

A PRIMER ON REVOCABLE INTER VIVOS TRUSTS

Prepared by David W. Wulfers

I.

INTRODUCTION

1. Definitions. The term "Revocable Trust" means a Trust created by written instrument during the lifetime of the "Grantor" which may be revoked or amended by the Grantor during his lifetime or other designated period.

The term "Grantor" is the person who establishes the Trust and is usually the person whose property is held by the Trust.

The term "Trustee" means the person or corporation or bank which has the duty and responsibility of administering the Trust.

The term "corpus" or "principal" is the property held by the Trust.

2. General. A Revocable Trust is a separate, distinct legal entity recognized by law as having the power, through its Trustee, to own and administer property, both real and personal. Property transferred to and owned by the Trust is administered and controlled by the Trustee. The Trustee in turn can only act in the manner directed or allowed by the Trust instrument or the law applicable to the Trust. Therefore, a Grantor can, within the bounds of the law, exercise as much or as little control over the actions of the Trustee as it desires through its power to draft, revoke or amend the Trust.

3. Purpose of a Revocable Trust. A Revocable Trust is usually created to serve as a vehicle for:

- (1) Management of property during the Grantor's lifetime;
- (2) Transfer of property to designated beneficiaries at the death of the Grantor without the necessity of probate;
- (3) Management of property after the death of the Grantor.

4. Alternatives to Trust for Management of Property During a Grantor's Lifetime. When an individual desires assistance in the management of all or some portion of his or her assets, a variety of possibilities are available. The individual may give a power of attorney or may transfer the property to a person as agent, such as custodian accounts, safekeeping arrangements, etc. However, fundamentally, powers of attorney, custodianships, safekeeping arrangements, etc., are all forms of the legal relationship of principal and agent. The authority of the acting party flows from the principal and ceases with the death and, usually, upon the incapacity of the principal.

In contrast, a Trustee acts as a principal. The discretion, authority and power of the Trustee to act continue unabated after the death or incompetency of the Grantor. A Trust, rather than an agency relationship, is recommended when the Grantor desires the powers, discretion and authority of the acting party (Trustee) to continue uninterrupted by the death or incompetency of the Grantor.

Another widely used alternative is Joint Tenancy. Joint Tenancy ownership is primarily considered as a means of transferring ownership of property to the surviving Joint Tenant without the necessity of probate. When a Joint Tenant dies, the entire interest of the deceased Tenant passes to the surviving Tenant or Tenants without probate. Many people use Joint Tenancy as a management tool. Since each Joint Tenant presumptively possesses the whole of the property at the same time, when one Joint Tenant becomes incapacitated, the other Joint Tenant could use the property for the benefit of the incapacitated Tenant. This ability of each Tenant to use the whole of the joint property also creates potential dangers. The whole of the joint property is exposed to the claims of the creditors of each Tenant. The whole of the joint property could be withdrawn by one of the Joint Tenants.

In contrast, a Revocable Trust may only be used for the benefit of the named beneficiaries and its property is not subject to the claims of the creditors of any person but the Grantor. Therefore, the potential dangers of Joint Tenancy ownership are avoided with a Trust.

II.

ADVANTAGES, DISADVANTAGES AND TAX EFFECTS OF A REVOCABLE TRUST DURING THE GRANTOR'S LIFETIME

1. Age as a Reason for a Trust. One of the factors to be considered concerning lifetime management is the problem of age. The declining ability of the aged to cope with the complexities that are often involved in managing their estates highlights one of the most important uses of the Revocable Trust. It is a sad truism that the aged person is usually the last to recognize and accept his or her own increasing tendency to take erroneous or erratic actions, or fails to act when action is in that person's best interests. If the individual possesses substantial property, eventually family or friends may have to petition for the appointment of a guardian or conservator, an expensive and often harrowing experience. A Revocable Trust is the best solution to property management for the aged.

2. Revocable Trust as a Testing Ground. A funded Revocable Trust allows a trial run of the Trust during the Grantor's lifetime. If the Grantor is not fully satisfied with the Trust operations, the Grantor may change the Trustees or the administrative provisions or make such other changes as experience indicates. Even revocation of the Trust and recovery of the assets of the Trust is an alternative available to the Grantor. These alternatives are not available with a Testamentary Trust (a trust created by a Will), for it comes into operation too late to make any changes.

