

LEGALLY SPEAKING



THE REVOCABLE LIVING TRUST

In recent years, the revocable living trust has become a widely-published estate planning tool to avoid or reduce estate taxes and to eliminate probate costs. Much of this publicity is provided through advertisements and free seminars offered by organization which sell trusts and/or investment services. The revocable living trust has actually been a significant estate-planning tool used by the legal profession for over 25 years; and it still remains the foundation upon which most estate plans are based. However, as with any legal document, people need to understand how a revocable living trust works, the advantages and disadvantages of the arrangement and, most importantly, whether the advantages are applicable to the individual's particular circumstances.

A trust is an agreement between individuals who establish the trust, called the trustors, settlors or grantors, and the individual(s) or company who will manage the

trust's assets, called the trustee. The individuals or organizations who receive the benefit from the assets in the trust are called the beneficiaries. A trust is called a living trust if it is a trust established between the trustor and trustee while the trustor is still alive, as opposed to a testamentary trust which is established pursuant to a person's Last Will and Testament and becomes effective upon the person's death.

A living trust can either be revocable or irrevocable. If it is a revocable trust, the trustor can change the terms of the trust and/or revoke the trust completely at any time during his/her lifetime and competency. However, if the trust agreement provides that the trust is irrevocable, the trustor is not legally entitled to amend or revoke the trust. While irrevocable trusts are utilized in estate planning to some extent, the vast majority of trusts are revocable living trusts.

Although some organizations which promote the use of trusts cite a number of advantages for establishing revocable living trusts, the three primary reasons for establishing trusts of this type are: (1) saving estate taxes; (2) delaying the distribution of the estate assets to family members, and (3) avoiding probate of the trustor's estate.

ESTATE TAX SAVINGS

Effective as of January 1, 2009, as provided under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the first \$3,500,000 of a decedent's taxable estate (commonly called the "estate tax exemption amount" or

the "bypass amount") passes estate tax-free as a result of the Unified Gift and Estate Tax Credit. EGTRRA further provides that the estate tax is fully repealed in 2010; however, it also requires that Congress revisit this issue at some point in the future, and if Congress does not do so, the provisions of the Taxpayer Relief Act of 1997 (with a maximum bypass amount of \$1,000,000) will be reinstated in 2011.

As you may know, the Internal Revenue Code currently provides an "unlimited marital deduction" which allows an unlimited amount of assets to be transferred from one spouse to the other spouse without any federal estate taxes. Therefore, in the case of a married couple, if the entire estate of the first spouse to die passes outright to the surviving spouse, no estate taxes would be due by the deceased spouse's estate. However, upon the death of the surviving spouse, all of the couple's assets would then be included in the surviving spouse's estate, and only the bypass amount which is then available to the surviving spouse would qualify as an exemption against the estate tax liability in his/her estate. As a result, every dollar of the couple's estate over the bypass amount (including, generally, their life insurance proceeds, as well as retirement assets) will be taxed at 45%. What has happened in this situation is that only the surviving spouse has utilized his or her estate tax exemption, and the first spouse to die failed to receive any benefit from his or her own bypass amount.

One of the primary functions of a revocable living trust is to permit the estate of the first spouse to die to utilize his or her federal estate tax exemption so that, upon both spouses' deaths, assets of up to current bypass amount in both of their estates may pass estate tax-free to the couple's beneficiaries.

There are two primary types of revocable living trusts which generally accomplish this result, namely: an "A/B" trust and a "QTIP" Trust. The primary differences in these trusts are discussed below.

THE REVOCABLE "A/B" TRUST

Upon the first spouse's death, the assets in the trust divide (as the attached "A/B" trust diagram indicates) into two separate trusts, namely: the "Survivor's Trust" and the "Bypass Trust". In the division of the trust assets into these two separate trusts, the Trustee will allocate so much or all of the deceased spouse's estate to the Bypass Trust as is required to fully utilize the estate tax exemption which is available to the estate (i.e., the "bypass amount which is available in the year of that spouse's death), and the balance of the deceased spouse's estate is allocated to the Survivor's Trust (together with all of the surviving spouse's interest in the trust's assets).

The estate receives a marital deduction for the assets of the deceased spouse which are allocated the Survivor's Trust. The assets allocated to the Bypass Trust are included in

the deceased spouse's taxable estate; however, since the amount of assets allocated to the Bypass Trust does not exceed the estate tax exemption amount (the bypass amount), the deceased spouse's estate does not have any estate tax liability.

The surviving spouse has the right to receive all of the income from the Survivor's Trust during his or her lifetime, and he or she may withdraw such amounts of the principal of the Survivor's Trust at any time as he or she wishes.

