

U N D E R S T A N D I N G T R U S T S :

A L O O K A T L I V I N G T R U S T S
A N D O T H E R T R U S T S



**IRA AND
LEGACY**

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UNDERSTANDING TRUSTS

INTRODUCTION

In recent years the public has been bombarded with a barrage of advertisements, brochures, and articles about trusts of all kinds, especially so-called living trusts. Some of the information offered for public consumption is misleading and some of it is simply false.

This brochure is offered as a public service to give the average person an elementary understanding of the subject of trusts and to point out the dangers and pitfalls of false advertising. Many authors have written volumes on the subject without answering every question that could be raised. Therefore, of necessity, this brochure is a very modest attempt to answer some of the most basic questions about trusts and thereby give the reader enough information to ask more detailed and probing questions of professionals who promote and prepare trusts.

Consumers should be leery of marketers who offer truly incredible claims about what a trust can do, and they should be doubly leery when a hefty price is attached to the product the marketer is trying to sell. When in doubt, the age-old advice of getting a second opinion from someone who has no ax to grind and no profit to make from your business is more apt today than ever before.

BASIC TERMS

Trust: Generally, a legal device designed to provide financial assistance to someone without giving that person total control over the trust assets. A trust may be revocable or irrevocable, express or implied. This brochure will deal only with express, written documents that become irrevocable upon the death of the person who created the trust.

Testamentary Trust: A trust created within and as part of a person's will.

Living (Inter Vivos) Trust: A trust created and activated while the person who drafted it (settlor) is still living. It should not be confused with a living will, which is another legal device incorporating the drafter's wishes concerning the removal of life support systems under certain circumstances.

Settlor: The person who creates a living trust, frequently the one funding it. This person may also be referred to as a grantor or donor.

Testator: The person executing a will, with or without a testamentary trust.

Trustee: The person or institution entrusted with administering the trust. The term should be distinguished from an executor or administrator, who is responsible for settling a decedent's estate regardless of whether a trust is involved or not. The common characteristic that trustees, executors, and administrators share is that they are all fiduciaries, meaning that they have been entrusted with other people's property, and they are legally responsible to manage it properly.

Beneficiary: A person or institution for whose benefit the trust was created. A beneficiary is frequently a close relative of the settlor but need not be. Other typical beneficiaries include charities, friends of the settlor, and others whom the settlor wishes to benefit in some way.

Term: A trust may last for a short, fixed period of time or, if properly planned, for a longer period, even spanning generations. The most common type of trust is one designed to last during the life of the settlor's surviving spouse and beyond, usually until the settlor's children or other descendants reach a certain age of maturity. Charitable trusts often last indefinitely — for as long as there are assets to manage and distribute.

Spendthrift Trust: A trust designed to be immune from the claims of the beneficiaries' creditors, often including the state or federal government.

Medicaid: A federally-created program, which is administered by each state, that provides long-term nursing care and other benefits to those qualified to receive it. Medicaid is commonly referred to as "Title XIX."

Accounting: A report of the trustee's financial transactions, including a list of receipts, disbursements, sales, and purchases of assets and distributions to beneficiaries.

WHY TRUSTS MAY BE of VALUE

Trusts have generally been used to help people who fall into two basic categories: people who need financial assistance and people who are unable to manage their own money properly. Hence, trusts have been used to benefit children, those over the age of majority who are immature and otherwise unable to manage large sums of money, those with disabilities who aren't able to manage their own affairs, and those with substantial creditors.

In addition, trusts are commonly employed as devices to shield a person's assets from unnecessary taxation or court supervision. The trustee is normally directed to pay income to one or more beneficiaries and is given discretion to distribute principal, usually subject to certain stated standards. The payment of income may also be discretionary. The trust, therefore, allows the settlor (even after his or her death) to distribute assets to favored parties and to control those assets "from the grave" through the trustee whom he or she has appointed. For example, an individual who has children from a prior marriage might establish a trust for his or her spouse to ensure that the individual's children receive the trust property after the spouse's death. If properly created, a "spendthrift trust" (see definition above) may be crafted to shelter assets from the reach of the beneficiaries' creditors, including the government.

Tax Benefits

One of the greatest advantages of the trust is its ability to shelter certain assets from taxation at the time of the settlor's death. The Internal Revenue Service taxes both lifetime gifts and property passing after death, if certain exemptions are exceeded. The subject is a complicated one, but the reader should be aware of the fact that gifts or bequests between spouses are normally exempt. As long as both spouses are still living and competent, the proper utilization of a trust may shelter additional assets from taxation if the trust is drafted properly. It does not matter whether the trust is a testamentary or living trust. Contrary to the suggestions of some living trust marketers, the tax benefits are identical.

