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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1439

Date: 02-Apr-09
From: Steve Leimberg's Estate Planning Newsletter
Subject: Selecting Revocable Trust Systems for Clients

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Here is their creative and innovative commentary:

EXECUTIVE SUMMARY:

Advisors have a wide variety of revocable trusts at their disposal, and there are a number of important factors that must be carefully considered. This commentary will review:

- 1) Protective Beneficiary Trusts,
- 2) "All to Survivor" Joint Trusts,
- 3) "First Death Lock-Up" Trusts,
- 4) "Separate Trust For Each Spouse" Trusts,
- 5) "Joint 100% Lock-Up" Trusts, and
- 6) "Joint 50% Lock-Up" Trusts.

FACTS:

Many estate plans involve revocable trusts, and selection and implementation of an appropriate plan is more of an art than a science.

Factors that should be considered when selecting a revocable

trust system include:

- 1) Whether a surviving spouse or beneficiary should have total control or protective advantages that may be available,
- 2) Whether income tax savings for a surviving spouse may be desirable, and
- 3) What assets and beneficiary designation situations the client may have.

Note:

Revocable trusts can be used to avoid probate and guardianship, but during the lifetime of the Grantor who establishes and owns the trust there is no creditor protection, Medicaid protection, or income or estate tax savings. After death, such protections and savings may apply depending on the revocable trust system selected.

COMMENT:

CONSIDERATIONS FOR A SINGLE INDIVIDUAL

Many unmarried individuals establish and maintain revocable trusts primarily to avoid probate and guardianship of their estate. Probate is the process whereby assets owned in individual names must be processed through the Probate Court System, in order to ensure that:

1. The proper will has been identified and approved,
2. Accountings are received by beneficiaries,
3. Creditors are paid, and
4. A fiduciary is appointed as personal representative to execute and monitor all of the above.

Many clients choose to bypass the "red tape" and expenses associated with the probate system by placing their assets under a revocable trust. Immediately upon its formation, the trust is controlled and administered by a non-court appointed relative, friend, professional or trust company.

Life insurance, annuities, and even pension benefits can be paid to the revocable trust upon death to facilitate the uniform distribution of assets. For pension plan purposes, it may be advantageous to instead name individuals who are able to withdraw the pension benefits out of an inherited IRA ratably over their life expectancy. Such ratably withdrawals may also apply under an appropriately drafted revocable trust agreement, but special technical language and planning is required to effectuate this.

Some clients choose to place their homestead under a revocable trust, which does have certain advantages. For instance, in Florida, as long as the client is alive, the homestead can qualify for the Florida \$50,000 homestead exemption and the 3% cap on increases in value.

However, placing the homestead under a revocable trust also presents a potential *danger* from creditors. There is one

bankruptcy court decision which has indicated that *the constitutional protection of homestead from creditors will not apply when the homestead is owned under a revocable trust.*

While other bankruptcy court decisions have not found this to be the case, our office generally suggests the more conservative approach of leaving the homestead *outside* of the revocable trust.

Clients who still wish to avoid probate of their homestead may be able to use a "Lady Bird Deed," which maintains creditor protection while still avoiding probate.

PROTECTIVE BENEFICIARY TRUSTS

A revocable trust will commonly provide that upon the death of the client the trust assets will divide into separate protective trusts for any children or other beneficiaries. Each child or other beneficiary may serve as sole or Co-Trustee for his or her benefit and receive amounts deemed reasonably appropriate to maintain his or her standard of living as well as to benefit his or her children.

The advantages of such a continuing trust include protection from:

1. Estate tax at the child's level,
2. Creditor and divorce claims that the child might have in the future, and
3. Inappropriate or risky spending and investments, which may be curtailed by mandating that the child serve with a Co-Trustee, i.e. a trusted relative, family friend, professional, or trust company.

