

The Purpose, Perils and Pitfalls Of Revocable Trusts

**NYSBA Trusts and Estates Law Section
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I. Purpose

The Revocable Living Trust (RLT) has an important place in the estate plan. Although the use of the RLT in New York may not be as popular as in other states, there are still many instances when the RLT is the most appropriate and favorable planning device.

Right from the start, it is important to dispel the myths that are attached to the use of RLTs and to clearly define the ramifications of the creation of these trusts. Revocable living trusts can be very useful tools for certain clients, but just like any estate planning device, use of these trusts should be decided on an individual client basis.

A. Advantages:

↳ **Unification of Assets.** By establishing a RLT and a corresponding pour over will, a Grantor can maintain all of his or her assets under one entity. This provides centralized ownership of assets which may be more manageable for some people. This is useful in the context of a client who owns property located in various states (eg: a summer home located outside of New York State). By transferring ownership of the assets to the trust, the client's estate will probably also be saved of the aggravation of ancillary probate proceedings in different states after death.

↳ **Asset Management.** A RLT can be used as an asset management tool in the event of incapacity on the part of the Grantor. In many ways, this is similar to a durable power of attorney, or a guardianship. In the event the Grantor becomes incapacitated, the Trustee of *funded* RLT can continue to maintain the client's assets, pay the client's bills and generally manage the client's affairs without the necessity of a guardianship proceeding. While a durable power of attorney is still advisable, it may not be utilized as much when the client has a funded RLT and a successor or co-Trustee in place.

↳ **Flexibility.** A RLT does provide flexibility in estate planning by the very nature of it being revocable. The Grantor is always entitled to revise the ultimate disposition of the assets to the intended beneficiaries; or to revoke the trust completely.

↳ **Control.** A RLT will also provide control for the Grantor in the disposition of his or her assets. Many clients are unwilling to give up any element of control in their estate planning. A revocable living trust offers the largest level of control to the Grantor besides retaining the assets in the client's individual name.

↳ **Avoiding Probate.** It is true that a RLT will avoid the necessity of probate proceedings at the Grantor's death. This *may* avoid a lengthy, costly process in which heirs would have the opportunity to object and contest the will. However, probate is usually not the demon it is often described as. In some cases, however, there are compelling reasons to avoid probate.

- Possible will contest
- Multiple distributees, unknown distributees or difficult to locate distributees
- Disabled or Minor Beneficiaries
- Need for immediate fiduciary control
- Out of state real property
- Filing Fees 1
- Commissions 2
- Privacy 3

1 Consider the fact that the judicial settlement of a \$750,000 RLT results in a filing fee of \$210 and the judicial settlement of a same-sized probate estate or testamentary trust is \$1,250. SCPA §2402

2 Compare SCPA §2307 to §2309

3 A probated will becomes public record. A fully funded RLT does not. If the trust is not funded, however, and a pour-over will must be probated, the Surrogate will often require a copy of the trust as part of the probate petition. Thus, defeating the purpose of privacy.

B. Disadvantages: Now that some of the advantages of using RLTs are apparent, consider some of the disadvantages.

↳ **The RLT will not save taxes.** Contrary to what the client has heard over the neighbor's fence, a RLT will *not* save any estate taxes. Because the trust is revocable, the trust corpus will be included in the Grantor's estate for federal and New York State estate tax purposes.⁴

If the trust is structured properly, however, the fact that the trust assets may be included in the gross estate does not necessarily mean they will generate a tax. For instance, the trust may include provisions which take effect at death which would in fact save taxes. Such provisions would include those that take advantage of the marital deduction, charitable deduction and estate tax exemption amounts - similar to what may appear in the client's will.

There are also no substantive income tax advantages to using a RLT. The Grantor of a RLT is treated as the owner of the trust for income tax purposes, and must report all trust income on his or her personal return under the "grantor trust" income tax rules.⁵ The Grantor would report on his or her personal return all items of ordinary income, capital gain and loss recognized in the trust. A fiduciary income tax return is not required to be filed if the Grantor is also the Trustee of the Trust or is the Grantor is treated under IRC §676 as the owner of the trust assets for the entire taxable year. If the Grantor is not a Trustee, Form 1041 needs to be prepared, but in the form of an informational return.

⁴ IRC §2038; §2036(a).

⁵ IRC §671; et seq.

✎ **The RLT will not preserve assets from Medicaid...or any other creditor.** There is a misconception that if an individual transfers assets to a revocable trust, he or she is somehow protecting those assets from exposure to a creditor such as Medicaid in the event he or she enters a nursing home. This could not be further from the truth. First of all, since the trust is revocable, and the assets in the trust are readily available to the Grantor, the trust assets continue to be owned by, and therefore, are considered a “resource” of the Grantor in determining Medicaid eligibility. ⁶

The assets in the RLT are, however, shielded from Medicaid recovery. A change in regulations which would have made trust assets available for purposes of Medicaid lien recovery was repealed. On September 9, 2011, New York State expanded the definition of *estate* to mean the probate or intestate estate, as well as any property in which the decedent has any legal title or interest at the time of death, “including such assets conveyed to a survivor, heir, or assign of the decedent through joint tenancy, tenancy-in-common, survivorship, life estate, living trust or other arrangement, to the extent of the decedent’s interest in the property immediately prior to death.” ⁷ Those regulations expired, however, and were eventually repealed by the passage of the New York State Health Budget Bill for 2012–2013 on March 27, 2012. ⁸ Therefore, the current regulations only include the probate estate as available for lien recovery.

⁶ EPTL §10-10.6 and 96 ADM-8

⁷ 18 N.Y.C.R.R § 360-7.11; NYSDOH 11 ADM-8.

⁸ See also GIS 11 MA/028.

