Often Overlooked Advantages of Revocable Trusts

Revocable and amendable trusts[1] are heralded as superior estate planning devices because of their ability to handle situations that cannot be addressed by traditional will-based planning. For example, revocable trusts allow the creator, or Trustmaker, to create a flexible planning document with instructions benefiting the Trustmaker and others (such as a spouse) in the event of the Trustmaker's incapacity. Since will provisions are not recognized until the death of the testator, will-based planning can only rely on powers of attorney for incapacity planning. However, powers of attorney are generally only agency documents. They deal with how assets are to be handled for the maker's benefit alone and typically ignore how the principal's assets can be used to take care of other loved ones. In addition, most advocates of revocable trust planning point out their utility in avoiding the costs inherent in state probate processes without focusing on the other benefits of family members not being forced to go endure these court-supervised procedures.

Revocable trust advantages, however, are not limited to just these often-cited general benefits. This article explores other or related overlooked benefits of revocable trusts:

Avoiding Probate in More than One Jurisdiction

When someone dies with individually owned assets, probate is required in the decedent's state of domicile to make sure that his creditors and taxes are paid and that his or her assets are distributed in accordance with the decedent's will or the testamentary pattern the state otherwise prescribes. The domiciliary probate includes all personal property owned by the decedent (e.g., furniture, motor vehicles, bank accounts, securities, and business interests). It also includes real estate owned by the decedent but only if it is located in that state where the decedent was a resident when he or she died. If a decedent owns real estate in more than one state, probate in some form is required in each state where such other real estate is located. Thus, if a Trustmaker owns out-of-state real property as Trustee of his or her revocable trust, multiple probates are avoided.

Keeping Asset Information Private after Death

Probate works to protect creditors and legatees because an estate's Personal Representative is required to appraise all assets owned by the decedent at death and to make those appraisals public information. In the law's eyes, only if this information is available to anyone in the public can potential creditors

[1] For the purposes of this article, we refer to revocable and amendable trusts more simply as "revocable trusts". When we do so, we are referring to a flexible trust that can be changed or revoked at any time by the creator(s) of the trust.

and legatees decide if it is worthwhile to process claims to protect their respective interests. In many cases, however, the legatees are closely related and would prefer instead that information about family wealth be kept private. Using a revocable trust in lieu of will-based planning allows this to occur. When a revocable trust is used to pass assets after death, potential beneficiaries are required to be notified of the identity and contact information of the Trustee and their right to receive a copy of the trust and to request information about trust administration, but this information is not required to be made public. In most close family situations, aside from this required notice, trust information is shared informally.

Avoiding Appraisal Costs After Death

In situations where post-mortem administration is handled informally by using a revocable trust without court or taxing authority supervision, beneficiaries can decide if they think the costs of appraisal are worthwhile. If a revocable trust is used to distribute a decedent's assets and there are no estate tax returns required to be filed because of the currently high exclusion amounts ($11.7 million for federal estate tax purposes and $5 million for Maryland estate tax purposes), beneficiaries can informally agree to asset valuations without the necessity for incurring appraisal costs. Because of their familiarity with the assets in question and prevailing market conditions, family members who are beneficiaries will often prefer to divide such assets without having their inheritance reduced by the cost of appraisals that are, in and of themselves, often subjective. Such costs are not avoidable where estate distribution is based on applicable Maryland probate laws.

Avoiding Additional Trauma for Family Members after Death

The death of a loved one is generally a traumatic experience for family members who are left behind. Having to go through a nine-month or longer probate process for the decedent's assets after that death with attendant deadlines, court and administrative review, and costs generally adds to that trauma. Using a revocable trust to avoid this probate process can also therefore avoid this additional trauma and expedite the distribution of the decedent's estate.

Revocable Trust Choice of Laws Advantages

As long as there is some connection to the designated jurisdiction, the terms of a revocable trust can designate what will be deemed to be the principal place of the trust's administration and, therefore, the applicable state law that controls that administration. A choice-of-law clause in a trust will be given effect, unless the state whose law is chosen has no substantial relationship to the parties to the trust and there is no other reasonable basis for the Trustmaker's choice. The Trustmaker's choice of the applicable law of the "connected" state will be followed unless application of the law of the chosen state would be contrary to the fundamental policy of the Trustmaker's residence state and which has a materially greater interest in the matter. Under the Maryland Trust Act, the terms of the trust do not have to specify the Trustmaker's place of residence as the applicable jurisdiction. They can

alternatively designate the principal place where a Trustee resides or does business or where all or part of the administration of the trust actually occurs. As long as such a connection exists, the Trustmaker is free to choose whatever state's laws are best suited to carrying out his wishes.

For example, Maryland does not currently have any statutory or case law expressly authorizing "decanting", a means by which a Trustee can transfer assets from one trust to a new trust with different administrative or other provisions. Decanting can be helpful if tax or trust law changes in an unanticipated fashion. Delaware has such statutory law that allows this in a variety of circumstances. If a decedent resides in Maryland at the time of his death, but his or her Trustee after death is a resident of Delaware, the Trustmaker could designate Delaware law to apply after this death so that decanting would have a statutory underpinning.