The Bypass Trust generally provides that the surviving spouse will receive all of the net income from the Bypass Trust's assets, plus so much of the principal thereof as the Trustee deems necessary or advisable for his/her proper health, maintenance and support.

Because the Bypass Trust becomes irrevocable upon the first spouse's death and the surviving spouse's rights to the assets in the Bypass Trust are limited to the rights granted to the surviving spouse by the trust agreement, the assets of the Bypass Trust (regardless of their value in the future) are not included in the taxable estate of the surviving spouse upon the surviving spouse's death, but rather these assets are held, along with any assets remaining in the Survivor's Trust, for the benefit of the couple's children (and/or other beneficiaries). Therefore, under this structure, both spouses may fully utilize the estate tax exemptions which are available to their respective estates, provided that each of them has a taxable estate that is at least

equal to the bypass amount which their respective estates are entitled to utilize.

THE REVOCABLE "QTIP" TRUST

A "QTIP" (Qualified Terminable Interest Property) Trust is generally recommended (i) when one spouse is significantly wealthier than the other, (ii) when a couple's current combined assets exceed \$6,000,000 in value, and/or (iii) in the case of a second marriage, especially if there are children from that prior marriage, and/or (iv) if a spouse wishes to prevent his/her assets from passing outright to the surviving spouse in order to "protect" the assets in the event of the surviving spouse's remarriage.

Upon the first spouse's death, the assets in the trust divide (as the attached "QTIP" Trust diagram indicates) into three separate trusts, namely: the "Survivor's Trust", the "Bypass Trust" and the "QTIP Trust". In the division of the trust assets into these three separate trusts, the Trustee will allocate so much or all of the assets of the first spouse to die to the Bypass Trust as is required to fully utilize the estate tax exemption which is available to the estate (the bypass amount which is applicable in the year of that spouse's death). The balance of the assets of the deceased spouse's estate are allocated to the QTIP Trust, and all of the surviving spouse's interest in the assets held in the trust is allocated to the Survivor's Trust. The assets allocated to

the Survivor's Trust are the surviving spouse's assets and, therefore, are not included in the deceased spouse's estate. The assets allocated to both the Bypass Trust and the QTIP Trust are included in the deceased spouse's taxable estate; however, since (i) the amount of assets allocated to the Bypass Trust does not exceed the estate tax exemption amount, and (ii) the assets allocated to the QTIP Trust qualify for the marital deduction and will not be subject to estate tax until the surviving spouse's death, the deceased spouse's estate does not have any estate tax liability.

The provisions of the Survivor's Trust and Bypass Trust established for the benefit of the surviving spouse in a QTIP Trust are the same as those discussed previously for the A/B Trust.

The assets of the QTIP Trust are held for the benefit of the surviving spouse for so long as he/she lives. Generally the QTIP Trust provides that the surviving spouse will receive all of the net income from the QTIP Trust, plus so much of the principal thereof as the Trustee deems necessary or advisable for his/her proper health, maintenance and support.

Upon the surviving spouse's death, the assets which remain in the QTIP Trust are included in the surviving spouse's taxable estate, although any estate tax which is attributable to these assets will be paid from the QTIP Trust's assets.

The net assets which remain in the QTIP Trust after the payment of estate taxes in the surviving spouse's estate are combined with the assets then remaining in the Bypass Trust (as well as the assets remaining in the Survivor's Trust, if the surviving spouse has not otherwise changed the dispositive provisions relating to those assets), and held for the benefit of the couple's children (and/or other beneficiaries).

DELAYED DISTRIBUTION

Without some type of trust provision, each adult heir will receive his/her entire inheritance outright, and each younger heir will receive his/her entire inheritance upon reaching the age of majority. Many people believe that the receipt of a substantial inheritance will have a significant adverse impact on younger beneficiaries if these younger beneficiaries receive the inheritance outright; and therefore, most couples desire to delay the distribution of the principal of their estates until their children reach certain "older" ages. The provisions of a revocable living trust permit a trustor to specify when, to what extent and under what conditions, the trust assets are distributed to or used for the benefit of their children and other beneficiaries. A delayed distribution scheme avoids the potential wasting of family assets by immature beneficiaries, while still providing for the beneficiaries' health, education, maintenance and support. Further, assets retained in a trust are generally safeguarded from the beneficiaries' creditors.

