

ESTATE PLANNING

D E V E L O P M E N T S

for Texas Professionals

THE BENEFITS AND DISADVANTAGES OF LIVING TRUSTS

*Gerry W. Beyer
Governor Preston E. Smith Regents
Professor of Law
Texas Tech University School of Law
Lubbock, Texas*

An inter vivos trust is a trust created during the settlor's lifetime which becomes effective while the settlor is still alive as contrasted with a testamentary trust which takes effect upon the settlor's death. Because an inter vivos trust becomes effective during the lifetime of the settlor, it is commonly referred to as a "living trust." Living trusts are often pitched as the panacea that reduces expenses and avoids lawyers, taxes, and probate in advertisements by attorneys and other promoters of living trusts. Despite the tremendous potential benefits of living trusts, however, they are not for everyone. Living trusts must be used wisely after thoroughly evaluating the potential benefits and disadvantages. This article provides a discussion of the pros and cons of inter vivos trusts which a client must consider before deciding to create an inter vivos trust.

I. ADVANTAGES OF INTER VIVOS TRUSTS

A. Provide for and Protect Beneficiaries

The settlor's desire to provide for and protect someone is probably the most common reason for creating an inter vivos trust. Although a donor could make a quick, convenient, and uncomplicated outright gift, there are many situations in which such outright gifts would not effectuate the donor's true intent.

1. Minors

Minors lack legal capacity to manage property and usually have insufficient maturity to do so as well. A trust permits the settlor to make a gift for the benefit of a minor without giving the minor control over the property or triggering the necessity for the minor to have a court-appointed guardian to manage that property. A trust is also more flexible and allows a settlor to have greater control over how the property is used when contrasted with other methods such as a transfer to a guardian of the minor's estate or to a custodian under the Texas Uniform Transfers to Minors Act.

2. Individuals Who Lack Management Skills

An individual may lack the skill necessary to manage properly the trust property. This deficiency could be the result of mental or physical incompetence or a lack of experience in the rigors of making prudent investment decisions. For example, persons who suddenly obtain large amounts of money, such as performers, professional athletes, lottery winners, or personal injury plaintiffs, tend to deplete these windfalls rapidly because they have never learned how to manage their money wisely. By putting the money under the control of a trustee with investment experience, the settlor increases the likelihood that the beneficiary's interests are served for a longer period of time.

3. Spendthrifts

Some individuals may be competent to manage property but are prone to use it in an excessive or frivolous manner. By using a carefully drafted trust, a settlor can protect the trust property from the beneficiary's own excesses as well as most of the beneficiary's creditors.

4. Persons Susceptible to Influence

When a person suddenly acquires a significant amount of property, that person may be under pressure from family, friends, charities, investment advisors, and opportunistic scam artists who wish to share in the windfall. An inter vivos trust can make it virtually impossible for the beneficiary to transfer trust property to these people.

B. Protect Assets From Beneficiary's Creditors

The settlor may protect trust assets from the beneficiary's creditors by including a spendthrift provision. A spendthrift clause does two things. First, it prohibits the beneficiary from selling, giving away, or otherwise transferring the beneficiary's interest. Second, a spendthrift clause prevents the beneficiary's creditors

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from reaching the beneficiary's interest in the trust. TEX. PROP. CODE § 112.035(a). The provision permits the settlor to carry out the settlor's intent of benefiting the designated beneficiary but not the beneficiary's assignees or creditors.

An important exception exists to the enforceability of spendthrift provisions. Spendthrift protection is not available if the beneficiary is also the settlor of the trust. TEX. PROP. CODE § 112.035(d). It is against public policy for a person to shield the person's own property from creditors with a spendthrift restriction. Note, however, that over a dozen states will enforce spendthrift provisions under certain conditions even if the trust is self-settled.