The use of an irrevocable life insurance trust or a charitable remainder trust may also offer potentially attractive tax benefits.

THE PROS and CONS of TESTAMENTARY and LIVING TRUSTS

Both testamentary and living trusts can play a viable role in professional estate planning. Each device should be analyzed on the basis of fact, not fiction. If scare tactics are employed in promoting one over the other, that is a fairly reliable clue that the entire truth is not being told, and the listener should beware. What follows is a summary of the most common benefits and detriments mentioned by objective practitioners in the field.

May a testamentary or living trust be modified or revoked?

A testamentary trust is always revocable and modifiable as long as the testator is living and competent. Naturally, it becomes irrevocable when the testator dies. A living trust, as the term is commonly used, is ordinarily revocable, although certain types of trusts established during the settlor's life may be irrevocable, usually for tax reasons. For example, a typical life insurance trust (and often a charitable remainder trust) is irrevocable upon formation.

Does the person creating the trust lose control of his assets?

Since a testamentary trust does not spring into use until the testator's death, the testator retains full control and use of his assets in his own name, without transferring them to the trust. In a revocable living trust, the settlor (who normally appoints himself as the first in a series of trustees) usually remains in control of his assets as long as he is alive and competent. He normally must transfer all of his assets to the trust and thereafter controls their use as his own self-appointed trustee. Therefore, all those holding his assets (banks, brokerage houses, etc.) must be notified of the transfers, and the correct forms must be completed to transfer the assets properly. Without completing these transfers, the living trust may be of virtually no value, since the trustee of a living trust cannot control assets that have not been properly transferred to the trust. It is somewhat cumbersome to transfer assets in and out of a living trust, and sometimes the result is that assets that were intended to be made part of the trust fall outside of the trust because they were not properly transferred to it.

How is real estate transferred to a living trust?

If real estate is part of a living trust, a proper deed must be drafted, executed, and placed on the public land records to properly transfer the real estate to the trust. If the settlor subsequently wants the real estate back in his or her name, another deed will have to be employed to reverse the process. The transfer may also necessitate notifying the mortgage holder and obtaining its approval. In addition, the homeowner's insurance company should be notified. An attorney should always be consulted before making real estate transfers, since important tax and other implications are involved. Property tax ramifications should also be carefully weighed and considered before making such a transfer, because the transfer may invalidate an existing tax exemption. With a testamentary trust, the settlor retains direct ownership of the real estate, so deeding it to the trust is not necessary.

What do attorneys charge for testamentary and living trusts?

There is no fixed rule about what attorneys may charge for either kind of trust. It is normally part of an overall estate plan. Traditionally, fees will depend on the complexity of the estate, the complexity of the legal document, and the amount of time expended.

Some attorneys charge substantially more to draft a living trust than a testamentary trust, even though the legal work may be very similar. It is always a good idea to obtain a fee quotation in advance for both kinds of trusts and to weigh the pros and cons of the work performed against the fees charged. When in doubt, get a second opinion.

What about the confidentiality of the trust?

A testamentary trust remains confidential until the settlor dies, and the will is submitted to the probate court. At that time, the entire will, including the trust, becomes a matter of public record, although few people bother to look at other people's wills. A living trust may remain confidential as to uninterested parties. Probate courts and the taxing authorities may, under certain circumstances, require a copy of the trust instrument. Interested parties may have a right to know the contents of the trust instrument, but the intervention of a Court may be required if the trustee fails to provide it. Contrary to the public statements of some promoters of living trusts, it is not proper to prevent a beneficiary with a legitimate interest in the trust from receiving a copy of at least the portion of the trust applicable to that beneficiary. In addition, a beneficiary has the right to petition the probate court for a copy of the instrument as part of his request for an accounting from the trustee.

Can a testamentary or living trust protect trust assets from creditors?

The promoters of living trusts often boast that the assets in a living trust can be insulated from the claims of the settlor's creditors. What they do not always say is that there are important exceptions. For example, the creditors of a settlor who has created a revocable, funded living trust (the most common of all) and named himself as trustee can and do reach the settlor's assets. That applies also to a settlor or his spouse who needs long term care (whether at home or in a nursing home) and submits an application for Title XIX Medicaid assistance. Under current federal and state law, the revocable trust assets will be deemed available to the settlor or his spouse and could result in denial of Title XIX benefits. On the other hand, properly drafted testamentary spendthrift trusts can shield trust assets from the creditors of beneficiaries. For example, the beneficiary of a properly drafted spendthrift testamentary trust would be eligible for Title XIX assistance, since the assets within such a trust would not be deemed available to the beneficiary. This area of the law is extremely technical and fraught with potential pitfalls. An attorney with expertise in Title XIX law should always be consulted beforehand.

