

LIVING TRUSTS

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Living trusts are revocable (changeable) trusts which are most often used as a substitute for a will to avoid the cost and delays involved with probating a will. However, there are many other reasons why an elderly client might want to use or not want to use a revocable trust as the main foundation of the client's estate plan. Generally a client has three ways to go in designing an estate plan. The plan can be based on transfers to the heirs based on joint tenancy and beneficiary designations, or the primary estate planning vehicle can be either a will or a living trust. If it is a will, then the will plus a durable power of attorney will provide what the client needs. If it is a living trust, then the living trust plus a pour-over will will provide what the client needs.

If the distributions are outright to adults, the joint tenancy and beneficiary designations may be entirely adequate. However, if the distributions are to be held in trust for minor children or grandchildren, then usually a will or living trust will be needed. Assuming a client needs a will or living trust, how does one

decide which is best? It depends on the circumstances and what the client wants most to accomplish.

A will is simplest now, because nothing happens or changes until the date of death. If a durable power of attorney is used along with the will, then the incapacity and medical decision issues can be covered too. However, there are certain advantages to a living trust compared to a will and durable power of attorney.

A. DETERMINING NEED FOR LIVING TRUSTS

Probate Costs Later vs. Trust Costs Now

Executor's fees for probate in Oklahoma are approximately 2.5% of the probate assets, and attorney fees for probate are similar. If the executor does not waive the fee, a reasonable estimate for administration costs for a probate is 5% of the probate assets. If most of the assets pass by the living trust, the probate estate will be greatly reduced and so will these fees. Even with a living trust, a client should have a pour-over will, which will be probated, but at less cost. For example this is the way to have all creditors' claims identified and paid or barred through the probate process. This stops any future claims, known or unknown, against the property of the client including what is in the living trust. It also transfers any property the client did not transfer to the living trust during lifetime to the trust, so that all the property ends up in the trust.

If there are going to be trustee fees while the living trust is in effect during the client's lifetime, these fees may add up to more than the probate costs. My rule of thumb is ten years. If the living trust is likely to be in effect for ten years before the client dies, and trustee fees are paid each year, then the living trust will cost as much as the probate, and there will be no savings for that reason. However, the client may get something extra for those services, such as investment management of the trust assets which will make the living trust trustee fees worth it now. The client may be his own trustee, or a friend or family member may be trustee and not charge any fee. That may work for the client, because he is doing it for his own benefit, but I recommend the client pay someone else a reasonable fee, if they are going to do the work and carry the

responsibility and fiduciary liability for managing the trust assets. How much trustee fee there will be depends on how many trustees there will be and who they are.

How Many Trustees? One Or More.

The client can be his own trustee, do all the work of the trust, and do his business by himself in trust form as trustee. Instead of signing documents in his own name, he signs them as trustee of his living trust. In the trust he may name a successor trustee to serve as trustee in case of his resignation, death or disability.

However, he may want to name a co-trustee to serve with him. This eliminates any question of the merger of the legal and beneficial estates, even though there are remainder interests. Also as a practical matter a co-trustee can act immediately if the settlor-trustee should become disabled or die. No steps have to be taken to qualify a successor trustee. If the client wants, the trust may be written to say that only the client as co-trustee has investment authority over trust assets, until he becomes disabled or dies, at which time the other co-trustee has full investment and management authority over the trust.

If the client wants a bank to be the investment manager of the trust, the bank can be sole trustee. If anything happens to the client, the bank is already operating as trustee. There will be no interruption in the management of the trust. Several family members may be named as co-trustees. Generally the more trustees, the more difficult it is to manage the trust.

Choice of Law.

A will is subject to the law of the residence of the testator. A living trust however may be operated under any law chosen by the settlor. The law of some other state than the state of the settlor's residence may be more favorable to allow an out of state trustee, or allow a broader range of investments, or some states may still have no rule against perpetuities.

Privacy

A will may provide more family privacy, because the family will only see the last will, not all those other embarrassing wills and codicils written when the testator was mad at one family member or another. However, all the world can know the final disposition of the estate when the will is filed in court and becomes a public record.

If you can keep the living trust from being filed for real estate purposes, no one except the beneficiaries and the trustee need know what it says. However, all the changes made in the living trust over the years to cut out and put back in those obstreperous heirs are done by amendment to the trust which become a permanent part of the trust instrument for all the family to see. The way around this is to put in the living trust a provision that says the disposition of the trust assets upon the death of the settlor shall be as the settlor by his last will, duly admitted to probate, shall appoint. Then all the changes are not filed, but the public sees the disposition in the will.

Incapacity

One of the main reasons living trusts are used today is to provide a smooth transition in the management of the client's business affairs, if the client

becomes incapacitated due to illness or accident. The co-trustee or successor trustee owns the assets and can do what is necessary with them. The expense, delay and extensive reporting requirements of a guardianship are avoided. People are chosen to manage the assets whom the client trusts. Bills can be paid, investment decisions made and money transferred to the client or paid for the client's benefit such as for medical bills or rent. It provides a wonderful sense of relief to know that someone responsible is in place to do what has to be done to keep the client's affairs running smoothly.

