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A Married Person's Guide to Using a Funded Revocable Trust to Reduce Estate Tax and Avoid Probate

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A. *The Role of the Revocable Trust in the Two Part Estate Plan.* An important purpose of "estate planning" is to arrange property ownership and its deathtime distribution to avoid or reduce administration costs, such as those associated with probate, and taxes which would otherwise be due upon your death. One popular way to do this is through a two-part plan involving a "*pour-over will*" and a "*revocable trust*". The will plays the secondary role of transferring - "pouring over" - any probate assets into your revocable trust upon your death. The trust, and not the will, is your primary vehicle: it will determine how, and to whom, your property is to be distributed on your death. It handles things like gifts to charity, specific gifts to specific persons, the creation of further trusts for minor or disabled children or other beneficiaries, etc. This is why the revocable trust is sometimes referred to as a "will substitute."

If you instruct your attorney to prepare wills and trusts for you, you may assume that you have completed your probate avoidance plan when you sign the documents. In fact, however, your job is then only partially finished. You must still focus on considering what property ownership rearrangements might be necessary to complete the project. A failure to follow through on this second step and to complete the necessary funding of the trusts may negate many or all of your planning objectives. It might be likened to buying a car but forgetting to put any gas in it. The "gas" which will fuel the revocable trust-centered estate plan is the lifetime funding of the trusts. Funding can achieve three important purposes. *First, funding can help minimize federal estate taxes through the utilization of the federal estate tax exclusion amount (currently \$1 million in 2003 and increasing gradually to \$3.5 million for the year 2009) and the "unlimited marital deduction" on the first spouse's death, thereby guaranteeing that estate taxes will be deferred until the second death and property equal in value to the married couple's entire combined federal exclusion (\$2 million in 2003) can pass to the children free of estate tax. Second, funding avoids probate administration and all of its costs, delays and publicity. Finally, funding will assist your family members and others easily to identify, assemble and administer your assets upon your death.* The following will elaborate on these benefits and provide some guidance

on how to fund your trust to achieve them.

1. The Funded Revocable Trust Can Help Accomplish Estate Tax Savings on the First Spouse's Death. In the typical case, revocable trusts created by a husband and wife can be designed to take maximum advantage of the federal exclusion and unlimited marital deduction available under current law. In order to take full advantage of the exclusion for each spouse, each spouse must have at least \$1 million amount in his or her own name (*not* in joint name with rights of survivorship) *or* in his or her trust. If you have between \$1 million and \$2 million of property just be sure that neither spouse has more than \$1 million in his or her own name.

The tax planning benefits incorporated into your and your spouse's revocable trust will *not* work unless each of you or your trusts own property which is available to fund your exclusions regardless of the order of your deaths. Property that you hold with your spouse (or any other person, for that matter) in joint tenancy with rights of survivorship will pass automatically upon your death to the surviving tenant. But beware: this is not the best way to title property since it will not pass into your revocable trust if you die before your spouse. As a result, you may lose part or all of the benefit of the tax planning provisions built into the trust. Accordingly, you should "sever" the title to all jointly owned property (except any real estate you acquired jointly before January 1, 1977) and put it into one spouse's name, into another form of ownership with your spouse without an automatic survivorship feature, or, preferably, into your and your spouse's names as trustees of your own trusts.

2. The Funded Revocable Trust Will Help Avoid Probate Administration. Planning to avoid or reduce the unpleasant aspects of probate administration is often cited as one of the primary benefits of revocable trusts. Probate is the court procedure which oversees the administration of much of the property ("estate") of deceased and incompetent persons. For example, upon your death, the probate court appoints the executor named in your will to be responsible for making an inventory of your assets, paying your outstanding debts at death and then distributing the assets remaining in your estate in accordance with your will.

The entire process can be costly, time-consuming and public. Fortunately, your family need not suffer from the benign neglect of our policy makers. Probate is voluntary, self-inflicted pain. If you change title to your assets to your revocable trusts during your lifetime, then upon your death or incapacity the successor trustee appointed under the trust has authority to manage and distribute your assets in accordance with the terms of the trust. Since the assets do not pass into your estate, there is no need for probate. You avoid all of the costs, delays, and publicity.

The trustee named in your trust has the fiduciary duty to manage and distribute trust assets in accordance with the trust terms. There is currently no direct probate court supervision of this process. Nor is there likely to be any in the future.

