore, no trust income tax return need be filed.¹³

Titling Issues

How should you title property. First of all, there are titling issues associated with estate tax planning that have nothing to do with revocable trusts.

¹²Garn-St. Germain Depository Institutions Act of 1982 (Public Law 97-320).

¹³See Treasury Regulation Section 1.671-4(b)

¹¹FNMA Announcement 93-10, June 29, 1993.

ADVANTAGES OF A REVOCABLE TRUST

Typically, estate planners will advise a married couple to try to arrange for \$600,000 of assets to be titled in the sole name of each person. This will insure that the \$1,200,000 estate tax exemption will be available to their estates.

However you decide to title your assets, titling an asset in the name of your trust is the same as titling it in your individual name for tax purposes.

For example, suppose you own a property, tenants in common with your brother. You can simply change the title so that you *as trustee of your trust* are one tenant, and your brother is the other tenant.

Suppose you and your wife own a property as joint tenants with right of survivorship? You can own the property in the same way and simply substitute your trusts as the tenants.

Trusts present no barriers to titling property in the way that you prefer. (Except for Tenants By the Entirety for married couples—two trusts can't hold property this way.)

Caution: The general issue of how to title property involves more than estate planning issues. We have already discussed the creditor protection offered to married couples by titling as tenants by the entirety. There are also issues concerning equitable distribution laws in case of divorce. Avoiding joint ownership in some states keeps some property—particularly inherited property and property owned before marriage—from being subject to division. Anyone concerned with these issues should get legal advice.

Who Should Be The Trustee of Your Trust?

We have noted earlier that *you* can be the trustee of your own trust. However, you should always specify several alternates to serve in case you cannot.

One common approach for married couples is to name both as trustees of the

trust, *able to act independently*. This arrangement is similar to how the couple has been used to using joint checking accounts. If one of the couple is incapacitated or dies, the other remains the sole-acting trustee.

Standby trustees are still needed though, in case both husband and wife are unable to serve. These can be trusted family members, advisors or trust companies.

What About the Will?

You still need a will. The modern estate plan will consist of a revocable trust *and* a “pour-over” will.

The will is still necessary, but becomes a much shorter document. It specifies the guardians for minor children, charges the executor with paying debts, filing tax returns, and distributing personal property.

The will does not have all the details of disposition that the trust has because it would be an unnecessary duplication. The will takes any property under its purview and distributes it (“pours-over”) to the revocable trust. You can think of the trust as being the “heir” of the will.

The trust then distributes the assets it received from the will according to the trust terms. Of course, since the property first passed through the will, it does go through probate.

The pour-over feature is necessary because not all of a decedent's property may be in his trust. He may forget or neglect to transfer some property.

He may get rich posthumously. Some property may come into his estate because of circumstances associated with his death—for example, a personal injury liability award. In all these cases, the will sends the property to the trust.

The revocable trust then becomes the document in which the primary bequests of the decedent are expressed.

Don't Use Ready-Made Forms To Set Up Your Trust

Revocable trusts require precise drafting just as do wills. Although you can find some versions in self-help legal literature, don't use them. A qualified attorney should draft the legal documents, one who specializes in trusts and estates.

You Don't Think You Need The Advantages of a Revocable Trust? Do it Anyway

Perhaps you don't think you would use the advantages of a revocable trust now. Unless the cost differential is substantial, you should implement your estate plan with a revocable trust anyway. Why?

Suppose you implement your estate plan using a revocable trust and pour-over will, but then never title anything to the trust. What happens? Have you wasted your effort or caused yourself any problems?

The answer is that nothing happens any differently than if you had only a will. When you die, all property passes as previously described: by law, contract or by will.

Since nothing was titled in your trust, everything in your "own" name will first pass via your will and will go through the probate process. The will, remember, sends all property to your revocable trust for final disposition.

For all practical purposes, your will and trust will be administered as though there were just one document—the will.

All that results from this strategy is that you will experience a few hundred dollars in extra costs when you set up your will and trust. But, this strategy is worth implementing because the trust benefits will be available if your circumstances change. How might they change?

First of all, you may change your mind and use the trust yourself. Second, if you

become disabled, or terminally ill, your helpers will have the option to use your power of attorney to transfer title to your trust and obtain its benefits if they so desire.

In other words, the trust is in a "standby" position: you maintain the options to use the trust later. For a few hundred dollars, maintaining the option is a prudent choice.

If you have minor children whose inheritance will be in trust; or if you plan to distribute your estate to your heirs over a period of time—say up to age forty—then you will find that the revocable trust approach has a major advantage, even if you throw it in the drawer and never transfer any assets to it.

Why? Because the probate court will *not* be involved in the administration of those trusts, saving considerable expense for your heirs.

Conclusion

Revocable trusts are a powerful and flexible estate planning tool. As long as the additional initial setup cost is not objectionable, there is no downside to incorporating a trust in your estate plan.

For these reasons, the objection of anyone who says "you don't need a revocable trust," is not valid. If you don't ever use it, nothing is lost. But, if you ever need the benefits of the trust, they will be available.

If you wish:

- significant savings in expenses, and avoiding the delays and frustrations of the probate process;
 - a better management tool in case of incapacity;
 - privacy of your affairs;
 - test-driving your trustees
- all are benefits available from the revocable trust.

ADVANTAGES OF A REVOCABLE TRUST

THE MODERN ESTATE PLAN