AVOIDANCE OF PROBATE

The reason most often alluded to for establishing a revocable living trust is often the least important. With just a Will, the assets of a decedent's estate will have to detour through probate court before those assets are distributed to the decedent's beneficiaries. In very general terms, a probate is designed to ensure that a decedent's debts are paid, and that the decedent's assets pass to his or her beneficiaries in accordance with the decedent's Will (or if the decedent did not leave a Will, then in accordance with Arizona's intestate laws). Although probate in Arizona can, in most cases, be finalized quicker and with less formalities and, therefore, less expense, than in many other states, it generally requires the services of an attorney and takes a number of months to complete. However, if a person is diligent in transferring the title to all of his or her assets to a revocable living trust prior to death, there would not be any assets titled in that person's name at his/her death and, as a result, there would not be any assets of the decedent required to go through a probate proceeding.

Please note that in order to avoid a probate proceeding, the trustor must transfer the title to all of his/her assets to the living revocable trust during the trustor's lifetime, and ensure that all life insurance proceeds and retirement plan assets which pass according to beneficiary designations upon his/her death are not payable to his/her "estate". This transfer process

generally requires the actual recording of new deeds for real estate, changing of the name on bank and stock brokerage accounts, partnership interests, etc., and reviewing/changing beneficiary designations on insurance and retirement assets. Following the transfer of assets, the trustee (which is normally the same individual as the trustor) transacts business involving the trust's assets in the name of the revocable living trust. However, the revocable living trust does not have to obtain a separate federal identification number (unless the trustee is not the same person as the trustor), nor does it need to file separate income tax returns, as all of the income of the trust is simply reported by the trustor under the trustor's social security number.

While probate proceedings can be avoided in this manner, it is important for individuals with substantial estates to understand that even if a trust is fully funded with all of the decedent's assets, there will still be professional fees incurred for the preparation of the estate tax returns, the administration of the trust, and the allocation of the trust's assets to the subtrusts which are established following the trustor's death.

ADDITIONAL CONSIDERATIONS

In addition to the primary benefits of a revocable living trust discussed above, there are other features of this type of trust which may be beneficial to trustors. For instance, in the event a trustor becomes physically or mentally incapacitated, the revocable living trust may eliminate the need for a conservatorship proceeding, and thereby permit the uninterrupted management of the trustor's assets by the named successor trustee(s) without any court interference. Further, when a Will is probated, the contents and distribution scheme of the Will, as well as a list of the decedent's assets, may become a matter of public record. In contrast, the provisions of a revocable living trust and a disclosure of its assets are not filed with the probate court (regardless of whether or not there is a probate). And finally, since the revocable living trust is simply an agreement between the trustors and the trustees, which are often the same individuals, it is very easy to make modifications or changes, or revoke the agreement entirely, without the formalities required by statutes for other testamentary documents.

CONTACT US FOR ADDITIONAL INFORMATION

The foregoing discussion gives you a brief overview of what a revocable living trust is, the advantages it offers, and how it works. This trust can be tailored to meet various special needs within the family, and it allows trustors the ability to specifically direct how, when and under what circumstances their property will be distributed. It is a valuable estate planning tool for both married couples with taxable estates, and for others who wish to take advantage of the specific benefits such a trust has to offer.

Santerre & Vande Krol, Ltd. devotes a substantial part of its legal practice to estate planning, and if you have questions concerning the revocable living trust or its application to your specific situation, please contact us to discuss your questions.

To contact Santerre & Vande Krol, Ltd. by phone, please call (480) 991-3990.

The offices of Santerre & Vande Krol, Ltd. are located at:

**7920 E. Thompson Peak
Parkway Suite 150
Scottsdale, Arizona 85255**

FAMILY "A/B" TRUST DIAGRAM

Family Trust

During Trustors' joint lifetimes, Trustee will pay to Trustors or apply for their benefit so much or all of the net income and/or principal of the Trust's assets as Trustors' request/require.

Upon 1st Spouse's Death:

- Decedent's personal effects are distributed pursuant to his/her Will and/or Tangible Property List.
- Balance of the assets are allocated to two new subtrusts:

Survivor's Trust

The Survivor's Estate, plus the balance of the Decedent's Estate after funding the Bypass Trust

Bypass Trust

The Decedent's Estate up to the maximum available Estate Tax Exemption (currently \$3,500,000)

- So much or all of income and principal to Survivor, as needed.
- Survivor may withdraw assets at any time.
- Upon Survivor's death, balance of assets are distributed as directed by power of appointment granted to Survivor; or if Survivor fails to exercise the power of appointment, then held for benefit of and/or distributed to Residuary Beneficiaries.
- All (or discretionary) income to Survivor during lifetime.
- Discretionary principal to Survivor for health, comfort and support, as needed.
- Upon Survivor's death, balance of assets are held for benefit of and/or distributed to Residuary Beneficiaries.