3. The Funded Revocable Trust Will Help Avoid Problems With the Identification of Assets. Funding the trust during your lifetime can also make it easier for your family in the event of your incompetency and upon your death. Your assets will all be readily identifiable in the trust name. Having an inventory of the assets will allow your successor trustee immediately to step in and manage the trust property without the delays that might otherwise occur if he or she were forced to identify and assemble them. This asset identification and inventorying process accounts for much of the delay, expense and inconvenience of probate.

B. How Do I Fund The Trust? You must first decide how your assets are to be divided between you and your spouse's trusts to achieve the objectives described above. Then you are ready to fund. In order to do this, it is necessary for you and your spouse to change the title of your assets into the name of the trust. You should consider the following when retitling your assets:

1. Real Estate.

(a) New Hampshire Real Estate. Normally, your attorney will prepare deeds and the necessary documents for you to transfer your real estate interests into your revocable trust. You should provide your attorney with photocopies of your recorded deeds along with instructions as to which revocable trust (your or your spouse's) you would like your property transferred into, keeping in mind that in 2003 you should have at least \$1 million, at least \$1.5 million in the years 2004 and 2005, etc., in each spouse's name or in the name of your respective revocable trusts (assuming that the value of your properties equal or exceed 200% of the applicable exclusion amount and this value can be split between your revocable trusts).

(b) Mortgaged Real Estate. If you are considering transferring mortgaged real estate into your trust you may have to first contact and receive the prior written consent of the mortgage holder. This may mean contacting each bank and reviewing the transfer with them. (Note, however, that under a recently enacted federal law this may not be required and you may be able to simply to inform the bank of the change of title after it occurs. We can consult with you to determine whether this option is available to you). Some banks charge an administrative fee and legal fees to review the request and process the change of title, while others have different requirements which you must

meet before they approve the transfer.

Be aware that many mortgages are sold on the secondary market and are subject to the policies of *Fannie Mae (FNMA)* or *Freddie Mac (FHLMC)*. These agencies establish certain requirements of transfers into revocable trusts. The major requirements you must meet are that the borrower must be an occupant of the property and the beneficiary of the revocable trust to which the property is transferred. Otherwise, you may find the bank will not approve the transfer.

(c) Out-of-State Real Estate. If you own real estate outside New Hampshire it may be particularly important to transfer it to your revocable trust. This will avoid the need after your death to hire an attorney in the other state to conduct “*ancillary*” probate of the property. This will often lead to even more expense and delay. Your New Hampshire estate planning attorney will probably work with legal counsel in the other state to review and prepare the necessary documents for the transfer. This will result in additional legal fees - but probably much less than an out-of-state probate administration would have cost.

(d) Owner’s Title Insurance. If you have owner’s title insurance (as opposed to title insurance that you purchase for the lender), you may lose the benefits of the insurance when you transfer the property to your revocable trust. It may be advisable to transfer the property via a warranty deed (as opposed to a quitclaim deed) or to purchase additional insurance rider. You should discuss this with us and give us a copy of the title insurance policy.

2. Stocks and Securities.

(a) Publicly Traded Securities. Securities held in “street name” in your brokerage account are easily transferred. Contact your stockbroker with instructions to transfer the account into your revocable trust. You will find that most brokers are familiar with this simple process and will prepare the necessary paperwork for you. Also consider accomplishing the more difficult task of transferring any original stock certificates which you do not hold in stock brokerage accounts. Many attorneys will help you handle this cumbersome process (including the preparation and delivery of transfer instructions, stock powers with signature guarantees, trustee’s certificates, etc.).

(b) Family Businesses. You can easily transfer your interests in “closely held” businesses by having your corporate or estate planning attorney prepare some simple corporate legal documents.

Beware:

i. Your stock of a closely held corporation may be classified as an S (also called a “subchapter S”) corporation for federal income tax purposes. The S corporation rules strictly limit the types of trusts which can hold the stock an S corporation without jeopardizing its continued S corporation status. Your revocable trust is an eligible shareholder for as long as you are living. But upon your death, it might not continue as such for long unless your attorney makes special provisions for stock in your revocable trust. Be sure to discuss this with your attorney: the income tax consequences of an inadvertent S corporation disqualification can be severe.

ii. Stock of professional associations. If you are a professional doing business in the corporate form as a “P.A.”, be aware that New Hampshire law prohibits trust ownership of the stock of a Professional Association. **Do not** transfer it to your revocable trust.

