The Benefits of Revocable Trusts in Estate Planning

By Danielle Friedman and Herb Fineburg

It is increasingly common to see the use of revocable trusts in estate planning in lieu of "testamentary trusts," those trusts set forth in a client's will. One reason may be that there often is no ascertainable benefit to using a testamentary trust over a freestanding revocable trust, but a revocable trust can offer numerous benefits. For those firms that include estate planning in their portfolio of financial services, this article may help bolster an understanding of revocable trusts in estate planning.

One of the primary benefits to using revocable trusts is that they generally simplify the estate administration process, including avoiding probate (i.e., the court-supervised administration of the decedent's individually owned assets in accordance with the decedent's will). Avoiding probate has two big benefits: privacy and the elimination or minimization of the time delays and costs of involving a court in estate administration. Further, some clients may own real estate (e.g., vacation homes) in more than one state, so if real estate is titled to a revocable trust the client can avoid separate court administrations in multiple states.

Revocable trusts provide privacy because they are not publicly recorded with the court when a client dies, unlike a will. With a revocable trust, the client can maintain a short will that transfers any remaining assets in his or her individual name at the time of his or her death into the revocable trust. None of your client's personal estate planning information needs to be contained in this short will. All dispositive terms are in the revocable trust, which is a private document. This privacy can be meaningful for many families.

Court involvement can also be avoided if your client later becomes incapacitated or is no longer willing (or able) to handle his or her financial affairs. Revocable trust assets can be managed by the successor trustee without the need of a court-appointed guardian, and the revocable trust can be funded with nontrust assets by the client's agent under a general power of attorney.

Revocable trusts afford a seamless transition after a client's death, while a will and testamentary trusts are not effective until they are approved by the court following the client's death. The court approval process can be time-consuming and costly. Moreover, a will can be contested after the client dies and the court could invalidate the will, forcing assets to pass pursuant to the state's intestacy laws.

These decisions may be inconsistent with the client's wishes, nor do they provide the tax or asset protection benefits available with revocable trusts. A revocable trust, on the other hand, is valid when signed and is not as easily contested.

Because there is no required court involvement with a revocable trust's administration (absent a voluntary petition to the court), a revocable trust and its assets can pass to beneficiaries sooner after a client's death. This can be especially critical for clients who own businesses in order to avoid disruptions.

Many clients transfer their business equity interests to their revocable trusts during their lifetimes. However, some clients who send their business tax returns to lenders may prefer not to change their Schedules K-1 to show the revocable trust as the new business owners rather than the client individually.

Fortunately, a little-known U.S. Treasury Regulation provision – 26 C.F.R. Section 301.6109-1(a)(2)(i)(B) – allows the client to leave his or her name on the Schedule K-1 even if a revocable trust holds title. This reporting exception follows the general policy that the revocable trust is effectively the individual's alter ego for individual income tax purposes.

Pursuant to Treasury Regulation Section 1.671-4(b)(2)(i)(A), a taxpayer identification number is not needed for a revocable trust because the client can simply report the business income, loss, and available deductions directly on his or her Form 1040. The same may apply to bank and brokerage accounts. There is no trust fiduciary Form 1041 or Form PA-41 required for a revocable trust. The business continues to list the client as the taxpayer and to use the client's Social Security number, while using the address of the revocable trust on Schedule K-1. Accordingly, the change in ownership is invisible to lenders.

Because revocable trusts can be revoked or amended at any time, a client may transfer his or her assets in or out of the trust (including business interests) with no income or gift tax implications. The revocable trust can act as a temporary surrogate for the client until his or her death.

Revocable trusts offer several benefits over the use of wills that contain testamentary trusts, including probate avoidance, privacy, and management during incapacity. Revocable trusts do not create additional filing requirements for clients or tax preparers, particularly those with business interests transferred to a revocable trust. Clients may want to review their current estate planning documents and discuss their options with their advisers.

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