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TRUSTS AS ALTERNATIVES TO WILLS

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I. Introduction.

Trust planning among estate and financial planners continues to grow as more and more people learn of the benefits of having a trust versus having a traditional will. Trusts provide all the same benefits of wills but do so with the added benefit of privacy and probate avoidance. As will be discussed in more detail below, trusts can be revocable or irrevocable and can also be grantor trusts with the income and estate inclusion being attributed to a certain grantor or be their own independent tax paying entity. Trusts include a number of items that need to be discussed with clients so the clients can make informed decisions about how the trusts are drafted. This outline will discuss those items from a relatively basic perspective and provide insight into how they all work together within trust documents.

II. When to Recommend a Trust Over a Will.

A. No Set Dollar Amount Required.

Clients often inquire about whether they have sufficient assets to establish a revocable living trust or some other type of trust. The simple answer to this question is that there is no certain dollar amount required for a person to establish a trust. With the substantial increase in the federal estate tax exemption being put in place at the end of 2017, and with portability being previously made a permanent part of estate tax law,[1] there are not as many reasons to have tax related sub-trusts

[1] The Tax Cuts and Jobs Act of 2017 increased the federal estate exemption to $11,180,000 per person (indexed for inflation) for persons dying in 2018. Portability was made permanent in 2013 in the American Taxpayer Relief Act.

inside wills or revocable living trusts. Some people incorrectly think that since their estates are below the estate tax exemption that they and their families would not benefit from a trust. It is normally the type of assets and the titling of assets, and not the amount of the assets, that dictates whether a person or family would benefit from a trust.

B. Reasons to Have a Trust.

1. Probate Avoidance.

The objective with revocable living trusts is for the trust to own the assets (except those that would otherwise pass by beneficiary designation) of the decedent at their death, so that no assets would be left in the decedent's name that would have to pass through probate. Since trusts can be administered without having to comply with all the probate filings related to wills, trusts can normally be administered within a few months in the lawyer's office without having to go through the probate court for approval to distribute assets. The probate process in South Carolina normally takes between a year to a year and a half, or longer, if the estate has particular issues or is comprised of difficult to administer assets, such as real estate or mineral rights.

2. Real Estate in Other State.

When a person does not have a trust and owns real estate in more than one state (and when the real estate is not owned with rights of survivorship), their beneficiaries or heirs[2] would have to probate the estate in the state where the decedent was domiciled and then also probate the estate in the state where the out-of-state real estate is located. This can be avoided by having a revocable or irrevocable trust that owns the real estate.

3. Privacy.

Often times clients do not want their final wishes to be part of the public record. When a person dies with a will, their will is required to be filed in the local probate court and made part of the public record. Also, the inventory and appraisement and final accounting documents for the estate are part of the public record. This can be avoided by having a trust. The trust is not required to be made part of the public record. The trust is treated in most all respects as a contract between the grantor and trustee for the benefit of the beneficiaries of the trust.

4. Trusts are More Difficult to Contest than Wills.

When a will is being administered, a probate file has been set up. The probate code has a number of provisions that make it easy for a beneficiary to contest how an estate

[2] Generally, individuals that receive assets because they were named in a trust or will are referred to as beneficiaries or devisees. Individuals who receive assets from an estate where the decedent died without a will are referred to as heirs.

is being administered. Beneficiaries can often file for matters without even hiring an attorney to assist them. With trusts it is more difficult for beneficiaries to contest the administration of the trust because they would be required to hire an attorney and bring a lawsuit for their claim. Since trust administration is normally handled without probate court involvement, this would make it much more difficult for a beneficiary or claimant to bring a merit less claim against the trustee of a trust.[3] The beneficiary or claimant would be required to thoroughly vet their claim with an attorney before bringing their action.

C. Same Capacity to Execute a Will and Trust.

The capacity requirements in South Carolina to establish a revocable living trust are the same as those required to establish a will. The general capacity requirements include that the person knows: 1) his or her estate, 2) his or her family (or objects of his or her affection), and 3) to whom he or she wishes to give the estate).[4]

III. Types and Functions of Trusts.

The primary focus of this outline is to discuss revocable living trusts. However, there are multitude of different kinds of irrevocable trusts. There are some attributes of trusts that apply to both revocable and irrevocable trusts.

A. Revocable vs. Irrevocable Trust.

The terms revocable and irrevocable are self explanatory. A revocable trust can be revoked or amended by the grantor at any time, while an irrevocable trust cannot. However, there are some nuances with irrevocable trusts in this regard that are worth noting. While an irrevocable trust cannot be revoked or amended, the grantor can reserve certain rights in the trust that he or she can exercise at a later time, such as a power of appointment or the right to change a trustee. Also, irrevocable trust documents will often times include trust protector language which will allow another unrelated person to come back and make changes or corrections to a trust document to

[3] It is important to understand that assets in a revocable living trust (along with some jointly owned financial accounts) can be brought back into an estate to be used for the payment of estate expenses if the probate estate is insufficient to pay for such amounts. See S.C. Code Ann. §§ 62-7-505 and 62-6-205 (1976, as amended). It is also important to consider filing the decedent's will (which would most likely be a special kind of will called a pour-over will) and publish notice to creditors, if it is important to start the eight (8) month creditor period. See S.C. Code Ann. §§ 62-3-801 and 62-3-802 (1976, as amended). Otherwise, the one (1) year from date of death of the decedent statute would apply. See S.C. Code Ann. § 62-3-803 (1976, as amended).

