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# THINK ABOUT IT



## LIVING TRUSTS – MYTHS AND REALITIES

This is the second of a two-part series on living trusts.

In Part I, **Probate and Living Trusts**, we explored:

- Reasons for the probate system
- Advantages of probate
- The revocable living trust and advantages of avoiding probate
- Why a revocable living trust does not necessarily save any taxes
- Why a revocable living trust cannot assure total probate avoidance
- The privacy factor in avoiding probate
- The real costs of probate

In this issue, we will examine:

- Costs of creating and maintaining a revocable living trust
- Using other tools and techniques to avoid probate (and their costs and benefits)
- Advantages and disadvantages of payment of life insurance to an estate
- Questions to ask when selecting the most appropriate estate planning tools or techniques
- The dangers of "trust mills" and trust promoters
- Pitfalls of a revocable living trust

### COSTS OF SETTING UP AND MAINTAINING A REVOCABLE LIVING TRUST

There are a number of costs or fees associated with the creation and ongoing operation of a revocable living trust. First, there are legal fees incurred in setting up the trust. A client's overall cost will be higher for a trust than for a will. While a will is necessary to ensure the proper disposition of an estate owner's assets at death (in accordance with his/her wishes, and even when no trust, or one or more trusts are used); whereas a trust must be flexible enough for a client-grantor's entire lifetime, as well as after the grantor's death if it is to be continued to serve other beneficiaries.

The costs a client incurs to having a revocable living trust drafted will depend on a number of factors. But the normal hourly (or fixed) fee of the lawyer is usually the single largest determinant. Here again, the lowest fee charged may not actually turn out to be the least expensive or the best value in the long run. Overall costs would depend on the degree of complexity of the trust involved, the lawyer's level of expertise, and the prevailing legal fees in the area, as well as ancillary costs – including fees for other professional services, such as appraisal, accounting, et cetera.

It is very possible that certain (sometimes unexpected) costs will be incurred in transferring title to various assets. For instance:

- Re-titling real estate and partnership interests may require the services of a lawyer or professional conveyancer.
- Conveyance of real estate to a trust, even if it is revocable, may trigger real estate transfer taxes.
- In any case involving real estate, a deed will be required.
- Marketable securities held in "street name" will be relatively inexpensive to transfer to the trust (assuming a small, fixed fee – e.g., $25 – to reregister each security). But reregistering securities titled in sole or joint names will require more paperwork, more time, and (as a result) more cost and aggravation.

A third cost of a revocable living trust is the payment to a trustee (other than the grantor) for services rendered. Even if a living trust has little (or no current) assets, bookkeeping and internal accounting costs may run annual trustee fees up to as much as 1.5 to 2 percent of trust assets. These annually recurring costs can mount up over a number of years.

In many cases it will not be economically feasible to operate a trust with few income-producing assets (even if it is a family business or an art collection worth millions). When comparing the pros and cons of using revocable living trusts (where current out-of-pocket costs are involved) versus by will (where most costs are incurred after death) to pass property, it is essential to take the time value of money into account.

Another cost that must be factored into the living trust?versus?will equation is what can be termed "hidden obstacles." An example of a hidden obstacle is when a bank holds a mortgage on your client's property and refuses to allow him, her, or them to transfer the mortgage to the trust. One reason a bank might refuse to do this is because a lender might have difficulty selling the mortgage on the secondary market if title is held by a trust (or the mortgage may have already been sold, and the transfer of the title would have adverse consequences for the lender or the present holder).

Yet another cost (and aggravation) is insurance. It is important to check to see if a client's property and casualty insurance carrier will insure a car, home, or otherwise insurable asset if legal title is held by a trust. Why would this even be an issue? It may not be clear who has the right to drive cars owned by a trust. In some cases, the casualty insurance company may increase premiums on cars held by a trust because of a business rather than a personal rating. Consider, therefore, suggesting that the client continue to hold the title to cars jointly with his or her spouse or another co owner, rather than placing title in the trust. (Some state laws do not even permit automobiles to be owned by a trust.)