Choice of Applicable State Income Tax Law for Inheritance Trusts with Non-Maryland Trustees

One of the current hot topics in trust law is the extent to which trusts established after a decedent' death are subject to income taxes levied by the decedent's residence state. For such "inheritance trusts," the decedent's residence state is likely to argue that it has the necessary connection to the trust that will allow it to impose such income taxes indefinitely. By Maryland statute, income tax is imposed on the "Maryland taxable income" of natural persons and fiduciaries. For a resident of Maryland, "Maryland taxable income" is pretty much all federal adjusted gross income. However, for a nonresident of Maryland, "Maryland taxable income" means only Maryland "source income" such as payments for services performed in Maryland, rents from Maryland real property, and distributions from businesses that are carried on in Maryland. Nonresidents (including Trustees), are allowed to subtract from Maryland adjusted gross income their income that is derived from, among other sources, property located outside Maryland; business income earned outside of Maryland; and annuities, pensions, state and local income tax refunds, interest, dividends, or most other intangible property. Since this last listed category often comprises the primary types of income held by Trustees, a nonresident Trustee can thus escape Maryland income tax on most of the non-Maryland source income held in the trust.

By Maryland statute, a Trustee is a nonresident Trustee if:

1. if that trust was not created, or consists of property that was not transferred to it, by the will of a decedent who was domiciled in Maryland on the date of the decedent's death;
2. if the creator or grantor of the trust is not a current resident of Maryland; and
3. if the trust is not principally administered in Maryland.

Under these criteria, the Trustee of a testamentary Inheritance Trust under a Maryland decedent's will can never be a nonresident Trustee. A trust created under such a will can be expected to always be subject to Maryland income taxation on all income from businesses or property, regardless of where it

is earned. Similarly, the Trustee of a trust created by a currently living Maryland Trustmaker will always be subject to Maryland income taxation.

However, if an Inheritance Trust created under a formerly revocable trust is principally administered outside of Maryland (and especially if the Trustee as an individual is a nonresident of Maryland), the Trustee of that Inheritance Trust can escape Maryland income taxation on non-Maryland source income. While the Trustee may be subject to income tax in the state where the trust is being administered, this distinction can provide substantial savings if that administration state's income taxes are lower than Maryland's or for the nine states where there is no state income tax. In such cases, revocable trusts offer a powerful advantage that is not available to Inheritance Trusts created under will-based planning.

As a Practical Matter, Revocable Trusts are Much More Difficult to Challenge than Wills

Post-mortem transfers are sometimes challenged by disappointed beneficiaries and/or nonbeneficiaries from a decedent's estate. Such challenges, while difficult to prove, are relatively easy to bring for a challenger in a probate estate. All that is required is the filing of a relatively brief "Petition to Caveat" that automatically changes an administrative probate proceeding into a much slower Judicial Probate process. Disappointed beneficiaries and persons omitted from a decedent's will are sometimes motivated to file such caveat petitions to negotiate to force a settlement that will allow the probate process to move more expeditiously.

Since there are fewer, if any, mandated formalities required to create a valid trust as opposed to those that must be followed to create a valid will, wills are generally much easier to challenge based on these technical requirements. While it is difficult to prove precisely what a Trustmaker intends to include in the terms of his or her trust without a signed written document, trusts are not even required to be in writing to be enforceable. To the contrary with wills, even minor execution procedural flaws may be fatal with regard to carrying out a testator's intent.

In addition, while the other grounds for alleging the invalidity of a trust are arguably the same as those for challenging a will (i.e., generally proof that the Trustmaker lacked the mental capacity to create a trust or was unduly influenced by another person who forced the substitution of the influencer's intent rather than that of the Trustmaker), the process for doing so is much more burdensome for the challenger to the validity of a trust. Instead of filing a simple unsubstantiated petition in a probate proceeding, the challenger of a revocable trust must bring a formal court action in a circuit court, pay the applicable filing fee, and serve all interested persons with process informing them why the challenge is occurring. Once such a challenge to a revocable trust is filed, the challenger can be required to answer written interrogatories and deposition questions to disclose his or her case before trial. All of these activities can be anticipated to be significantly more expensive for the challenger than merely filing a Petition to Caveat in a probate action.

A will challenger in a probate process does not have to face the testator (who is dead) and will likely be challenging a will made shortly before the decedent's death. In contrast, a revocable trust is likely

to have been administered for a considerable period during the lifetime of the Trustmaker, thereby making the proof of the Trustmaker's lack of mental capacity or the alleged undue influence at the time of the trust's creation much more difficult. Unlike the probate situation where an estate administration has recently commenced, equity courts are quite naturally loath to invalidate Trustee actions that have been ongoing for years prior to the challenge.

Finally, a judicial proceeding to contest the validity of a Maryland revocable trust is by statute required to be commenced within the earlier to occur of (1) one year after the death of the Trustmaker or (2) six months after the Trustee sends the challenger a copy of the trust instrument, the Trustee's name and address, and the time allowed for commencing the proceeding. If a Trustmaker anticipates that someone might challenge the validity of his trust in the future, he can have the Trustee (who is often himself or herself) send the potential challenger the required six month notice to force the challenge while the Trustmaker is alive and able to answer it. If the challenge occurs after such notice during that Trustmaker's lifetime, the challenger is faced with challenging the Trustmaker's mental capacity or showing undue influence upon him or her, while that Trustmaker is alive and can prove otherwise.

Because of all these advantages, we have for many years made revocable trusts a primary estate planning tool for our clients. Regardless of how clients feel about the probate process and the relative simplicity of wills and powers of attorney, revocable trusts are far and away the most comprehensive and best alternative to plan for incapacity before death. While we will of course use wills where clients feel that they are more appropriate or where they are more comfortable having a probate court supervise the administration and distribution of their estate, we believe that the advantages listed in this paper usually outweigh the financial and emotional costs involved with probate processes that can otherwise be avoided. If you have questions about these advantages or would like to discuss these topics, please contact us for a consultation, and we will be happy to speak with you.