Revocable Living Trusts: Myths And Reality

One of the most frequent comments an estate planning attorney hears from a client is "I think I need a revocable living trust." For some, creating a living trust is a wise decision. Many people, however, have no need to go through the expense and bother of creating and funding a living trust. While living trusts offer certain advantages, they also present disadvantages. In addition, there are many myths surrounding revocable living trusts.

For those who haven't read one of the ubiquitous articles about revocable living trusts, perhaps while waiting in a doctor's office or standing in the checkout line, what follows is a brief explanation of what we are talking about. A revocable living trust is, first of all, a trust. This means the person creating it (the "grantor") designates a trustee to manage whatever assets are placed in trust. It is "living" because it is created during the grantor's lifetime, as opposed to a trust created after a person dies under her last will and testament. It is "revocable" because the grantor can change her mind and undo the trust, as long as she remains of sound mind. Generally, the grantor is the initial trustee. The trust agreement typically provides that, when the grantor becomes incompetent, another person steps in as trustee, managing the grantor's assets until her death. Like a will, the trust agreement sets forth how the client's assets should be distributed upon her death.

Why set up a living trust? Why not just have a will? There are several reasons why persons should create revocable living trusts.

AVOIDING PROBATE

A person who has reason to avoid probate (the legal process by which a last will and testament is deemed valid by a court and an executor is appointed to administer the estate) is a suitable candidate for a living trust. In most instances, however, probate is not to be feared. It is not true, unless there is a will contest, that probate goes on for years. Nor is it true that probate means the government takes most of the money. Oddly, although often considered one of the most bureaucratic of states, New York does not have an overly cumbersome or expensive probate process. Nonetheless, New York courts require that a decedent's next-of-kin (called "distributees") be put on formal written notice of a probate proceeding because they are the persons who might possibly have a reason to challenge probate (for example, on the ground that the signature on the will is a forgery or that the person who signed the will was not of sound mind). Most distributees do not have a legitimate reason to object. As a result, will contests are rare; successful will contests even more so. Most probates proceed quickly and uneventfully.

Despite this, sometimes probate should be avoided. Bad blood in a family might trigger a will contest, even a frivolous one. A gay person may be concerned that his family will fight his partner after his death. Or a person may not know who her distributees are. This is not uncommon, especially in New York, which attracts people who have left their families in faraway places. Imagine an unmarried person who is an only child and has no children. With no siblings, nieces or nephews, that person's distributees would be her cousins. In today's mobile society, it is not unusual for people to lose track of cousins or perhaps never have met them. If a person does not know who all her cousins are, it is even less likely her executor will know when it comes time to probate her will.

Another reason to avoid probate is if the person owns real property in more than one state. Real property (house, condominium, land) has a special status in the law. As a result of this special status, most states require their own proceedings (called "ancillary probate proceedings") to transfer title to real property. So, if a person owns a house in New York and a condominium in Florida, for example, she might consider a living trust as an alternative to probate so as to avoid court proceedings in two states

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Yet another reason to fear probate is publicity. Probate files are open to the public. Anyone can inspect a file and read the will and probate petition. These documents reveal the names of the heirs and, frequently, the assets of the decedent. For most people, publicity is of little concern. For some, however, it might present a serious issue. Nevertheless, while a living trust should avoid the publicity at risk in a probate proceeding, it too can be subject to scrutiny. For example, financial institutions often request copies of trust agreements for their files.

PLANNING FOR DISABILITY

Another reason to create a living trust is to provide for managing a person's assets in the event she becomes disabled, whether physically or mentally. A trust agreement should provide for the appointment of a new trustee upon the person's disability. The trustee will then manage the person's finances until her death, at which time the trustee distributes the assets as the person instructed. This continuation of management is often desirable. Without a living trust, when a person becomes disabled, a costly guardianship proceeding is usually required for a court to appoint someone to manage her assets. Then, when the person dies, an executor must be appointed to administer the estate.