A trial run may be particularly valuable when the assets of the Trust are a going business, stocks, or other investments that require attention, because the Trustee has an opportunity to become familiar with the problems of managing the assets while the Grantor is still available for consultation.

3. Relief from Responsibility. The Grantor's reasons for using a Revocable Trust often are not only to obtain investment advice and direction during lifetime, but also to be relieved of the technical problems of keeping records, managing property, and preparing tax returns. Relief from the mechanical problems of managing property is particularly welcome when the Grantor is older, ill, retired, or inclined to enjoy traveling or other interests that make management difficult. By creating a Revocable Trust and appointing an independent Trustee or a co-Trustee, the Grantor is then relieved of management and has the opportunity to observe the Trustee's ability to perform.

4. The Mobile Grantor. The Revocable Trust has substantial advantages for handling the business and financial affairs of a mobile Grantor. For individuals who travel, whose occupations require that they move state-to-state or around the countries of the world, a Revocable Trust centralizes management and places authority and responsibility with the Trustee, still reserving the final word to the Grantor through the powers of amendment and revocation.

5. Predeath Administration. A potential disadvantage of a Revocable Trust is the predeath administration. In the case of a Will, no predeath formalities are required other than the execution of a Will. A Revocable Trust necessarily involves a number of predeath actions. In the usual case, the Trustee must open one or more bank accounts for the Trust, the Grantor must formally transfer assets from his or her name to that of the Trustee, and the Trustee should operate the Trust as a legal entity separate and independent from the affairs of the Grantor.

The extent to which predeath administration will be a problem depends upon the type of Trust created, the beneficiaries and on the choice of the Trustee. If the individual is willing to name a bank or other professional Trustee, the professional can effectively perform the administrative functions, and the only disadvantage to the Grantor is the cost. If the Grantor wishes to be Trustee or to name a friend or relative as Trustee, the administrative requirements may then be a burden.

A particularly ideal arrangement can be for the person, bank or trust company the Grantor wishes to be the successor Trustee to be Co-Trustee with the Grantor, since the Co-Trustee will establish a close working relationship with the Grantor during his or her lifetime, and will be

familiar with the operations of the Trust and its assets and be in a position to assume the duties of Trustee at the Grantor's death or incapacity.

6. Amendment of Trust. Another potential disadvantage deals with the amendment of the Trust. If the Grantor of a Revocable Trust wishes to change the beneficiaries designated to receive property following his death, he can readily do so by amendment, but if he does not wish the beneficiaries whose rights have been diminished to become aware of the previous terms of the Trust, the Grantor faces a more difficult administrative problem. Generally, the original Trust instrument and any amendments to it are part of the Trust and its history, and the Trust beneficiaries probably have a legal right to them. Therefore, the superseded provision will usually be available to a beneficiary unless the Grantor exercises his rights to completely revoke the prior trust and go through all the necessary mechanics of creating a new trust and transferring assets to it.

If this is a potential problem, the Trust can be drafted so that this problem is diminished by restating the Trust to include its current wording in its entirety, thereby eliminating prior wording.

7. Tax Effects. Creation of a Revocable Trust generally has no substantive income tax effects during the Grantor's lifetime. Because the Grantor has retained the power to revoke, the Grantor is treated as the owner of the Trust and therefore the Trust income is taxable to the Grantor, whether or not it is payable to the Grantor under the Trust terms. In most instances, while the Grantor is living, neither a State nor a Federal income tax return need be filed, as all items of income, deductions and credit are reported on the Grantor's individual return.

Creation of a Revocable Trust and payment of principal or interest to the Grantor or in fulfillment of his or her legal obligations has no Federal gift tax effect during the Grantor's lifetime. Because the Grantor has retained the right to revoke, the Grantor has not "parted with dominion and control", and the transfer is not subject to gift tax. However, when income or corpus of a Revocable Trust is gratuitously transferred to or used for the benefit of a third party beneficiary, the Grantor has made a gift to the beneficiary of the property transferred and the transfer is subject to gift taxation. In effect, for Federal income and gift tax purposes, the Revocable Trust is ignored and the acts of the Trustee are considered those of the Grantor individually.

III.

ADVANTAGES, DISADVANTAGES, AND TAX EFFECTS OF A REVOCABLE TRUST AFTER THE GRANTOR'S DEATH

1. General. Use of a Revocable Trust is frequently urged as a means of avoiding probate at the death of the Grantor. If title to property has been transferred to a Revocable Trust before death, the property (if retained by the Trust) is not subject to probate as part of the Grantor's estate even if the Grantor was the Trustee at the time of death. Although the avoidance of probate is an important factor to be considered, it is not the only reason to select a Revocable Trust. Factors other than the avoidance of probate should be considered before one creates a Revocable Trust.