C. Retain Flexibility

An outright gift, either inter vivos or testamentary, gives the donee total control over the way the property is used. With a trust, the settlor can restrict the beneficiary's control over the property in any manner the settlor desires as long as the restrictions are not illegal or in violation of public policy. This flexibility allows the settlor to determine how the trustee distributes trust benefits, such as by spreading the benefits over time, giving the trustee discretion to select who receives distributions and in what amounts, requiring the beneficiary to meet certain criteria to receive or continue receiving benefits, or limiting the purposes for which trust property may be used such as health care or education.

D. Change With Less Difficulty

Many formalities are required to execute a valid will as well as to amend an already existing will. Changing an existing will is a hassle and may require as much effort as making the will in the first place. On the other hand, the settlor may update and revise a revocable inter vivos trust with a minimum of effort thus avoiding extended procedures and technicalities. An amendment to a written trust need only be in writing and signed by the settlor. TEX. PROP. CODE § 112.051(c).

E. Avoid Probate

Property in an inter vivos trust is not part of the probate estate upon the settlor's death. The property remaining in the trust when the settlor dies is administered and distributed according to the terms of the trust; it does not pass under the settlor's will nor by intestate succession.

1. Accelerate Asset Distribution

The probate process creates a gap between the time a decedent dies and the time the heirs or beneficiaries physically receive the decedent's property. This delay may range from months, to years, and even to decades, especially if the decedent's will is contested. This delay is potentially damaging from three perspectives.

First, the heirs and beneficiaries are unable to use the property. During the delay period, the educational, medical, or other needs of the survivors may go unmet because they cannot reach the decedent's property.

Second, the decedent's property may not be able to withstand a gap in management. Some types of property require constant monitoring

to maintain value. Corporate securities need to be traded as the market dictates, crops need to be timely harvested and then processed or sold, and foreign investments must be evaluated in light of the constantly changing world political scene. If the decedent owned a business operation in which the decedent was actively involved, time may be of the essence in the transfer of control of the business after the death of the decedent. Any delay in the transfer of control may hinder or disrupt the business activity, as well as cause the loss of customers.

Third, the decedent's survivors may have to endure the emotional impact of a prolonged administration. The constant reminder of a loved one's death that results from a drawn out administration may prevent closure and keep the survivors from moving on with their lives.

2. Reduce Administration Expenses

Expenses incurred during estate administration include attorney's fees, personal representative fees, and court costs. The use of an inter vivos trust may be effective to reduce these expenses because less of the decedent's property would pass through the decedent's estate.

3. Increase Privacy

Most people like to keep their financial and family matters private. During life, it is relatively easy to keep these matters confidential, unless the person is a celebrity or politician. A person needs only to be careful with whom the person shares intimate details. However, an entirely different situation exists when the person dies. All estate proceedings are on the public record. Typical documents filed in an administration include an inventory of all of the decedent's assets and their appraised values (unless the affidavit in lieu of inventory procedure is used) and the names of the new owners, be they intestate heirs or will beneficiaries. Of course, the will itself is public record. A reporter, marketer, creditor, or merely curious person needs no excuse to view, copy, distribute, or publish the documents. Used properly, however, inter vivos trusts which do not involve real property can escape conspicuous notation on the public record or in other readily available sources. The settlor can thus keep private the extent of the settlor's assets and their disposition.

F. Avoid Ancillary Probate of Out-of-State Real Property

If a decedent owned out-of-state real property, the decedent's will is usually probated in the state of the decedent's residence with some type of ancillary administration being necessary in the state or country in which the real property is located. This potentially expensive, inconvenient, and time-consuming "double-probate" process may be avoided if the property passes by way of an inter vivos trust.

G. Protect Property From Creditors

While the settlor is alive, a creditor may not usually attach the property transferred to an irrevocable inter vivos trust if the settlor is not a beneficiary of the trust. TEX. PROP. CODE § 112.035(a), (d). If the settlor retains the power to revoke the inter vivos trust or is a beneficiary of the inter vivos trust, then there is no protection from

the claims of the settlor's creditors. *Id.* § 112.035(d). Note, however, that the creditor may attempt to set aside the settlor's initial conveyance of property to the trust by having the court deem it a fraudulent transfer.