Finally, your client will have to be willing to complete special forms at banks and brokerage houses because titling assets in a trust's name may not be an everyday occurrence (or routine procedure). Likewise, the client must be willing to hire a conveyancer to prepare and record new deeds. (In states such as Pennsylvania, clients should also be prepared in some instances to pay real estate transfer taxes even if the transfer is from the client's sole name to the client as trustee, because of the nonexempt status of beneficiaries.)

Moreover, your client must be willing not only to make these reregistering and title transfers for all currently owned assets, but also to remember to transfer title to all assets he or she acquires in the future. If the client does not continue to title assets for the rest of his or her life in the name of the trustee, to that extent, he or she will forfeit the benefits for which the living trust was established.

## WAYS OTHER THAN A REVOCABLE LIVING TRUST TO AVOID PROBATE

There are many tools and techniques to avoid probate other than through the use of revocable living trusts. Some of these include:

1. **Title property jointly with a spouse or other heir.** To the extent property is titled jointly with right of survivorship (or as tenants by the entireties for a married couple) the client's will is irrelevant. The property automatically and immediately passes at death of a joint owner to the surviving owner(s) and does not become part of the decedent's probate estate. In this regard, probate will be avoided at the first death, although not at the second death. For instance, if your client and his spouse own their home jointly with right of survivorship or as tenants by the entirety, at either spouse's death, the survivor will receive the home without having it pass through probate. But, just as a revocable trust is not a panacea, neither is the blind or thoughtless use of jointly-held property.

Consider the following, for example:

- If your client puts real estate into joint names with his or her children, he or she will be unable to sell the property, or even change his or her mind about the division or disposition of the property, without the consent of every person named as a joint owner. This means your client, the original owner, may have lost control over who will eventually receive the property because it will pass outright to the surviving joint tenants.
- Although your client may still be able to change the joint ownership of bank accounts or brokerage accounts at any time, your client's joint owner(s) may have the same power to treat the property as his/her/their own, or even take it away from the client. For example, once an adult child is named as joint owner of an account, the client would be unable to stop that child from withdrawing money from the account at any time.
- If a joint tenancy involves someone other than the client-owner's spouse, the client may be making a taxable gift when the joint tenancy is created – or when it is divided up (or partitioned).
- If a client has many children or other beneficiaries, it may be cumbersome to list each beneficiary on each asset as a joint owner.
- In some states, an inventory of joint accounts must be publicly recorded, so a client will not necessarily achieve any privacy.
- In some states, a joint account is "frozen" when a person dies until the issuance of a tax waiver certificate.
- In some states, your client might be required to pay a state death tax if one of the joint owners predeceases, even though the property was originally his or hers. (There should be no federal estate tax provided your client can prove that he or she paid for the property.)
- As a practical matter, it is more difficult to plan an equal distribution of assets when jointly held property is involved.
- Too much jointly held property with a spouse will result in "over qualifying the marital deduction." It wastes the federal estate tax unified credit at the first death; and needlessly adds assets to the surviving spouse's taxable estate and may result in excessive estate tax (or higher estate tax brackets) if trust assets are consumed at a much lower rate than their growth/appreciation. This is often called the "second death whammy."

2. **Life insurance.** Proceeds payable to a named beneficiary (including a trust), and not to the insured's estate, will not be subject to the probate process. It is always prudent (if not imperative) to name secondary (or contingent) beneficiaries; otherwise, the insurance proceeds might still be paid to the insured client's estate (if the sole beneficiary predeceases him or her).

3. **Qualified retirement plans and certain insurance products.** The proceeds of a qualified retirement plan, such as a pension or profit-sharing plan, Keogh plan (HR-10), simplified employee pension (SEP), 401(k), or stock bonus plan, as well as an individual retirement account (IRA), tax-deferred annuity, and other forms of contractual benefits can be made payable to a named beneficiary (including a trust), and so avoid administration by a court-supervised representative.

4. **Totten trusts.** Some states recognize "Totten" (or "tentative") trusts for bank accounts and brokerage accounts, or accounts "payable on death" to a named beneficiary. Under each arrangement, your client is still considered the sole owner during lifetime. But the named beneficiary automatically becomes the owner of the account upon the client's death, without any probate or other court proceedings.