[4] See S.C. Code Ann. § 62-7-601 (1976, as amended) and Weeks v. Drawdy, 329 S.C. 251, 495 S.E.2nd 454 (S.C. Ct. App. 1997).

comply with changes in tax or Medicaid laws or in family or beneficiary circumstances. Some states also have recanting statutes that provide for ways that an irrevocable trust can be changed.

B. Inter Vivos vs. Testamentary Trusts.

An inter vivos trust is a trust that is established and valid during the life of the grantor or person who establishes the trust, while a testamentary trust is established and comes into effect upon the death of a person. An inter vivos trust or a will can have a testamentary sub-trust contained within it, to become effective upon the death of the grantor or testator.

C. Grantor Trust vs. Non-Grantor Trust.

The term "grantor trust" is used loosely but can have significant implications for tax purposes in certain situations. For tax purposes, a grantor trust denotes how and to whom the income and gain in the trust will be taxed. It also concerns the issue of whether the assets in the trust will be included in the estate of the grantor at their death. Revocable living trusts are by their very nature grantor trusts for the grantor for income and estate inclusion purposes.[5] The assets are also part of the grantor's estate upon their death.[6] The question of grantor trust status for irrevocable trusts is not as simple. Numerous factors related to the trust would need to be considered to determine if an irrevocable trust is a grantor trust for income purposes and/or for estate inclusion purposes. A discussion about those items is outside the scope of this outline.[7]

D. Joint Trusts vs. Single Trust.

Before portability and the estate tax exemption being raised, practitioners regularly debated whether it was better for couples to have their own single trust or whether they should share a joint trust. Now with the new tax laws, it is much easier to justify having all the assets of a couple in one joint trust. The joint trust operates in a lot of ways like the simple "I Love You" wills that we have prepared for years. Both spouses serve as trustees during their lives and then the surviving spouse serves by himself or herself. Normally, the survivor also retains the right to amend the trust after the death of the first spouse.

Single trusts are still preferred and used when there are specific reasons to have them. When a person is in their second or later marriage and wants to make sure that assets are left to their children from a previous relationship, they can have a single trust with some sort of sub-trust in it such as a qualified terminable interest trust (QTIP) for their surviving spouse.

[5] I.R.C. § 676.

[6] I.R.C. § 2038.

[7] The author previously prepared an outline related to grantor trust tax laws and it can be found at www.davisboydlaw.com under the heading Articles and Publications.

IV. Selecting Trustees.

A. Individual Trustee vs. Corporate Trustee.

Choosing who should serve as successor trustee of a revocable living trust is a matter that can require a great deal of effort and thought. The easiest answer to the question of whether it is better to use an individual trustee instead of a corporate trustee is to find an individual that is suitable to serve as successor trustee. That sounds easy. The hard part is finding someone that is suitable. Appointing a surviving spouse who is a step-parent to the grantor's children, or appointing a child of the grantor who is a sibling to the other beneficiaries, can often result in many issues with the beneficiaries. Inevitably, a beneficiary will get the idea that the successor trustee is not doing something right, which could be the case, but which is often not the case. To avoid these types of issues, grantors should strongly consider whether it would be better to name a corporate trustee or even possibly a corporate co-trustee to serve with an individual successor trustee. The grantor can also consider whether it would be better to name individual co-trustees.

B. Right to Change Corporate Co-Trustee.

Appointing a corporate co-trustee to serve with an individual can be a very good solution to the potential issues that can arise. When this is done, it is good to include a provision that allows an individual co-trustee serving with a corporate co-trustee to remove and replace the corporate co-trustee with another corporate co-trustee. This retains a certain amount of control in the individual co-trustee in case the corporate co-trustee starts doing things that are not consistent with the trust terms or if the corporate co-trustee is going through some unusual staffing issues.

V. Choosing Trust Situs

The situs of trust is initially the state in which the grantor resides and is domiciled. It is important to include language in the trust document that allows the trustee to change the situs of the trust if it becomes necessary, and to be able to do that without having to file anything with a probate court. Below is some sample language used in trusts for this purpose.