REVOCABLE TRUST SYSTEMS FOR MARRIED COUPLES

Revocable trusts for married couples incorporate the above principles, but married couples have a number of configurations to choose from:

"ALL TO SURVIVOR" JOINT TRUST

The simple "All To Survivor" joint revocable trust. A married couple who would typically own their assets jointly with right of survivorship may prefer to use a revocable trust in order to facilitate avoiding probate upon the second death, and avoiding guardianship over trust assets if a spouse is declared by a court to be incompetent.

Although most couples who would use right of survivorship as their primary estate plan can simply have assets pass by will on the second death, using an All to Survivor Joint Trust assures that there would be a revocable trust in place after the first death. The All to Survivor Joint Trust eliminates the surviving spouse's need to engage in estate planning and decision-making regarding the use of a revocable trust after the first death.

Note:

Clients should be careful to confirm that the joint revocable

trust with survivorship can be considered to be a tenancy by the entireties ownership vehicle for the married couple.

Under Florida law joint assets held as tenants by the entireties between a husband and wife are not subject to the creditor claims of an *individual* spouse unless *both* spouses owe the creditor. This is a very good reason to keep assets jointly as tenants by the entireties where spouses are creditor exposed.

Most joint revocable trust forms used by lawyers will not qualify the trust assets to be considered as held by tenancy by the entireties, but with proper drafting this can be accomplished.

"FIRST DEATH LOCK-UP TRUSTS"

There are several good reasons that a married couple might wish to have some or all of their assets "locked up" in a protective trust upon the first death, including:

1. Avoidance of federal estate tax upon the second death.
2. Creditor protection for the surviving spouse upon the first death.
3. Securing a Co-Trustee for the surviving spouse to help prevent loss of assets to undue influence, poor investments, or unwise distributions or loans to friends or family members. The surviving spouse can serve as Co-Trustee with the power to select and replace the other Co-Trustee, and can receive benefits as needed for the spouse and descendants.

The "All To Survivor" Trust described above will not provide these protections. Therefore, the married couple wishing to have the protections provided by a "Lock-Up Trust" may choose one of the following three revocable trust systems:

- 1) "SEPARATE TRUST FOR EACH SPOUSE" TRUST SYSTEM
- 2) COMPLEX JOINT TRUST: "JOINT 100% LOCK-UP" TRUST SYSTEM
- 3) COMPLEX JOINT TRUST: "JOINT 50% LOCK-UP" TRUST SYSTEM

These 3 trust systems are described in more detail below.

"SEPARATE TRUST FOR EACH SPOUSE" TRUST SYSTEM

Each spouse will have a separate trust that "locks up" upon the first death to benefit the surviving spouse with those assets held by such trust and those assets made payable to the trust by beneficiary designation.

This "*Separate* Trust for Each Spouse" trust system is the most popular, and traditionally has been the only revocable trust system used by most estate planning lawyers. In this system, a "bypass trust" or "family trust" can be established upon the first death to be held for the surviving spouse without the assets under such trust being subject to federal

estate tax, creditor claims of the surviving spouse, or claims of future spouses and the descendants of future spouses.

Most of the married couple trusts work that our office performs uses the Separate Trust for Each Spouse trust system with separate revocable trusts for each spouse, but there are other alternatives.

"COMPLEX JOINT LOCK-UP"- ALL ASSETS

Clients who may instead be better suited for a "Complex Joint Trust" would typically have one or more of the following characteristics:

1. Clients who prefer a simpler plan with assets under one trust as opposed to two.
2. Clients who wish to "lock up" more than the assets of the first dying spouse upon the first death (which is the case under the Separate Trust for Each Spouse trust system). The surviving spouse would become Co-Trustee of the trust holding these assets. Similar to the Separate Trust for Each Spouse trust system, these assets are held without being subject to federal estate tax, creditor claims of the surviving spouse, or claims of future spouses and the descendants of future spouses.
3. Clients who have had an All to Survivor Joint Trust in the past and do not wish to retitle to separate revocable trusts when updating their planning.

As stated above, clients who elect to have a Complex Joint Trust may choose between a "JOINT 100% LOCK-UP" trust system and a "JOINT 50% LOCK-UP" trust system."