3. Tangible Personal Property. Transfer your unregistered “tangible” personal property (household effects, antiques, jewelry, furs, classic automobiles, boats, etc.) into your trust by signing a Deed of Gift or Transfer which your attorney can easily prepare. There is no requirement that this deed provide a detailed listing of these tangibles; however, it may be a good idea to do so to provide an inventory (and perhaps a memo describing your desired distribution of the tangibles) to allow for their easy identification and distribution after your death. Separately transfer vehicles and all other personal property which have a certificate of title. Consider the convenience of re-titling vehicles into the name of your revocable trust upon renewal of your registration.

4. Certificates of Deposit and Bank Accounts. Begin splitting any joint bank accounts which you own into the names of your respective revocable trusts. Some banks will allow you to retitle a CD into your individual name, or in the name of your trust before maturity, without penalty. You may find it easier to retitle CDs upon maturity; you can change your checking and savings accounts at any time. The tax identification number of your revocable trust will be your social security number.

5. IRAs and Tax Qualified Retirement Plans. For married persons owning IRAs, SEP, 401(k) plan assets and other qualified pension and profit sharing funds, it is often prudent planning to name the spouse as the primary beneficiary, and your children as your secondary beneficiaries, with both the spouse and children having the power to disclaim the interest if income tax planning considerations warrant it. Having individual beneficiaries - and not your trust - succeed to a substantial retirement account balance might allow them the flexibility to continue the growth of the plan balance in an income tax sheltered solution for a significant period of time after your death. This flexibility

might be reduced if the trust is the designated beneficiary. **Beware:** if you are interested in naming someone other than your spouse as the primary beneficiary, the tax law may require your spouse first to waive certain rights he or she is given under federal law. Other technical rules in this area are complex and there are several traps for the unwary. Discuss these issues with us.

6. Insured Property. Contact your insurance carriers if you are considering transferring insured property (most notably automobiles and real estate) into your revocable trust. Be certain that any individuals who “use” the property owned by the revocable trust are named as an “insured” on the property’s insurance policy with the revocable trust named as an additional insured. Confirm with your insurance agent that revocable trust ownership will not result in higher premiums under some fine print in the policy.

7. Life Insurance Policies and Annuities. Obtain change of beneficiary forms for any insurance policies and annuities from your insurance agent or directly from the insurance company. For life insurance policies your revocable trust normally is designated as the primary beneficiary with designated individuals as the contingent beneficiaries. For annuities, the rules become complex. Designating your revocable trust as annuity owner may jeopardize the income tax deferred status of the annuity. Work with your insurance agent and direct him or her to change the beneficiary of your policies.

C. What If Some Stranger Asks For A Copy of My Trust?

When transferring your properties into your trust, you may encounter requests from banks and other companies including stock brokerage firms, stock transfer agents, mutual fund companies, etc., for a copy of the complete trust. They might insist that their in-house legal department needs to review it. They don’t. It will usually suffice for you to give them a copy of the first page identifying the date you signed the trust, and the signature page showing that the trust was validly executed and notarized. There is no reason for them to see those parts of the trust that contain sensitive, personal information about how your property is to be distributed upon your death. This keeps the terms of the trust document private - one of the important advantages of having a revocable trust and avoiding probate. Some of these people may ask for a certified and attested copy of the date and signature pages of your trust. Let us know and we can provide the appropriate certification and attestation.

D. Final Word: By Funding My Trust, Have I Created a Monster? No. Many people worry that by funding their trust during their lifetime they are irrevocably transferring their property or losing control over it. Nothing can be farther from the truth. Such people are confusing “irrevocable” living trusts with “revocable” living trusts. Funding an

irrevocable trust requires you to sacrifice the use and enjoyment of the property you transfer to it. By contrast, your funded revocable trust is a “paper tiger” throughout your lifetime. You remain the captain of the ship: you retain absolute power to amend or revoke your trust, and may move property in and out of the trust at any time. You continue as the ultimate owner of the property through the trust. You need not obtain from the IRS a separate taxpayer identification number for the trust. Your trust identification number is your Social Security number. This eliminates any need to file any separate trust tax return. You report all items of trust income and capital gain on your Form 1040 as if you received it directly.

Although retaining all of this flexibility and control is a good thing, note that since you have complete access to the trust, it will not insulate your assets from your creditors. Furthermore, the trust will not protect funds in the event of catastrophic occurrences, such as lawsuits or long-term nursing home care. And, as indicated above, all assets in your revocable trust will be subject to federal estate taxation upon your death. You just can't have your cake and eat it, too.

Feel free to call us if you encounter any difficulties or if you have any questions about funding your trust.

Endnotes