5. **Lifetime sales.** Your client can sell property during lifetime to an intended beneficiary under an installment sale – for which the buyer pays the seller a fixed amount for a specified number of years. Or, the sale may be structured as a SCIN (self-canceling installment note) – an installment sale in which the buyer-debtor's obligation is canceled if the seller-lender dies before payments are completed (i.e., the note is paid off). Alternatively, the client may use a private annuity whereby he or she transfers complete ownership of the property and receive periodic payments from the buyer. As the name "private annuity" implies, the buyer is generally obligated to pay the seller a fixed annuity for the seller's life.
   In each of these techniques, the property will be owned by the buyer, without any probate process, and the only assets that might be subject to probate are the payments owed at death (or accumulated during lifetime).

6. **Lifetime gifts.** Generally, assets given away will not be part of a client's probate estate because he or she no longer owns the asset at death. However, a gift of appreciated property immediately before death can have adverse income tax consequences, because the recipient of the gift will carry over the client-donor's tax basis, and will not receive a "stepped-up" basis at death. This can result in unnecessary income taxes on capital gains when the asset is sold by the client's recipient-donee.

## PAYMENT OF A SMALL AMOUNT OF LIFE INSURANCE TO THE EXECUTOR OF THE ESTATE

Some authorities have suggested that a small amount of life insurance be paid directly to the executor of an estate. Why, with so much talk about the advantages of avoiding probate would any expert make such a recommendation – especially when life insurance passes to the beneficiary by contract and, therefore, is a non-probate asset? The answer is to achieve three goals:

- To provide cash for the estate to pay taxes and other expenses it must meet;
- To ensure that there is no question that the estate can meet its financial obligations; and
- To achieve administrative simplicity in dealing with the estate's creditors.

Creditors' rights and their ability to reach non-probate assets (such as those in a revocable living trust) are expanding steadily and significantly. Paying a relatively small amount of life insurance to the executor is an acknowledgment of that fact. The death benefit provides the means for the executor to deal with the issue more efficiently and directly (rather than exhausting the estate assets in an attempt to sidestep it).

However, we suggest this technique be used very sparingly and only with the advice of a competent lawyer or tax accountant working together with a CLU, ChFC, or CFP.

## SELECTING THE RIGHT ESTATE PLANNING TECHNIQUE(S)

When assisting clients in their planning process, insurance and financial service professionals should consider: What tools or techniques (or a combination of them) will most efficiently and cost effectively. . .

- accomplish the client's personal ("people-planning") objectives?
- eliminate or substantially reduce federal and state death taxes?
- reduce income taxes?
- minimize administration expenses in the client's estate and his or her spouse's estate (avoiding probate, if necessary)?
- provide management and investment expertise?
- help to unify the client's assets, or coordinate them with the dispositive provisions of his or her employee benefit plans?
- add to the client's peace of mind?

## "TRUST MILLS" – CLEAR AND PRESENT DANGERS

Selling "pre-packaged" revocable trusts to the public is to the legal, insurance, and financial planning professions what the film-fabled aluminum siding sales pitch is to the legitimate home improvement industry.

First, the con-artist aluminum siding salesman points out real or imagined problems with your client's house, including cracked paint, rot, and termites. Then the salesman promises to solve all your client's home maintenance problems – forever – through the installation of over-priced aluminum siding that covers up (or obscures) the maintenance problems but does not solve or eliminate them.

Similarly, trust promoters "invite" prospective clients/clients to "estate planning seminars," where the attendees listen to the promoters' predictions of the incredible expenses, numerous delays, and frustrations that their heirs will encounter during the probate process. The trust promoter (who is most likely not a state licensed local attorney, or a CLU, ChFC, or CFP, or CPA) then promises that all of the prospective client/clients' problems will be solved if they purchase the promoter's package of forms or services.

It is the classic "panic them and then sell them the panacea" routine.

What are some of the problems with these "trust mills"?