What about legal and other fees in administering a trust?

The legal and other professional fees in administering (as opposed to creating) either kind of trust may vary, but it is becoming more common in the legal community for attorneys to charge their clients on the basis of time and effort expended and not on the size of the estate. Ordinarily, accountants do the same. In that regard, there should be little difference between the legal or accounting fees incurred in handling one trust over another. The work is virtually identical:

- (1) a list of the assets of the trust must be compiled, together with date of death values (and alternate valuation dates with larger estates);

(2) creditors' claims must be reviewed;

(3) appropriate tax returns must be filed with virtually identical tax results;

(4) information should be provided to interested beneficiaries as reasonably requested, and finally,

(5) some kind of an overall account should be provided to the beneficiaries. Any suggestion that the administration of a living trust does not entail this work, especially in larger estates, is irresponsible and misleading. The trustee of a living trust who did not perform this elementary work would violate his fiduciary duty to the beneficiaries.

Some states have statutory schedules for the payment of testamentary trustees, executors, and administrators. In fact, some Connecticut promoters of living trusts use those fees as examples of the kinds of fees charged in Connecticut probate courts. Connecticut has no such law, and all fees are subject to probate review for reasonableness. Any party may challenge the fees charged by a trustee or any other fiduciary, and the fiduciary, under Connecticut law, has the burden of proving their reasonableness. If the Court considers the fees unjustifiable and excessive, the Court can and will reduce them.

The fees charged by the trustee of a living trust are not screened by anyone but the parties themselves. Even if they are excessive, the parties may not be aware of that fact and may be reluctant to question or object to them. If a disgruntled beneficiary gets up the courage to challenge the fees officially, he could invoke the jurisdiction of the probate court (at least in Connecticut) or bring a more costly action in the superior court.

What delays are involved in trust administration?

Promoters of living trusts frequently cite undocumented delays in the probate process as reasons for using a living trust. Delays in administering testamentary or living trusts are virtually always related to the actions of the trustee, not the document itself. Common causes of delays include time needed for federal or state tax audits, litigation involving the estate or trust, or simply the reluctance or inability of the trustee to perform the necessary duties in a timely fashion. It is almost never the probate court itself that causes a delay in the administration or distribution of trust assets. On the contrary, it is often the prodding of the probate court that prompts the trustee to complete his duties more expeditiously. With a living trust, there is no apparatus to "move the trustee along," except for the informal prodding of other family members. The problem is often compounded when the trustee and the beneficiaries do not enjoy a close personal relationship or worse, fight like cats and dogs.

What is the truth about "avoiding probate"?

Perhaps the most advertised "benefit" of the living trust is that it "avoids probate." What that often-misunderstood phrase means is that it avoids the supervision of the probate court. Avoiding probate does not avoid estate or inheritance taxes. Those taxes apply equally to assets held in a living trust or a testamentary trust, and the opportunity of minimizing those taxes applies equally to both kinds of trusts. Unbeknown to most

lay people, a living trust does not avoid the statutory fees charged by the probate court. These fees, which are established by the state legislature, are a matter of public record, and they may be found in the Probate Court brochure entitled *The Probate Court and You*. For example, a \$250,000 estate passing to a non-spouse would result in a \$990 probate fee, while the fee to a surviving spouse would be \$552.50, since there is a special exemption for spouses. Many experienced probate practitioners do not find these fees excessive, and most lay people, when they discover what they are, find them reasonable as well.

Living trust marketers usually fail to advise their clients that these probate fees are charged on the basis of the gross taxable estate as shown on the state estate tax return (or sometimes the federal estate tax return), which must be filed in the probate court even if all the decedent's property is passing through a living trust. Therefore, the same fees will generally be charged whether or not a living trust is used.

What are the advantages of probate court supervision?

If the beneficiary of a testamentary trust is not sure what the trustee is doing, and the trustee will not respond to legitimate requests for information, the beneficiary may ask the Court to hold an informal conference, and one will generally be held within 30 days. These informal conferences frequently resolve problems before they are formally litigated, thereby saving the parties a great deal of time and money. This is just one reason why many people consider the supervision of the probate court to be a positive, not a negative, feature. The role of the Court is not to interfere in the management of the estate, but to expedite it. Here are two other examples:

(1) When executors, administrators, or trustees are not acting properly or promptly, the Court can and will spur them on to complete their duties.