Appointment of Guardian

This appointment can be done in the living trust. It does not need to be the same person as the successor trustee, but it may.

Medical Power

The trust may provide the client's wishes as to medical treatment. This can be done in a durable power of attorney, or through the client's appointment of a guardian. The most effective simple way is to sign a Physicians Directive which is recognized by statute in Oklahoma and gives the doctor some protection against liability if he follows the client's wishes in the Physicians Directive.

Cost of Living Trust

A living trust generally costs more than a will and a durable power of attorney - at the time they are set up. A will generally costs more at the time of death. There is the cost of designing and drafting the living trust. Then in addition is the cost of transferring assets into the trust. The trust does no good

until the assets are transferred into it. The prevailing opinion now is that the lawyer who writes a living trust has a duty to see that all the assets are transferred to the trust or have written evidence of direction from the client that specific assets are to be left out. This seems harsh, but emphasizes that the living trust is no good until the assets are put into it. With complex assets which require negotiations and legal transfer documents prepared by a lawyer, these transfer costs can be more than the cost of the trust. If trustees fees are going to be charged there may be no economic advantage to a living trust, unless the client was going to pay for investment management services anyway.

Income Tax Returns

If the client is a trustee or co-trustee, the trust income is considered the client's income and is included on the client's Form 1040. The living trust does not file a return. IRC Reg. 301-6109-(1)(a)(2).

Transferring Assets from Trust

It is generally easier to buy sell and transfer assets in the client's own name than in the client's name as trustee. Parties involved in the transfer often want to see a copy of the trust to determine if the trustee has authority to make the transfer. If a business is incorporated and only the stock is in the trust this problem will not arise. However, if a client deals in buying and selling property, the client may not want to put such property in the trust. Other property that will not be transferred for a long time may be put into the trust. This is another reason for the pour-over will, and for the attorney to have in writing the client's decision not to put these assets in the trust.

Avoid Ancillary Probate

If out of state real property is owned by the trustee of a living trust, the transfer of that property is accomplished by recording a trustee's deed in the county where the property is located. However, if the real property goes through probate, it will have to be an ancillary probate in the state where the property is located after the domiciliary probate is begun. That makes two probates that can be avoided with one living trust, when you have out of state real property.

Contest

It is more difficult in some respects to contest a living trust, especially if it has been in effect for several years. Probate is an invitation to contest the will. Notice of the opportunity to contest is sent out to all the heirs. This is not the case with a living trust. The transfers to heirs described in the trust are made after the estate tax releases are obtained, and in some cases sooner. However, the attorney with a client whose mental competency is potentially questionable should be aware that the competency standard for executing a valid will is lower than for creating a trust.

The mental capacity to make a will, called testamentary capacity, is a lower standard than the mental capacity required to form a trust, sign a contract or convey real property by a deed, which is called contractual capacity. A person may be legally incompetent as determined by a court, and still have testamentary capacity sufficient to make a valid will. Estate of Bailess, 569 P.2d 543 (Okla.App., 1977). The definition of testamentary capacity is "having sufficient mind and memory to understand the nature and extent of his property, the proper objects of his bounty and the nature of the testamentary act". In re Anderson's

Estate, 286 P. 17, 20 (Okl., 1929). This test applies even though the testator was an alcoholic or had other chemical dependency. Lambe v. First National Bank & Trust Company of Oklahoma City, 710 P.2d 772 (Okl., 1985).

A living trust with a pour-over will where the client was found competent to write a will, but not a trust could result in an intestacy. The will directs distribution to something that does not exist. The attorney should either take precautions to demonstrate the client's capacity to understand the business effect of his act in creating the trust at the time the trust is executed, or provide a savings clause in the pour-over will which provides for distribution through the will if there is no such trust in existence on the date of death and the date of distribution.

B. DRAFTING AND EXECUTING LIVING TRUSTS

There are many forms available for standard living trusts. The key provision is that they are revocable and amendable. In Oklahoma an express trust is revocable unless it is expressly made irrevocable. 60 O.S. §175.41

Making the Trust Irrevocable.

When should you make it irrevocable? Certainly on death of the settlor it should by its terms become irrevocable. Also on the settlor's incapacity. Some draftsmen use as a trigger for this provision the written determination by two board certified medical doctors that the settlor can no longer manage his or her business affairs due to deteriorating or intermittent impairment from illness or injury. You may also want to provide that the trust becomes irrevocable in the event the settlor disappears for some period of time such as six months or a year. If there is a co-trustee who can act, the time can be longer. If the settlor is the sole trustee, the time should be shorter, so that the successor trustee can have the authority to manage the trust. If the likelihood of disappearance is small you may want to leave this out.

Recovery of Competency.

What happens when the client comes out of the six week coma and recovers competency, or is declared legally restored to competency by a court? The client will probably want control of the trust back. Do you provide that what was irrevocable is now revocable again? Logically when the trust is made irrevocable, the settlor cuts all strings on the trust. Therefore it is preferable to

give the recovered client the power to remove assets from the trust upon the written statement of two similar doctors, or a finding of competency by a court of proper jurisdiction. The trust is still irrevocable, but the recovered client can by its terms can direct the trustee to distribute the assets to the client, and the client can create a new revocable trust. This amounts to a general power of appointment in the recovered client.