Most property that passes through the settlor's probate estate is subject to the claims of the settlor's creditors. If the property does not pass through the probate estate, however, it may escape liability for the decedent's debts. The use of some non-probate transfers to avoid creditors upon the debtor's death is very controversial. Creditors generally accept that they cannot reach certain non-probate assets such as the proceeds of a life insurance policy which is payable to a named beneficiary. This makes sense because the creditors did not have the ability to reach the proceeds while the insured was alive. However, creditors are reluctant to agree that they cannot pursue other non-probate transfers to satisfy their claims, such as property passing via an inter vivos trust which the decedent could have revoked while alive. The creditors do not think that the death of a debtor should protect assets that were not protected during the debtor's life. Courts, legislatures, and legal writers are currently debating whether the debtor's death should be deemed a "transfer" of the asset under statutes prohibiting fraudulent conveyances if the asset was subject to the creditor during the decedent's life but passes upon death outside of the probate estate.

H. Isolate From Contest

Inter vivos trusts are often more resilient to contest than wills, although individuals dissatisfied with trusts may attack them on many of the same grounds which may be used to contest a will, such as the settlor's lack of mental capacity or that the transfer was the result of undue influence or fraud. The settlor may make arrangements for inter vivos trusts long before the settlor's death. Trust creation and subsequent trust activities may require the settlor to engage in ongoing transactions with people who can testify to the settlor's capacity, such as bank officials, insurance agents, business associates, and trust officers. Thus, individuals who wish to uphold an inter vivos trust have a greater likelihood of locating evidence to rebut a contestant's claims.

I. Avoids Need For Guardian

Once an individual is incompetent due to illness, injury, or other cause, the person cannot manage the person's own property. Unless an effective durable power of attorney exists, the court needs to appoint a guardian of the estate to manage the property. The process of judicially determining a person's incompetency may cause the person considerable private and public embarrassment and there is no guarantee the incompetent person will be happy with the guardian's decisions. Guardianships are also inconvenient and costly because guardians act under court supervision and are required to submit detailed reports on a regular basis.

An inter vivos trust can be used to avoid the need for a guardian. The settlor may create a trust and maintain considerable control over the trust property by, for example, serving as the trustee, retaining the power to revoke the trust, and keeping a beneficial life interest.

However, upon incompetency, the settlor's designated successor trustee would take over the administration of the trust property in accordance with the directions the settlor expressed in the trust instrument.

J. Provides Professional Management of Property

The settlor may create a trust to obtain the services of a professional asset manager, either for the benefit of third party beneficiaries or for the settlor as the beneficiary. Professional trustees, such as banks and trust companies, have more expertise and experience with various types of investments than most individuals. Assume that your client has just inherited a wheat farm located in Kansas, an office building in New York City, an apartment building in San Francisco, United States government savings bonds, corporate stock in a dozen domestic corporations, oil and gas property in Texas, and an import-export business in Italy. Would your client have the skill to handle all of these different types of assets? If not, placing the assets in trust would be one way of obtaining professional management. And, there is another advantage to making a trust conveyance. If the client negligently manages the client's own property and suffers financially as a result, there is not much the client can do about it; the client cannot successfully bring a law suit against him- or herself. However, if a trustee is negligent, the client can bring suit for breach of fiduciary duties and, if successful, have a strong chance of recovery because most financial institutions and trust companies have money or other assets which can be reached to satisfy a damage award.

Professional trustees also have greater investment opportunities. For example, a bank may combine funds from several trusts into one common trust fund to take advantage of opportunities that require a large investment and to diversify, thus reducing the damage to the value of the trust when one investment turns sour.

K. Minimize Taxes

Another popular reason for utilizing inter vivos trusts is tax avoidance. Income taxes can be saved by transferring income producing property to a trust which has a beneficiary who is in a lower tax bracket than the settlor. Additionally, gift taxes may be avoided by structuring the transfers to a trust to fall within the annual exclusion from the federal gift tax which, as of 2014, is \$14,000 per year per donee. Likewise, if a trust is properly constructed, the trust property will not be included in the settlor's taxable estate. The specific methods for minimizing taxes are beyond the scope of this article.