Upon 2nd Spouse's Death:

Assets Held For Residuary Beneficiaries

- Personal effects are distributed pursuant to the Survivor's Will and/or Tangible Property List.
- So much of the income and/or principal of the remaining assets is distributed as the Trustee deems necessary to provide for the health, education and support of the children until youngest child reaches ____ years of age.
- When youngest child reaches ____ years of age, the remaining assets are divided into equal shares for (i) living children and (ii) deceased children with surviving descendants. Each share created for a living child and a living grandchild is held in a Beneficiary's Trust.

Beneficiary's Trust

The assets of each share created for a living Child of Trustors;
or if a Child of Trustors is deceased, the share created for each child of a deceased Child of Trustors

- All distributions from Retirement Asset Accounts are paid to the Beneficiary or applied for his/her benefit.
- If distributions from Retirement Asset Accounts are not sufficient to provide for the health, happiness and prosperity of the Beneficiary, additional discretionary income and principal may be paid to the Beneficiary or applied for his/her benefit.
- Upon the Beneficiary's death, any assets remaining in his/her Beneficiary's Trust will pass according to power of appointment granted to the Beneficiary; and to the extent the Beneficiary fails to exercise the power of appointment, the remaining assets are distributed to his/her descendants, per stirpes.

Decedent's Estate - Decedent's 1/2 share of community property, plus all of Decedent's sole and separate property, other than assets passing directly to Survivor.

Survivor's Estate - Survivor's 1/2 share of community property, plus all of Survivor's sole and separate property.

FAMILY "QTIP" TRUST DIAGRAM

Family Trust

During Trustors' joint lifetimes, Trustee will pay to Trustors or apply for their benefit so much or all of the net income and/or principal of the Trust's assets as Trustors' request/require.

Upon 1st Spouse's Death:

- Decedent's personal effects are distributed pursuant to his/her Will and/or Tangible Property List.
- Balance of the assets are allocated to three new subtrusts:

Survivor's Trust

The Survivor's Estate, personal effects passing to the Survivor pursuant to the Decedent's Will, and any other assets specifically bequeathed to the Survivor by the Decedent

QTIP Trust

Balance of the Decedent's assets

Bypass Trust

Assets of the Decedent's Estate up to the maximum available Estate Tax Exemption (currently \$3,500,000)

- So much or all of income and principal to Survivor, as needed.
- Survivor may withdraw assets at any time.
- Upon Survivor's death, balance of assets are distributed as directed by power of appointment granted to Survivor; or if Survivor fails to exercise the power of appointment, then held for benefit of and/or distributed to Residuary Beneficiaries.
- All income to Survivor during Survivor's lifetime.
- Discretionary principal to Survivor for health, comfort and support, as needed.
- Upon Survivor's death, balance of assets are held for benefit of and/or distributed to Residuary Beneficiaries.
- All (or discretionary) income to Survivor during lifetime.
- Discretionary principal to Survivor for health, comfort and support, as needed.
- Upon Survivor's death, balance of assets are held for benefit of and/or distributed to Residuary Beneficiaries.

Upon 2nd Spouse's Death:

Assets Held For Residuary Beneficiaries

- Personal effects are distributed pursuant to the Survivor's Will and/or Tangible Property List.
- So much of the income and/or principal of the remaining assets is distributed as the Trustee deems necessary to provide for the health, education and support of the children until youngest child reaches ____ years of age.
- When youngest child reaches ____ years of age, the remaining assets are divided into equal shares for (i) living children and (ii) deceased children with surviving descendants. Each share created for a living child and a living grandchild is held in a Beneficiary's Trust.

Beneficiary's Trust

The assets of each share created for a living Child of Trustors;
or if a Child of Trustors is deceased, the share created for each child of a deceased Child of Trustors

- All distributions from Retirement Asset Accounts are paid to the Beneficiary or applied for his/her benefit.
- If distributions from Retirement Asset Accounts are not sufficient to provide for the health, happiness and prosperity of the Beneficiary, additional discretionary income and principal may be paid to the Beneficiary or applied for his/her benefit.
- Upon the Beneficiary's death, any assets remaining in his/her Beneficiary's Trust will pass according to power of appointment granted to the Beneficiary; and to the extent the Beneficiary fails to exercise the power of appointment, the remaining assets are distributed to his/her descendants, per stirpes.

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- Decedent's Estate** - Decedent's 1/2 share of community property, plus all of Decedent's sole and separate property, other than assets passing directly to Survivor.
- Survivor's Estate** - Survivor's 1/2 share of community property, plus all of Survivor's sole and separate property.