II. Perils & Pitfalls

The inadequacies with RLT's often arise in the funding and drafting. Although RLT's play a valuable role in probate avoidance and asset management, these goals are only met with proper funding and thoughtful drafting.

- **Funding Requirements.** EPTL §7-1.8 formalized funding practices for all lifetime trusts by providing that the trust is valid “as to any assets therein to the extent the assets have been transferred to the trust”.
 - Bank Accounts, Stock, Bonds & Brokerage Accounts: by registration of the asset in the name of the trust
 - Real Estate: by deed.
 - Notify Homeowners Insurance to add Trustee as an insured party
 - Contact bank or lending institution if there is a mortgage
 - Vehicle: Change title – NYS DMV online or in person (Form DTF-802)
 - Tangible Personal Property: By assignment or bill of sale.
 - Condo or Co-Op: Consult the condo or co-op association

- **Pour Over Will.** If the intent is to avoid probate and continuity of asset management upon death of the Grantor, the goal should be to fully fund the RLT. Nonetheless, a duly executed will which distributes the residue to the trust upon death is good practice. Often, a client has assets which are not disclosed or obtains assets after the trust is established. It is these assets which require the probate process necessary to “pour-over” into the trust.
 - The treatment of trusts is different in every state.⁹ Some states do not require the disclosure of a full copy of the trust when probating

⁹ For a useful survey of RLT's from state to state, See: ACTEC Survey on Revocable Trusts, February 2009, Prof. Ira Bloom

the pour-over will. Over 30 states allow for a trust certification to be filed instead. New York State is not one.

- **Lost Trusts.** New York State has a “lost will” statute.¹⁰ If an original will cannot be located at the Testator’s death, the law provides that a copy can be probated if it can be established that the will was not revoked, that the will was duly executed, and that the provisions of the will are “clearly and distinctly proved by two credible witnesses or by a copy or draft of the will proved to be true and complete”. There is no similar provision for a lost trust. When real property or other assets are titled to a trust and no trust agreement or copy can be found, this can create a legal dilemma. Jurisdictions outside of New York State have dealt with this issue by allowing extrinsic evidence to prove the trust terms.¹¹ New York does not have significant case law on point. As revocable trusts continue to be used as will substitutes, however, one must ponder whether the New York legislature will enact a statute similar to SCPA 1407 to prove lost or destroyed trust documents.
- **Joint Revocable Trusts.** Under a joint revocable trust, spouses create separate identifiable shares within the trust and fund those separate shares with their individual assets. Although this arrangement may seem simple, it contains all the traps joint registration can cause—for example, when the trust is examined upon the death of one spouse, what proof does the surviving spouse have of his or her contribution to any particular asset? Such proof might not matter in a community property state like California, but it will in New York. Furthermore, a joint revocable trust raises questions like the following related to basis, unintended gifting, title, commingling and disclaimer.

¹⁰ SCPA 1407

¹¹ See *In re Estate of Berger*, 174 S.W.3d 845 (Tex. App. 2005); *Estate of Richard Getman*, 15 Quinnipiac Prob. L.J.257 at 262 (2001).

- What happens if the couple with the Joint Revocable Trust divorces?
- What happens if one spouse needs care in a nursing home and an application is made for Medicaid?
- What happens if the estates are taxable?

There are many intricacies involved in the successful drafting of a joint revocable trust. Particular care must be taken to draft a trust that creates two separate shares for each spouse to ensure optimal tax treatment. Often, these intricacies are ignored and a joint trust is utilized for simplicity's sake not realizing the complications that can result.

➤ **Drafting for Incapacity.** Perhaps one of the more litigious areas of RLT planning is what happens when the Grantor becomes disabled and the appointment of a successor Trustee occurs.

- **How do we define “incapacity”?**

☞ By Committee?

How many?

Who are they?

Is there a mechanism for non-agreement?

☞ Family Physician?

In consultation with family?

Spouse?

Multiple physicians?

Declared Incompetent?

☞ Admission to a facility? 12

☞ By Attorney-in-fact? Guardian?

Removing a Grantor/Trustee is a delicate matter and one that should be contemplated at that drafting stage to avoid ambiguity and allow for a dignified removal mechanism that promotes family unity.

➤ **Interplay of Trustee, Attorney-in-Fact & Guardian.** A Trustee clearly has the capabilities of managing assets within the trust estate. 13 An agent under a Power of Attorney can have the authority to “create, amend, revoke or terminate an inter vivos trust”.14 A guardian can be granted the capability of amending or creating inter vivos trusts of the incapacitated person. 15 While all fiduciaries must act with the best interest of the principal in mind, these roles can complement each other or they can create conflict.

☞ Consider this conflict when drafting the trust.

- The right to amend, revoke, or withdraw from the RLT shall be personal to the Grantor and limited if the Grantor loses capacity.
- The RLT becomes irrevocable upon incapacity of the Grantor.
- Analyze the right result for the situation.

☞ Consider this conflict when drafting the Power of Attorney or Guardian’s powers.

12 Consider the unfortunate case of Dorothy M. Baker who was fully mentally capacitated but was a chronic care resident at a Utah nursing home. Under the terms of her RLT, she was deemed “incompetent” and was replaced as the Trustee. *Manning v. Glens Falls National Bank & Trust Co.*; 265 AD 2d 743 (3rd Dept 1999).

13 EPTL §11-1.1

14 GOL § 5-1514(3)(c)(8)

15 MHL §81.21(a)

↳ Avoid the Court's interpretation.

- *Perosi v. LiGreci*, 948 NYS 2d 629 (2nd Dept 2012) wherein the attorney-in-fact was permitted to amend an irrevocable trust.
- *Rice v. Novello*, 25 AD 3d 992 (3rd Dept. 2006) wherein the attorney-in-fact was not permitted to amend a revocable trust.