(2) Probate proceedings can be very simple and informal. Approximately 50% of Connecticut estates are administered by family members without the assistance of an attorney. These family members often forego the payment of a fiduciary's fee or charge less than a professional.

Finally, experience has shown that some fiduciaries act dishonestly. While the vast majority of trustees perform their duties with integrity, one cannot ignore those incidents in which funds have been misappropriated, sometimes for years, without anyone being aware of it. The supervision of the probate court can be an excellent deterrent to such problems, and, in the event that a problem arises, it can be an effective and inexpensive mechanism to effect a remedy.

What can happen when the settlor of a living trust becomes incapable?

A currently-funded living trust provides a seamless mechanism for meeting the needs of a settlor who becomes incapacitated after creating the trust. What typically happens is this: the settlor, in the living trust instrument, provides that if he or she becomes incapacitated, a new trustee (named by the settlor) will take over management of the trust assets and provide for the settlor's care for the remainder of his or her life. Then, upon the settlor's death, the trustee would continue to manage the trust assets for the benefit of the settlor's beneficiaries. Advocates of this arrangement argue that this procedure avoids the appointment of a conservator for the incapacitated individual by the probate court, and they are right. It does. But whether or not that is a good thing is something for the settlor to consider carefully.

First of all, the trust normally provides that someone other than the settlor will determine whether the settlor has become incapacitated. If that determination is made, the settlor will be stripped of all rights over his own property without any impartial Court determination whatsoever. It is possible that a family member who would personally benefit from administering the trust could wrest control of the trust from an ailing but competent settlor.

Secondly, the trustee will be managing the trust assets for the incapacitated settlor without anyone checking to see whether he is treating the settlor fairly or not. Since a power of attorney for health care decisions is normally given to the trustee at the same time the trust is executed, the new trustee could sell the settlor's home, admit the settlor to a convalescent home of his own choice, and do a host of other things without any Court oversight at all.

Conversely, if the living trust did not provide this kind of power, the trustee or other family member would probably need to seek the appointment of a conservator through the probate court. Once an application is filed, certain important due process rights are guaranteed to the alleged incapable person:

- (1) a copy of the application is given to the person so that he or she knows exactly what is being alleged and can challenge those allegations if he or she disagrees with them;
- (2) an attorney must be appointed for the person if he or she cannot request one, so that his or her legal interests are adequately protected;
- (3) a hearing is held before the judge in an informal atmosphere, which may occur within the person's own home or hospital room if he or she cannot attend the hearing in court;
- (4) the person is invited to participate fully in the process, and his or her wishes are carefully considered by the Court, including the identity of the person who might become the conservator;
- (5) the conservator's actions can be controlled by the Court, so that an inappropriate admission to a nursing home or the premature sale of the person's home can be avoided;
- (6) the conservator must account to the Court for the actions taken, so as to avoid self-dealing, improper use of assets, and the taking of excessive fees;
- (7) if any interested party is dissatisfied with the actions taken by the probate court, an appeal can be made to a higher court.

None of these fundamental rights are automatically afforded to a settlor in a living trust. The legal remedies available to such a settlor are cumbersome and very costly. Whether or not incapacity provisions should be included in a living trust is a very personal matter and should never be glossed over by the person preparing the instrument. As you can see, the settlor's most basic rights are at stake.

Can a dissatisfied family member attack a trust?

Some argue that it is easier for dissatisfied heirs to attack a person's will rather than a living trust. The fact is that either device may be challenged in court by a person with

proper standing. Any competent attorney will take the necessary precautions to buttress the relevant instrument against attack, whether it be a will or a living trust. That is why great care should be exercised in selecting the proper attorney to advise about the appropriateness of each device.

If I have a living trust, do I still need a will?

Most lawyers will recommend to their clients who choose to have a living trust that they also execute what is called a “pour-over” will, simply because a living trust is ineffective as to any asset not transferred to the trust. For example, if the settlor neglects to transfer his house to the trust, that asset must pass through the probate process. If the settlor didn’t execute a will leaving his assets to the trust or some other person, those assets may pass by law to persons the settlor never wanted to inherit from him. Hence, it is always a good idea to execute a will in addition to a living trust.

Do I need a living trust or not?