II. DISADVANTAGES OF INTER VIVOS TRUSTS

Despite the tremendous potential benefits of inter vivos trusts, a trust may not be the best tool to accomplish a client's intent. This section reviews the major concerns which a settlor should consider before electing to create an inter vivos trust.

A. Loss of Control Over Trust Assets

The settlor must make the trust irrevocable to obtain many of the benefits of inter vivos trusts such as tax reduction and creditor

protection. Some settlors are not willing to release control over their assets. For example, the settlor may wish to have the power to terminate the trust at any time or to make changes as the settlor's financial circumstances change and the needs and responsibilities of the beneficiaries evolve.

B. Trust Must be Funded

A trust does not exist unless there is trust property. TEX. PROP. CODE § 112.005. Thus, the settlor must be certain to transfer legal title to trust property to the trustee. Legal title to the trust property must reach the hands of the trustee. It is not enough for the settlor to sign a trust instrument, own assets that would make good trust property, and intend for that property to be in the trust. The settlor must consummate this intent by actually transferring the property. For example, the settlor should deed real property to the trustee and deliver personal property to the trustee. A formal transfer is needed even if the settlor and the trustee are the same person. A deed from the client as an individual owner and to the client as the trustee of the trust is needed. Personal property should be separated from all of the client's other property and then be marked in such a way that the trust property can be easily distinguished from the client's other property. A formal deed of gift is highly recommended.

C. Probate Required For Assets Not Transferred to Trust

To completely avoid probate, all assets the settlor owns must be transferred to the trust or be held in some other non-probate form (e.g., in a joint tenancy with survivorship rights). If the settlor fails to transfer every single one of the settlor's assets to the trust or make other non-probate arrangements for every non-trust asset, probate will still be required. Settlors often do not realize that every asset from the major (real property, securities, certificates of deposit) to the minor (e.g., photograph albums, clothes, and dishes) must be handled via a non-probate technique to totally avoid probate. Thus, although inter vivos trusts avoid probate of the property transferred to the trust, it is highly likely that probate will be necessary to handle the settlor's other property.

D. Costly to Create and Maintain Trusts

Inter vivos trusts have significant creation and maintenance costs. The settlor will typically incur legal fees to create the trust which can exceed \$2,500, especially if the estate is relatively complex. These fees may be much greater than those for a will which accomplishes the same goals. The settlor will also incur the cost of transferring property to the inter vivos trust. For example, if real property is involved, a deed needs to be prepared and properly filed. If the settlor is the trustee, the settlor may incur the expense of professional advisors to advise the trustee regarding the settlor's fiduciary obligations. If the trustee is a third party, then the trust may incur trustee fees for the trustee's fiduciary services. Some trust promoters have been accused of writing trusts as "loss leaders for getting control of assets and doing transactions that carry high commissions." Scott Burns, *Living Trusts Have Dark Side*, SAN ANTONIO EXPRESS-NEWS, Aug. 18, 1998, at 1F. In addition, the settlor may incur substantial expense to modify the trust when circumstances change (e.g., the birth of a new child, divorce, etc.).

The time-value of money must also be considered. "In real economic terms, the initial costs may be greater than any savings that ultimately are achieved. For example, if a person pays \$2,000 for a living trust at age 50 and dies at age 75, the real cost of the trust is what an investment of \$2,000 would have earned during the intervening 25 years. Assuming a modest five per cent rate of return, the initial \$2,000 would have grown to more than \$6,700. Thus, the person's beneficiaries would have to save \$6,700 in probate costs just to break even." Edwin G. Fee, Jr., *Living Trusts: Debunking the Myths*, PRAC. LAW., June 1997, at 27, 31.