> <u>Law Applicable for Interpretation of Document</u>. The validity of this Trust, the validity of the particular provisions of this Trust, and the meaning and effect of the terms of this Trust Agreement (and of any amendments) shall be governed by the laws of the State of South Carolina.
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> <u>Law Applicable for Trust Administration</u>. The administration of this Trust shall be governed from time to time by the laws of the state in which this Trust is then being administered (based on the location of the administrative office, or residence, of the Trustee then having custody of that Trust's principal assets and records), which state's courts shall have exclusive jurisdiction over the administration of the Trust with respect to any period during which it was then being administered in that state. The foregoing rules shall apply even though the

situs of some Trust assets or the home of the Grantor, a Trustee, or a beneficiary may at some time or times be elsewhere. Furthermore, to the greatest extent permitted by law, this Trust (and its then serving Trustee) shall be exempt from the supervision of any court or other governmental entity.

Trustee Discretion to Change Applicable Law. Notwithstanding either the location of the Trustee or the location of the Trust Estate, the then serving Trustee may, in the Trustee's sole and absolute discretion, change the situs or governing law of any Trust share established under this Trust Agreement to a different state. If the Trustee elects to change the situs to another state, the Trustee will administer the Trust (or the applicable Trust share) in accordance with the law of that new state. The Trustee shall no longer be required to maintain qualification within any prior state nor account to any prior state. The powers granted to the Trustee may be exercised multiple times, it being the Grantor's intent to grant the Trustee maximum flexibility with respect to choosing the state whose laws will govern this Trust, or any sub-trust created under this Trust Agreement.

VI. Trust Funding Basics

A. Real Estate.

It is important to retitle the real estate of the grantor in the name of the trust, if the grantor wants the property to be governed by the trust. If the grantor would prefer to rely on survivorship language in the deed for some reason, they can leave it out of the trust. When the grantor's principal residence is retitled in the name of the trust, it will be necessary for the grantor to reapply with the county assessor's office for the principal residence (and homestead) taxation. Otherwise, the county will change the tax status of such property to investment property.[8] It is particularly important to retitle out of state real estate into a revocable living trust to avoid having to do some sort of probate administration in the other state.

B. Interests in Entities.

It is important to remember to assign all of the grantor's ownership in entities into the trust to avoid having to probate such interests.

C. Changing Banking and Financial Accounts.

For financial accounts to be governed by the terms of the trust without having to go through probate, it is necessary to either change the ownership of the account into the trust or to make the trust the beneficiary of the account. When putting checking accounts into a revocable

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[8] Transferring residential real estate that has a mortgage into a trust wherein the grantor retains the right to live in the residence should not trigger the due on sale clause in the mortgage. See 12 U.S.C. § 1701j-3(d)(8).

living trust, it is important to insist with the bank that the name on the account be changed and that the numbers remain the same. Banks will sometimes ask the person to close one account and open another account. This can be a problem for people because that may require them to change their existing direct deposits and drafts. When the trustees of the trust are different than the existing owners of account, banks will normally insist that a new account be opened in the name of the trust.

D. Trust as Beneficiary of Life Insurance and Retirement Accounts.

It is important to discuss with the client whether life insurance and/or retirement accounts should pass outside the estate and trust and directly to individual beneficiaries or whether it would better meet the client's objectives to have the life insurance and/or retirement accounts paid to a trust upon their death. From a tax standpoint, having a trust named as the beneficiary of life insurance is simple. The proceeds are generally not income taxable. There is a much different case with retirement accounts.

When a person leaves their spouse as beneficiary of their retirement account, the account essentially becomes the surviving spouse's retirement account and is treated the same for the surviving spouse as other retirement accounts that the surviving spouse already owns. When children are named as beneficiaries, the children have essentially four (4) options with regard to receiving the retirement account benefits. They can i) take all the benefits immediately and pay the income taxes on the entire amount of the account that tax year, ii) take all of the account within five (5) years, paying tax each year on the amount they take from the account, iii) take the account over the life expectancy of their parent, paying tax each year on the amount taken that year or iv) take the retirement account over the child's life expectancy, paying tax each year on the amount taken that year (which is referred to as stretching the payout).

When a trust is named as the beneficiary of a retirement account, it is important that the beneficiary of the trust be identifiable and considered a "designated beneficiary" for retirement account purposes. Otherwise, unless some exception can be worked out, the entire retirement account may have to be paid to the trust, creating an immediate tax liability for the entire account.

1. Accumulation Trust.

An accumulation trust exists when the trust provides that part or all of the current year's distributions from the retirement account will remain in the trust at the end of the year. This would result in the amount that remains in the trust being taxed at the higher compressed trust income tax rates.

2. Conduit Trust.

Conduit trusts or sub-trusts inside a revocable living trust provide that all distributions from the retirement account to the trust are to be distributed out to the beneficiary in the year received, so that all the income tax liability is passed on to the beneficiary to be paid at their lower income tax rate instead of the trust tax rate. Conduit trust provisions are also used to force children to spread the distribution of the retirement accounts over their lives, so as to defer the income tax liability as long as possible and to keep the children from spending all of the retirement account funds too soon.