Prohibiting Estate Planning Changes.

You may want to include language which prohibits a guardian or attorney in fact under power of attorney from amending the living trust or removing assets from it. This is especially true if the living trust is the major estate planning tool used by the client to plan the disposition of the estate. The client may want to keep those decisions. However, some clients prefer flexibility and would want some proper person to be able to change their estate plan while they were incompetent.

Adding Assets to the Trust.

Often there will be language allowing the settlor or any other person to add assets to the trust. You may want to specify that assets may be added by an attorney in fact. A corporate trustee may want veto power over accepting any assets, or the power to disclaim assets which carry with them unusual liability, such as real property with hazardous materials or waste on them. You may not want to include these provisions, but if you do not, then you should include a provision that the trustee may resign at any time for any reason, or no reason. Then if unduly burdensome assets are added to the trust the trustee's remedy is

to resign. Some corporate trustees may refuse to accept any real estate, because of the potential liability for clean-up costs.

Executing the Living Trust.

It is important that the living trust be in existence before you refer to it in other documents, or the law may view the reference as being void because the trust did not then exist. Therefore execute the living trust first, and fund it with some assets so it will exist as a trust and not be a dry trust.

You may want to put the date and time of execution on the trust instrument. Have it signed and notarized, in case it must be filed in the deed records some day. Then have the settlor transfer some assets to the trustee. If they are the same person have the settlor write a check to the trustee. If they are different people have the check delivered to the trustee. Now the trust is in existence. Next have the client sign, date and time the pour-over will and have the self proving clause notarized. Then sign, date and time the durable power of attorney, and any transfer documents transferring property to the trustee, which may be transferred at that time. This may include deeds to real property, beneficiary designations to insurance and pension benefits, bills of sale to personality, car titles, stock certificates or stock powers and other instruments of title transfer. Once the trust is created, a memorandum of trust, containing the name of the trust, the date it was created and the name of the trustee, may be filed in the deed records in the county where the property is located, and the trust may then own property in its own name. 60 O.S. §175.6a. If the real property is to be held in the name of the trustee the procedure in 60 O.S. §156, by either filing notice of the trust before recording the deed or by identifying the trust in the

deed by conveying title to "John Doe, Trustee of the John Doe Living Trust Dated February 27, 1992".

C. FUNDING AND OPERATING LIVING TRUSTS

After the initial property has been transferred to establish the living trust, other property may be transferred to the trustee at any time. It may take time to transfer stocks, bonds and other securities. Some assets have special problems.

Insurance on Trust Property.

Check with the insurance company that has the homeowners policy on the residence or the fire and extended coverage policy on any other buildings to be sure the insurance company knows of the trusts and the client's interest in the property. You may want to change the policy to make the trustee a named insured. Be sure that if the client is the beneficiary, the insurance company accepts that the client has an insurable interest in the property.

Mortgage Holders.

Similarly check any mortgages to see if there is any restriction on transferring the property such as a due on sale clause which would accelerate the loan payments. Get the approval of such a mortgage holder to make the transfer before the transfer to the trustee is made.

Personal Gifts By Settlor.

If the client wants to give up to \$10,000.00 per year per donee, with out Federal gift tax, the trustee should transfer the cash to the settlor and the settlor should write a personal check to be sure the gift will qualify for the gift tax

exclusion. Gifts directly out of the trust, paid by the trustee to the donee, may not be considered as a gift from the settlor.

Fiduciary Duty.

Even though the trust is revocable, and the settlor could take out all the property at any time or amend the trust, the trustee is still obligated to operate the trust in a fiduciary manner under the terms of the trust at that time.

D. FEDERAL TAX CONSIDERATIONS

Estate and Gift Taxes.

A living trust can provide all the major estate and gift tax benefits that a will can. The client will not save any more estate or gift taxes by having a living trust or a will. The living trust will have to be carefully drafted as a will would have to be to take advantage of available estate planning techniques, but generally a living trust and a will provide the same estate and gift tax benefits.

Income Taxes.

A will provides some minor income tax advantages over a living trust. A probate estate may use a fiscal year, while a trust must use a calendar year. An estate does not have to pay estimated tax payments for the first two years. A trust must pay estimated taxes from the beginning. An estate can continue to be an S corporation shareholder until completion of estate administration. This could be a major advantage in the right situation, if the estate were open for many years. A revocable trust can be an S Corporation shareholder for two years. IRC Sec. 1361 (c)(2)(a). Drafting a will is not a deductible legal expense. However, legal and accounting fees for drafting a living trust and transferring assets to it may be deductible as services for creating a vehicle for management and conservation of property held for the production of income. IRC Sec. 212.

A living trust can be an excellent foundation for an estate plan in the right circumstances. There are many ways a living trust can benefit an elderly client. Avoiding probate is one that has gotten much press, but there are many other

advantages which might serve a client's needs very well and should be considered in estate planning for the elderly client.