Most wealthy clients who use a revocable trust system choose a "JOINT 100% LOCK-UP" trust system in order to achieve the following:

1. The ability to claim a "stepped up" basis for income tax purposes on all assets held under the joint revocable trust. For example, a stock purchased for \$200 that is worth \$1,000 upon death could be sold thereafter for \$1,100 with capital gains tax only owed on \$100 worth. With a typical joint revocable (ATS) trust there is only a "step up" for half of the value upon death, so the capital gains tax would be based upon the excess of \$1,100 over \$100 plus \$500.
2. The ability to "lock up" as much in assets as possible to avoid estate tax upon the second death. For example, a married couple with good earnings may have \$4,000,000 worth of assets and may wish to lock up a full \$3,500,000 worth of assets in a bypass trust upon the first death, with the expectation that the surviving spouse will have future earnings and the possibility that the estate tax exemption will be reduced in the future.

The Joint 100% Lock-Up Trust has special design features that allow the trust assets to be considered for federal income and estate tax purposes to have passed from the first dying spouse into the surviving spouse's trust upon the first death.

This is done by giving each spouse the right to execute a separate document directing how the trust assets would pass if that spouse were to die first. To ensure that the first dying spouse does not appoint assets to somebody other than the surviving spouse or the Joint 100% Lock-Up Trust, the tax law permits the appointment of "Trust Protectors," who have the power to disapprove any exercise of such "power of appointment" by the first dying spouse.

For example, a husband and wife could appoint one or two close family friends or advisors as Trust Protectors under the trust. Their sole function would be to have the power to disapprove either spouse's decision to direct assets anywhere besides the Joint 100% Lock-Up Trust or the surviving spouse, unless the surviving spouse also approves of such direction of assets.

The tax law does permit the entire Joint 100% Lock-Up Trust to be held upon the first death for the surviving spouse, without being subject to federal estate tax upon the surviving spouse's death. The tax law is not clear on whether all the assets of the trust receive a "stepped up" basis upon the first death.

Many tax commentators, myself included, believe that *all* assets inside a revocable trust should receive the "stepped up" basis. But the IRS has disagreed.

"JOINT 50% LOCK-UP" TRUST SYSTEM

The other Complex Joint Trust that can be used for estate tax and/or protective trust planning would be the "JOINT 50% LOCK-UP" TRUST. This is a simpler document than the Joint 100% Lock-Up Trust, but only allows the lock up of 50% of the assets of the couple upon the first death.

The Joint 50% Lock-Up Trust does provide a "stepped up" income tax basis for the 50% of the assets that are locked up, but there is no stepped up basis for the other 50% of the assets. Under the Joint 50% Lock-Up Trust, the spouse who dies first cannot override the mutually agreed trust document, as he or she could under the Joint 100% Lock-Up Trust system, and therefore the language used in the trust document is not as complicated.

BE SURE TO CONSIDER MEDICAID ISSUES:

Medicaid planning for a married couple adds one more twist to revocable trust structuring. Unfortunately, the Medicaid regulations provide that assets passing by revocable trust into a protective trust for a surviving spouse can be used by Medicaid before the surviving spouse can qualify, unless such assets have passed through the probate estate of the first dying spouse.

We may therefore suggest to clients who wish to help ensure that their spouse will qualify for Medicaid without using trust assets place the assets in their personal names, to pass into a revocable trust system by a "Pour Over Will" upon the first death.

PLANNING TIPS:

Obviously, revocable trust planning is varied and complex. We hope that this commentary will open up planning opportunities, as well as common configurations, to clients and advisors.

As with most estate planning techniques, "one size does not fit all." It is best to structure a joint trust (or *any* trust for that matter) that is appropriate for the client's needs and circumstances.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A
POSITIVE DIFFERENCE!**

Alan Gassman

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26 U.S.C. Sec. 1014, T.A.M. 9308002 (Nov. 16, 1992), P.L.R. 200101021
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