2. Avoiding Delay in Transferring Assets to Beneficiaries. The speed with which assets may be distributed to a beneficiary after death is dependent, primarily, on the provisions of Oklahoma law permitting distributions and, secondarily, on the provisions of Federal or State law that may make the fiduciary liable for estate taxes, unpaid income taxes of the decedent, or claims of the decedent's creditors if the effect of the distribution is to leave inadequate property to pay those taxes and claims.

If the Trustee is the sole beneficiary, or enjoys a relationship with the other beneficiaries such that the Trustee's potential liability for unpaid taxes or claims is unimportant, a Revocable Trust will allow most of its property to be distributed to its beneficiaries within a short time after the Grantor's death. In contrast, except for the family allowance to the spouse and dependents, distribution of a probate estate cannot be made to the beneficiaries until an order of distribution is entered by the probate court, which is usually many months after death.

When the Trustee is not the sole beneficiary and is concerned about possible liability to the various taxing authorities and creditors, major distributions generally cannot be made from a Revocable Trust any sooner than they could be made from a probate estate. Even though there may be limitations upon the distribution of the corpus from a Revocable Trust because of the foregoing considerations, income generated by the Trust assets can be currently distributed to the beneficiaries, in most instances the surviving spouse, with immediate availability of income from the assets of the Trust. This immediate availability may not be the case if the estate must be probated.

3. Costs of Administration. Whether the executor's commissions in a probate estate will exceed the fees of the Trustee of a Revocable Trust depends on the circumstances of the particular case, including the amount of property involved, the period of administration, and whether administration will be followed with a continuing Trust. The executor's commissions in Oklahoma are fixed by law. Trustees' fees are not fixed by law, but must be reasonable. The fees of banks and trust companies are generally published by them and is a guide for "reasonable" fees to be charged by individuals. Trustees' fees, in the aggregate, may be greater than executors' fees, depending on the length of time the Trustee must act, the property in the Trust and other factors. If the Trustee did not act prior to the Grantor's death, some banks request an acceptance fee for accepting the Trust assets, but we usually draft our trusts so that the bank will not be required to impose an acceptance fee and, in exchange for that, the bank will not be liable for any action or inaction of the predecessor Trustee. In most instances, the successor Trustee is a beneficiary or the parent of a beneficiary, and a fee is, therefore, not charged. In such cases, the cost of administration is not a material consideration.

4. Attorneys' Fees. Attorneys' fees for probating an estate are generally negotiated. Many attorneys will charge a reasonable fee for the services actually rendered in a probate based on time expended, nature of services required, responsibility assumed and results produced. Since property transferred to the Trust does not require probate, it is reasonable to assume that attorney fees in connection with the transfer of property upon death when the property is in a Trust will be less than if the property required probate. This does not mean that attorney fees will not be incurred if property is transferred by a Trust, because the same problems such as tax problems, disputes among heirs and beneficiaries, etc., can arise even though the property is in Trust. If

these problems do arise, attorney fees will be incurred, but they should not be any greater than if those problems arose during the probate administration of an estate.

The expenses of creating a Revocable Trust and companion Will and transferring assets to the Trust are more than the expenses of preparing a Will alone, so that predeath legal expenses are greater with the Revocable Trust.

5. Administration of Assets after Death. When a Revocable Trust is used, the Trustee can continue to exercise all investment and other administrative powers given it by the Trust instrument, without court approval. Those powers are not interrupted by the death of the Grantor unless the Grantor was the Trustee. Even if the Grantor were the Trustee, if the successor Trustee is designated and is willing to serve, no court proceedings will be required and the successor Trustee can act immediately. In contrast, there is delay in having an executor appointed.

6. Multistate Assets. An important advantage of a Revocable Trust is the avoidance of ancillary administration when the Grantor owns real property in several states. Ancillary administration is usually expensive in that it requires a duplication of many of the efforts in the main probate. In some instances it may be advisable to create a Revocable Trust just to hold the multistate assets.