E. Beneficiaries Have Right to Demand Accounting

The trustee must keep accurate trust records and render detailed accountings upon a beneficiary's written demand. TEX. PROP. CODE § 113.151. The time and cost associated with these accountings may be significant.

F. Trust Termination Expenses

When the trust ends, title to the trust assets must be conveyed from the trust to the ultimate beneficiaries. This extra set of transfers when compared to an outright disposition by will, adds to the expense of an inter vivos trust especially because legal assistance is usually needed to be certain the transfers are done correctly.

G. Trusts May Be Contested

A settlor's use of an inter vivos trust is not a guarantee that the trust arrangement is safe from contest by unhappy heirs. Although inter vivos trusts are often more resilient to contest than wills, individuals dissatisfied with trusts may attack them on many of the same grounds which may be used to contest a will, such as the settlor's lack of mental capacity or that the transfer was the result of undue influence or fraud.

H. Privacy Potentially Compromised

Although inter vivos trusts do not automatically become public record, there are numerous situations where the trust terms must be revealed. Many times a third party (e.g., a bank or brokerage firm) will require the trustee to produce the trust instrument to establish that the trustee has the legal authority to act for the trust. While the terms of the trust instrument are not disclosed to the public in general, the privacy sought by many settlors is weakened when a third party requires production of the trust instrument. (Note that the certification of trust procedure may help solve this problem. TEX. PROP. CODE § 114.086.) Further, if a dispute arises from the trust instrument, the trust instrument may be disclosed in a court proceeding, which again defeats the settlor's desire for privacy. If the trust contains real property, the trust may need to be recorded in the real property records. Consequently, the settlor must accept that there will be some disclosure, albeit not as much disclosure as incurred in probate, as well as a risk of full disclosure, when an inter vivos trust is created and managed.

I. More Difficult for Client to Understand

Most clients already understand how a will works before consulting an estate planner. In other words, clients know that a will is document which specifies who gets the client's property upon death.

Trusts, on the other hand, are not really understood by most people, even if they have a general idea that they operate to give benefits to selected individuals. The estate planner needs to spend time explaining how trusts operate such as the split of legal and equitable title, the imposition of fiduciary duties on the trustee, and the liability of the trustee for breaches of trust.

J. Tax Savings Problematic

1. Income Tax

Income tax savings is touted to be one of the more significant benefits of an inter vivos trust. However, an inter vivos trust generally does not provide any personal income tax savings. To obtain relief from personal income taxation, the settlor must not derive any benefit of the income or corpus of the trust. *See* I.R.C. §§ 671 et seq. If the settlor retains too much control, including the power to revoke, the settlor will be considered the owner of the trust and hence taxed on the income. Even if the settlor is not personally liable for income taxes, the inter vivos trust remains liable. I.R.C. §§ 641 et seq. In fact, the trust is generally subject to higher income taxes.

2. Gift and Estate Tax Liability

A revocable inter vivos trust does not avoid estate or gift taxes. No gift tax is incurred when the settlor transfers property to a revocable inter vivos trust because the gift is not complete – the settlor can reacquire the property at any time. Thus, none of the transfer can qualify for the annual exclusion. In addition, the settlor's estate will incur an estate tax liability based on the value of the assets held in the trust at the date of the settlor's death. I.R.C. § 2038.

On the other hand, an irrevocable trust may be structured to reduce transfer taxes. Generally, a transfer to an irrevocable trust is a taxable gift. Except for the value of any income interest, a transfer to a trust does not usually qualify for the annual exclusion because the donee/trust beneficiary does not receive a present interest. The donee does not have an unrestricted right to the immediate use, possession, or enjoyment of the property placed into the trust. However, there are two methods which a settlor may use to obtain the benefit of the annual exclusion with respect to transfers to irrevocable trusts – the *minor's trust* which meet the requirements of I.R.C. § 2503(c) and a *Crummey trust* which gives the beneficiary a present interest by giving the beneficiary a right to withdraw each year the lesser of (1) the annual exclusion, or (2) the value of the assets the settlor contributed during the year. *See Crumney v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

The assets in an irrevocable trust are usually not included in the settlor's gross estate and thus are not subject to estate tax when the settlor dies. However, care must be taken to make certain the settlor did not retain any rights in the trust which may cause the property to be included in the gross estate. For example, assume that the settlor created an irrevocable trust which gave the settlor all trust income during life with the remainder upon the settlor's death passing to various named beneficiaries. The entire trust corpus is included in the settlor's gross estate because the settlor retained a life interest in the trust income. I.R.C. § 2036.

