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Revocable Trust Drafting: Funding Issues, Transfers, Tax Planning, Disposition of Personal Property and Real Estate

TUESDAY, MAY 10, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Schnader | *The Higher Calling of the Law*

Revocable Trust Drafting: Funding, Transfers, Tax

May 10, 2022

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BACKGROUND: WHAT IS A REVOCABLE TRUST?

- Revocable trusts (also known as living trusts) are created when:
  - An individual (commonly referred to as the grantor, settlor or trustor) transfers assets to the trustees of a trust over which that individual has the power to amend, revise, revoke and generally change the provisions of the trust.
  - The grantor is typically a trustee (and often the sole trustee) of the trust.
  - During grantor's lifetime, property is generally held for the grantor's benefit.
  - After the grantor's death, the trust becomes irrevocable and functions like the grantor's Will.

REVOCABLE TRUSTS: USES AND ADVANTAGES

- Avoid probate and ancillary probate to the extent assets transferred to trust during grantor's lifetime (probate is the legal process by which a Will is determined to be valid and an executor appointed).
- Eliminate or reduce need for guardianship proceeding or other court proceeding in the event of the incapacity of the grantor.
- Continuing trusts administered outside of court supervision.
- Privacy.
- Immediate availability of funds in the event of incapacity or death.

REVOCABLE TRUST VS. IRREVOCABLE TRUST

- Modification of trust terms:
  - Revocable trust – provisions may be modified by grantor at any time.
  - Irrevocable trust – provisions may not be modified by grantor.
- Tax planning:
  - Revocable trust -
    - No income tax planning/advantages during lifetime (income tax borne by grantor as if grantor owned assets).
    - Trust assets included in estate and subject to estate tax in same manner as if owned by grantor.
  - Irrevocable trust –
    - Grantor decides at time of trust creation whether grantor or trust will bear income tax.
    - Trust assets generally not included in estate for tax purposes.

REVOCABLE TRUST VS. IRREVOCABLE TRUST [Con't]

- Creditor protection
  - Revocable trust – no creditor protection for grantor.
  - Irrevocable trust – assets protected from creditors of grantor and beneficiaries (absent a fraudulent transfer).
- Avoidance of probate
  - Revocable trust – probate avoided on assets transferred to trust prior to death.
  - Irrevocable trust – probate avoided on assets transferred to trust prior to death.

Joint Revocable Trusts

- Very common in community property states.
- In separate property states, joint revocable trusts are more common when combined estate is less than one estate tax exemption.
- For spouses who need or desire tax planning, joint trusts involve planning and drafting issues that can be avoided by using separate revocable trusts.
- Potential tax problems include: transfers of assets to the trust may be taxable gifts which may not qualify for the gift tax marital deduction; if the trust, or a portion of the trust, becomes irrevocable at the death of the first spouse, the surviving spouse may be considered to have made a taxable gift to the remainder beneficiaries of the irrevocable trust; at the death of the first spouse, it is unclear whether one-half the value of the trust is included in his estate or the entire trust is included; at first death, unclear which portion of estate receives a stepped-up basis; if assets contributed to the trust by each spouse are commingled in a joint trust, it may not be possible to keep what is intended to be a credit shelter trust from being included in the surviving spouse's estate.

General Estate Planning Considerations: Planning for Married Couples

- Married couples: Planning for use of the marital deduction and applicable exclusion amount; creating credit shelter trusts; using portability of the applicable exclusion of first spouse to die.
- Using formula clauses; planning for use of disclaimers and partial QTIP elections; Clayton QTIP planning.
- Determining desired amount of marital deduction – maximum (portability); optimum (reduce all tax to zero; reduce Federal tax only to zero); equalization (pay estate tax at lower rates; pay tax at first death – currently not relevant.
- Selecting the vehicle for holding and administering the marital assets – outright; general power trust; QTIP trust; QTIP trust with delayed power of withdrawal; estate trust.
- Selecting formula (vs disclaimer or partial QTIP) – pecuniary (date of distribution values); pecuniary (fairly representative); fractional share.

GENERAL ESTATE PLANNING CONSIDERATIONS: DRAFTING ADVANTAGES

- Include definitions to account for grantor's particular circumstances (*e.g.*, the definition of "incapacity").
- Supply terms for procedures not readily available under state law (such as an internal decanting provision).
- Avoid potential limitations under relevant state law (ex: restrictions under New York and Florida law on naming certain fiduciaries in a Will).
- Provide instructions for distributions and care for grantor in the event of incapacity.

GENERAL ESTATE PLANNING CONSIDERATIONS: ADMINISTRATION CONSIDERATIONS

- Incapacity of grantor – coordinating with agent in power of attorney.
- Post-death administrative trust – effective equivalent of executor.
- Probate avoidance.

Funding the Trust

- Trust must be funded to obtain the benefits, such as avoiding probate.
- Retitling assets; changing beneficiary designations of life insurance and retirement plans/IRAs.
- Pourover will is only a safety net.
- Determine whether you will leave this up to the clients (with instructions*) or insist on handling it for them (and charging them for the service).

* See written materials

PITFALLS: INCONSISTENT PROVISIONS IN WILL AND REVOCABLE TRUST

- Bequests in Will and revocable trust should match or should be contained in either the Will or revocable trust but not both (ex: bequests of tangible personal property in Will should match bequests of same in trust; cash bequests should generally be made only in trust).
- Tax apportionment provisions and provisions governing estate administration expenses should be coordinated.

The Will and revocable trust must be consistent!!

Pitfalls: Trustee Designation and Succession

- Trustee selection; naming and providing for the appointment of successor, additional and replacement trustees.
- Role of the fiduciary; powers and duties; potential liability.
- Explaining and emphasizing the importance of these decisions to clients.
- The case for a corporate fiduciary.
- Drafting trustee succession provisions*.

* See written materials

Pitfalls: Powers of Appointment

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- Including general and limited powers of appointment can provide flexibility and permit adaptation or adjustment to tax and non-tax changes in circumstances.
- Types of powers of appointment – general versus limited (special).
- Defining the class of permissible appointees.
- Formula grant of power of appointment.
- Independent trustee grant or elimination of general power of appointment.
- Pitfall: providing for the proper method of exercising a power of appointment, whether inter vivos or testamentary.
- Pitfall: exercising inter vivos limited power constitutes a gift for gift tax purposes.