7. Publicity. Freedom from publicity is an advantage of a Revocable Trust. Wills and probate administrations are matters of public record. The principal provisions in the Wills of prominent persons are frequently published in the newspapers. Inventory of assets for a probate estate, showing the nature and the value of the decedent's estate, is a matter of public record. Although a Revocable Trust is not entirely private, since copies must be filed with taxing authorities and certain transfer agents and banks require submission of copies of the Trust, it is definitely a more private method of administering and passing a person's property on death than probate.

8. Trust as Sole Distributing Media. A Revocable Trust may be used advantageously as a receptacle for the residuary estate under a Will. Further, it may be used for life insurance proceeds and for benefits payable under pensions or profit sharing plans. The use of the Revocable Trust in this manner makes possible unified management and greater flexibility after death than would be possible with a separate and uncoordinated administration of insurance benefits, retirement plans and a Will.

9. Contest of the Trust. The legal requirements for contesting a Revocable Trust are generally similar to those for a Will contest, *e.g.*, mental competence or undue influence. There may, however, be a difference in time limitations within which the instrument must be contested, the period being shorter for a Will than for a Trust. But, it may be more difficult to contest a Revocable Trust that has been in active operation for a period prior to the Grantor's death as compared to the contest of a Will.

10. Taxability of Income of the Trust. Generally, a probate estate and a Trust are treated in the same manner for Federal and State income tax purposes.

11. Basis of Property in the Trust. For Federal tax purposes, property placed in a Revocable Trust receives on death the same treatment as to basis as property of the same character which passes by Will. Property of Revocable Trusts receive a new basis equal to its fair market value at the date of death of the Grantor or at the alternate evaluation date.

12. Estate Tax. The Grantor's interest in property transferred to a Revocable Trust is included in the Grantor's gross estate for estate tax purposes. The use of a Revocable Trust, therefore, does not affect the taxability of the property and any estate tax advantage which can be obtained by the use of a Will can be obtained by the use of a Revocable Trust.

IV.

PLANNING THE TRUST

1. Selection of Trustee. A Trustee must meet certain minimal legal requirements. Because the Trustee must deal with the Trust property, it must be legally competent to hold title and to contract. A Grantor may act as Trustee, but when the Grantor acts as Trustee, use of the Trust as a testing ground is lost. Although the cost of maintaining and administering the Trust are reduced when the Grantor acts as Trustee, it may be more difficult to find a qualified successor Trustee willing to act because of possible liability for failure to discover and redress breaches committed by its predecessor.

A beneficiary other than the Grantor may act as Trustee. However, when a beneficiary acts as Trustee, conflicts of interest may develop because a Trustee's rights as beneficiary are affected by its acts as Trustee. This situation arises, for example, when a parent is a life tenant and children are remaindermen, or when one sibling is Trustee for himself or herself and other siblings. The conflict of interest problem may be met in several ways, such as defining Trustee powers or the appointment of a Co-Trustee. Furthermore, when a beneficiary is a Trustee, certain income and estate tax problems may arise which would be adverse to the interests of the Trustee/beneficiary.

2. What Property Should be Transferred to Trust. The Grantor who establishes the Trust must determine at the outset whether all or only part of the property is to be transferred to the Trust. Because the Grantor of a Revocable Trust is considered the owner of the Trust property for income tax purposes, the Grantor need not be concerned with many tax considerations, such as the effect of transferring property with low basis. Nevertheless, tax considerations do play a role, *e.g.*, in the transfer of stock of a Subchapter S corporation, the election may be lost if certain Trust criteria are not met. A point to remember is that if all property subject to probate is not transferred to the Trust, the advantage of avoiding probate is lost.

3. Powers of the Trustee. The powers and duties of a Trustee are governed by the Trust and State law. Oklahoma law is not overly restrictive in the powers and duties which it allows the Trustee, and in most instances, allows the Trust instrument to expand upon the powers granted by law. Therefore, within reason, the powers and duties of a Trustee can be drafted in the Trust to suit the particular needs and desires of each Grantor.

4. Distribution of Trust Assets. Since the Trust assets may be distributed to beneficiaries to the same extent as one could do by Will, the Grantor of a Trust needs to make the same decisions concerning distribution of assets as he or she would in making a Will. In addition to the flexibility, the management and distribution can be controlled after death by the terms of the Trust. After-death management and distribution is, in many instances, one of the primary reasons for the creation of a Trust.

V.

CONCLUSION

A Revocable Trust is not a panacea for all problems of an estate but, in a majority of instances, is far preferable to a Will or use of Joint Tenancy.