- The trusts that are sold are usually not tailored to the specific needs of the individual estate owner, but are mass produced from standard forms.
- Sometimes, the forms are not even very well prepared, causing tax problems that would (and could) have been avoided with competent drafting.
- Signing a trust document is only part of the solution. If the purpose of the trust is to avoid the probate process, then the assets of the grantor must be transferred to the trust. Otherwise, the trust is worthless as a probate avoidance device. And yet most trust promoters do not take responsibility for, or oversee, the transfers of assets, and do not adequately explain the procedure to the prospect/client.
- The generic trusts that are sold are frequently over-priced – with the trust promoter charging exorbitant fees for what amounts to pre-printed forms. Often, the fee is considerably higher than what would have been charged by a qualified lawyer for a customized document and individual and highly specific tax and legal advice.
- The sale of a trust package, where the product precedes the problem (or solution), is the antithesis of good planning. Proper planning should be a process which begins with an investigation of the client's problems and goals, and ends with the selection and implementation of one or more appropriate tools or techniques – that would solve the problems and achieve the goals in the most efficient and cost effective manner possible. When the trust promoter has only

a single product to sell, then the investigative process of delving into many important (but unaddressed) issues and searching for viable alternatives or a more efficient mix of solutions is all but foreclosed.

A typical trust promotion scheme is described in a complaint settled by the Federal Trade Commission (FTC) in 1997 against two companies that had sold more than 3,000 revocable trusts to elderly consumers in 43 states. According to the FTC, the companies falsely claimed that the trusts would avoid all probate and administrative costs, allow assets to be administered immediately upon death, and protect against catastrophic medical costs.

The companies also falsely represented that the trusts were appropriate estate planning devices for every consumer and that the trusts were prepared by local lawyers. (In fact, the trusts for almost all 43 states were prepared by one lawyer in Arizona.) More importantly, the companies charged $2,000 to $3,000 for preparing the trusts and took no responsibility for seeing that assets were transferred into the trusts.

According to a representative of the FTC,

*"The practices we challenge in this case are particularly contemptible because they were designed to prey upon the financial fears of the elderly."*

## POTENTIAL PITFALLS IN REVOCABLE LIVING TRUSTS

A revocable living trust is one of many available estate planning tools. It is an excellent and highly flexible tool – if and when it is drafted by a knowledgeable, competent estate planning lawyer and coordinated with other wealth management/transfer and estate planning tools and techniques.

But a revocable living trust is a potentially dangerous and harmful device when used as a one-size-fits-all, "do-it-yourself" panacea, or in an insulated manner and without regard to an effective, over-all estate plan.

As explained above, fear mongers have used (or misused) the revocable living trust to sell their books or other products or services – generally with little or no regard to the individual's tax and non-tax objectives.

First, they instill panic at the prospect of probate as an overly complex and expensive process (which it generally is not).

Then they claim or imply,

*"If you buy my book or set up this trust, all your estate and financial planning problems are solved."*

Nothing could be farther from the truth. As noted above, used alone and without due regard to a multiplicity of other factors (as well as planning tools and techniques), the revocable living trust can fool clients into a false sense of security. Some of the potential pitfalls include: the choice of the wrong trust form; failure to customize the trust to a client's particular circumstances; or worse yet, ignoring a client's overall real planning needs; or failing to transfer assets to the trust.

The use of a trust – without proper planning – can actually lead to a more complicated, time-consuming, and expensive estate "plan" than the probate process could ever have created. In other words, the revocable trust (or, more accurately, the lack of an estate planning process that lead to the revocable trust) will not make matters better, but worse.
Whatever your view or your client's view on avoiding probate, and no matter how appropriate you feel a revocable living trust might be for your client's situation, make sure he or she knows that no one can (or should) purchase a book, fill out the forms, pull them out, sign them, and then expect to "beat the probate system." This is unrealistic thinking, and is as dangerous as treating a life threatening medical problem with a home or over-the-counter remedy.

View probate avoidance as one of many possible estate planning objectives, and consider the *revocable living trust* not as an "either-or" alternative to a will, but rather as another highly useful tool that in many cases may (and, in our opinion, should) be used in conjunction with a will and other appropriate and complementary wealth management/transfer and estate planning devices.