K. Trustee Owes Fiduciary Duties to Trust Beneficiaries

A trustee owes numerous fiduciary duties to the beneficiaries of a trust, including the beneficiaries of an inter vivos trust. TEX. PROP. CODE §§ 113.051 et seq. As a fiduciary, the trustee may be personally liable for breaches of the fiduciary duties. TEX. PROP. CODE § 114.001. Therefore, a client who creates an inter vivos trust and appoints himself or herself as the trustee must understand that the client is now subject to a higher standard of care with respect to the trust property and must avoid self-dealing and conflicts of interest. The trustee will be personally liable to the beneficiaries for any breach of these duties. If the settlor appoints a family member or a friend as the trustee, this individual will also be subject to the fiduciary duties and potential personal liability. If the settlor desires, the trust may include an exculpatory clause which will operate to protect the trustee from liability for mere negligent breaches of duty. The trustee must exercise caution in relying on exculpatory clauses because courts construe them strictly and hold that it is against public policy to exculpate reckless, knowing, or intentional conduct.

L. Creditor Protection Problematic

Settlors often wish to use inter vivos trusts to protect their assets from creditors. This protection, however, may be hard to obtain. If the settlor can revoke the trust, no creditor protection exists. Even if the trust is irrevocable, a spendthrift clause in favor of the settlor will not protect the settlor's interest in the trust. TEX. PROP. CODE § 112.035(d). Further, a transfer by the settlor to an inter vivos trust may be set aside as a fraudulent conveyance. TEX. BUS. & COM. CODE §§ 24.001 to 24.013.

M. Homestead and Exempt Personal Property Protection Jeopardized

A limited number of claimants may pursue the homestead and exempt personal property upon the owner's death. TEX. ESTATES CODE §§ 102.004, 353.051-.056. These protections, however, may be lost if the homestead and exempt personal property are in an inter vivos trust rather than the decedent's probate estate. Note, however, that the homestead tax exemption may be preserved even if the homestead is held in trust under TEX. TAX CODE § 11.13(j) and the homestead may still be protected from certain creditors under TEX. PROP. CODE § 41.0021.

N. Title Insurance at Risk

The transfer of real property into a revocable inter vivos trust "may result in loss of owners' title insurance coverage. The trust may be treated as an entity, separate and distinct from the transferor." Clifton B. Kruse, Jr., *Critical Differences in Estate Planning Strategies Between Revocable Trusts and Wills*, 23 ACTEC NOTES 145, 148 (1997).

O. Probate May Be More Efficient and Economical

An inter vivos trust may not be the most efficient or economical method to transfer an estate. If the decedent provides for independent administration in the will or if the distributees agree to have an independent administration, the only court action needed is to probate and record the will and submit any required inventory, appraisal, and list of claims of the estate. TEX. ESTATES CODE § 401.001.

Independent administration allows the personal representative to work without court supervision unless an issue requires court involvement or an interested person, such as an heir, beneficiary, or creditor, complains about the way the representative is conducting the administration. If the estate is small, even simpler administration methods may be available.

III. CONCLUSION

Before an inter vivos trust is recommended to a client, the estate of the client, the status of the intended beneficiaries, and the goals of the

client must be considered. An inter vivos trust may be an extremely useful and effective part of the client's estate plan. However, inter vivos trusts are not appropriate in all cases. A careful review of the potential benefits and drawbacks must be made before deciding whether the client should include an inter vivos trust as part of the estate plan.

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