If disability is the only concern, however, there is a less cumbersome alternative to a trust which should avoid a guardianship proceeding. A person can sign a durable power of attorney giving control of her financial affairs to someone else while she remains alive. The power of attorney can be "springing," meaning it only takes effect when the person signing it becomes disabled. Unlike a trust, however, a power of attorney becomes invalid when the person who signed it dies. It has no further effect upon her death and is not a substitute for a will. Yet, along with a living will and health care proxy, a durable power of attorney often satisfies a person's needs without going through the burden and expense of transferring assets into a trust.

MANY MYTHS

Avoiding probate and planning for disability, therefore, are the most frequent reasons for creating revocable living trusts. There are many myths, however, which cause some persons to believe they should have a trust. The most common myth is that a trust avoids taxes. There is absolutely no truth to this myth. A person will not avoid either income or estate taxes by putting her assets into a living trust. If that were the case, everyone would create a living trust. The morale: don't create a living trust if your only reason is to save taxes. You (or your heirs) will be disappointed.

There are other myths surrounding living trusts. Just as they do not save taxes, living trusts do not shield assets from creditors. If a creditor has a claim against a person, he will be able to satisfy his claim against assets held in that person's trust. It is also not true that property is distributed more quickly from a trust than a will. Assuming there is no will contest, the amount of time is about the same since both an executor and a trustee should hold off distributing assets until all debts and taxes are paid. If speed is a concern, a person should consider holding assets jointly with another person or designating that person as a beneficiary. Transferring assets into a living trust will not qualify a person for Medicaid. In New York, a person cannot disinherit a spouse by moving her assets into a trust. Lastly, although the rule varies from state to state, it is a myth that heirs cannot challenge a living trust as they can challenge a will. However unlikely, court challenges are always a possibility. In fact, the legal standard of mental competence for executing a will is usually lower than that for executing a trust.

PROBLEMS WITH TRUSTS

There are reasons why a person might not want to create a living trust. In order for the trust to have its full impact, the person should transfer all of her assets (which are not jointly owned and which do not have beneficiary designations) into the trust. This can be cumbersome and expensive. It takes persistence to ensure all bank accounts, stocks;

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property deeds, etc. are transferred into the name of the trust. Unfortunately even the most persistent sometimes fail. Many cooperative apartments will not permit shares of their stock to be placed in trust. Given that a person's apartment is often her major asset, this would defeat the purpose of the trust. Pension plans and IRAs generally cannot be transferred to a trust, although the trust can be designated as beneficiary of such assets.

Another weakness of a trust is that, unlike a will, it does not automatically adapt to changed circumstances in a person's life. For example, if a person marries, divorces or has children after signing a will, the law frequently changes the terms of a will to provide for the new circumstance. There are no similar provisions in the law for a trust. In New York, however, a spouse does have a right of election against trust assets, so a person should not create a living trust with the hope of disinheriting a spouse.

Despite their best intentions, persons often forget or are unable to transfer all their assets into living trusts. Therefore, a person with a living trust should also have a "pour over" will, which provides that any assets not in the trust at the time of death be transferred into the trust and distributed pursuant to the terms of the trust. A will is also necessary in case a trust is revoked by the person before death or rendered void by a court. Of course, a will must be probated to have effect. This may open the will to publicity. But it will accomplish the person's testamentary wishes.

EXPENSES

Commissions, legal fees and other expenses can be considerations in deciding whether to create a living trust. The law provides that executors of wills and trustees of trusts are entitled to commissions. These can be waived but no one can be forced to serve without compensation. The rate for a trustee's commission is generally lower than an executor's commission. However, it is possible that a trustee will serve for several years during a person's disability. In that case, the trustee's commission may be no different than an executor's.

Legal fees incurred in a probate proceeding might be avoided with a living trust. However, there are fees associated with creating a trust and transferring the assets into the trust which might equal the fees associated with probate. If probate is unnecessary, the estate will not have to pay court filing fees. But those are generally negligible and ought not to be a consideration.

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A revocable living trust often serves legitimate estate planning goals. Too frequently, however, people mistakenly believe they need a living trust. Careful consideration ought to be given to a person's family, financial and health situation before deciding to create a revocable living trust.

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