As the reader can readily see, there is no automatic answer to the question, “Should I have a living trust?” Living trusts, wills (with or without testamentary trusts), the utilization of jointly held assets, and other devices are all potentially useful and desirable estate planning tools to consider with proper legal advice. Embarking upon a sophisticated estate plan without proper professional guidance is like walking through a minefield without a map. The results can be catastrophic. Similarly, small estates with typical family beneficiaries do not usually warrant the cost or complexity of a living trust. For example, in general, a married couple with combined assets (including potential life insurance proceeds) below the federal estate tax exemption will not need a trust to save taxes. Also, those with modest estates consisting of a jointly held home and cash or securities under a few hundred thousand dollars may find little benefit in using a living trust. A cost/benefit analysis should be undertaken to determine if the added costs warrant such a device. Therefore, great care should be exercised in locating a competent estate attorney to discuss the pros and cons of a living trust and any other estate planning device. If assistance is needed, contact your local or state bar association or obtain a referral from some other knowledgeable authority.

YOUR RIGHTS as the BENEFICIARY of a TESTAMENTARY or LIVING TRUST

The right to information and an accounting

The trustee of either a testamentary or living trust should communicate periodically and regularly with the trust beneficiaries as the trust or circumstances dictate. Beneficiaries should normally be kept abreast of major decisions affecting the trust: for example, the sale or exchange of a major asset of the trust, a major expense, the fees of the trustee and any other professional hired by the trustee, amounts distributed to beneficiaries, and other matters of direct concern. If the trustee does not so communicate, or if any beneficiary believes he or she is being kept “in the dark” by the trustee, the beneficiary has the right to petition the appropriate probate court for relief.

Section 45a-175(c) of the Connecticut General Statutes permits the probate court to order an accounting from the trustee of a living trust, if the Court finds:

- (1) the beneficiary has a sufficient interest in the trust,
- (2) cause has been shown that an accounting is necessary, and
- (3) the request for an accounting is not for the purpose of harassment.

The location and identity of the specific probate court is determined by Section 45a-175(c)(2), which allows the matter to be brought to that probate court:

- (1) which is the residence of the trustee, or if a corporate trustee, in which it has an office, or
- (2) in which the trust assets are maintained, or
- (3) in which the settlor presently resides or resided immediately prior to his death.

The beneficiary of a testamentary trust may ask the Court for an accounting at any time upon a proper showing of cause. In addition, the trustee of such a trust must render a written accounting to the Court at least every three years, unless the filing is excused by the will itself and the Court.

The right to a copy of the trust instrument

Any person may obtain copies of any non-confidential file in the probate court upon the payment of a reasonable copy charge. Testamentary trusts and wills so filed are not considered confidential and are therefore available for copying.

If the beneficiary or other interested party of a living trust requested the trustee to supply a copy of the trust but was refused, that person may apply to either the probate court or the appropriate superior court for an order compelling that disclosure as part of an action for an accounting. It is within the discretion of either Court to grant the request or not. Normally, the Court would be inclined to do so if the party could prove sufficient economic interest in the trust, which might be jeopardized without direct knowledge of the terms of the trust.

The right to compel the distribution of income or principal from the trust

Whether the beneficiary of either a living or testamentary trust has the right to compel the trustee to make a distribution of principal and/or income to him or any other beneficiary depends on the circumstances of each case. The answer depends on a number of factors, most importantly the provisions of the trust itself and, secondly, the finding by the Court that the failure to make such a distribution would be a violation of the trustee's fiduciary responsibility. For example, it is common for family trusts to provide for the mandatory payment of income only to a surviving spouse and such amounts of principal as the trustee determines are appropriate and reasonable. A surviving spouse who did not receive the mandatory payments of income would have a right to seek a court order compelling those income payments. However, whether or not the trustee's refusal to pay principal to the spouse amounted to a violation of fiduciary duty would be for the Court to determine after hearing all of the relevant facts of the case. It is always a good idea to consult with a knowledgeable attorney before attempting to file an application with the court to compel such a payment.

CONCLUSION

As the reader can see, it is not easy to decide whether or not to have a testamentary or living trust. The final decision depends upon the needs of the settlor and those of the family or others the settlor wants to benefit. The use of “one size fits all” trusts is almost always a bad idea — not because they cost so little, but because they can do so much damage to the unsuspecting consumer. Tax considerations, potential Title XIX issues, and a host of other critical factors must be carefully weighed in making the final decision. Both testamentary and living trusts can play a legitimate role in proper estate planning. Ask your attorney what makes the most sense for you.