

TERMINATING THE REVOCABLE LIVING TRUST

We are frequently asked: "What happens to assets held in a living trust when those assets are inherited by the beneficiaries? What procedures are required to terminate the trust and to transfer assets to beneficiaries?" This article will provide an overview of steps required, and things to consider when acting as trustee.

First, a bit of background on how the revocable trust works. If Jane Smith owns assets in her sole name and she becomes incapacitated or passes away, the assets are frozen until someone with legal authority to manage them appears. Unless a beneficiary designation applies to the asset, in most cases solely-owned assets must go through the probate process. If the assets are titled in the name of the trustee of the revocable living trust, the trustee has the right to access assets without court intervention.

During her lifetime, for as long as Jane is able, Jane would manage the trust assets -- just as she would if they were in her name. When she is no longer able, a successor trustee named by Jane in the trust agreement takes over. The court is not involved since the 'owner' of the assets has not changed -- the trust is still the owner. The manager of the trust has simply changed, according to the provisions outlined in the trust agreement.

When a revocable living trust is used as a tool in estate planning, assets are retitled in the name of the trust, so the successor trustee named in the trust may step in when needed without court intervention. If the asset is titled in the name of the trustee of the revocable living trust, the trustee has the right to access assets without court approval, since the trust agreement itself authorizes the trustee to act. Since the probate process only applies to assets owned by a deceased person, all assets owned by the trust totally avoid the probate process. It is essential, when a trust is signed, that titling of assets is changed to the trustee of the trust. Then, when a death occurs, the bank or other institution looks at the signature card and says, "We don't freeze this account. It's held by a trust."

Upon Jane's death, the trustee should consider the following steps. The trustee is legally responsible only for management and distribution of trust assets, but if the trustee is also a family member, often the trustee also handles funeral arrangements and other details. The following list includes practical responsibilities that should be considered. Since each situation is somewhat different and since many tax and other legal considerations will affect steps taken by our office, this list is not all inclusive.

- Locate and review all of the deceased's important papers. Sometimes directions for funeral and other pertinent information may be located with other papers, so these documents should be reviewed as quickly as possible. If a safe deposit box exists, it should be checked. If the trust was the lessee on the safe deposit box, the successor trustee will now have access to the box. Locate the original of the trust agreement and any other pertinent documents.

- If the deceased was living alone, change locks and take any steps necessary to close the house. If the house will be vacant, insurance carriers should be notified of this fact.
- Automobile insurance and any other pertinent insurance policies should be checked to be certain trust assets are insured against potential loss or liability.
- Make funeral or other formal arrangements for burial, cremation or memorial services. Obtain certified copies of the death certificate from the funeral director, County Health Department, or Register of Deeds/County Recorder in the county where the death occurred.
- Make a list of all household goods, and, to be absolutely safe if several beneficiaries are involved, photograph personal property and take an unrelated, disinterested witness along when you make your list. The list will be of great help in keeping track of where personal property items are distributed, and to be certain they are distributed as provided in the trust agreement.
- Create a general list of assets, along with the account number(s), address and phone number of each agent or institution handling assets. Locate the most recent statement for each account and bring them to us along with the general list of assets.
- If several different accounts exist, it simplifies things greatly if liquid assets that are titled in the name of the trust are consolidated into one account (or one savings and one checking account, if a variance in interest earned is a factor). However, consolidation should not be done prematurely, in case some assets are not held by the trust. Accounting issues can become complicated if nontrust assets are mixed with trust assets. *After* the inventory is completed, we can be of help in coordinating consolidation of accounts.

By using one account for payment of all bills and to deposit any receipts, the check register for that account can be used to account for trust activity. Be certain that records are kept to describe where money deposited came from, and the purpose of checks that are written. As trustee, you are in the position of safeguarding the funds for beneficiaries, and it is important for you to be able to account for trust activity while the trust is under your control. This information is also very important for tax reporting purposes, since, if records aren't kept showing where income came from and what expenses were paid, it's impossible to determine what income is taxable and what expenses are deductible.

- Determine whether any legitimate outstanding bills or debts exist and pay them. If the trustee does not pay bills, the trustee could be held personally liable for those bills. It is safest to determine outstanding liabilities and to complete the inventory of assets before making distributions to beneficiaries, since it is very awkward for a trustee to go back to beneficiaries and ask for money back with which to pay bills.
- If the trust will generate income from the date of death until all trust assets are distributed (which is generally the case), a taxpayer identification number needs to be obtained for the trust. We can be of help in obtaining the taxpayer identification number. While the

person whose assets were placed in the trust has power over the trust property, the grantor's social security number was the taxpayer identification number, and trust income was simply reported on the annual 1040 tax return. When the grantor no longer has power over the trust (due to death), then the trust is required to report income under its own taxpayer ID number. For the year of death, income earned from January 1 through date of death will be reported on the decedent's final 1040. Income earned from date of death through date of distribution of all assets will be reported on a form 1041 trust tax return. The assets themselves are NOT subject to income tax. Only the income generated by the assets (interest income, etc.) is subject to tax.

- We can help in making certain that all required tax returns are filed. Possible state and federal tax returns required would be the deceased's final income tax returns, the trust's income tax returns, an inheritance tax return if the deceased's state of residence has an inheritance tax, and estate tax returns if the total value of taxable assets the deceased had an interest in is more than the amount that is excluded from estate tax. In determining the total value of assets subject to estate tax, generally all assets are included, including death benefits on life insurance. Total value of assets that may be transferred free of estate tax may vary depending upon year of death and state of residency.
- We will file the deceased's will with the probate court in the county where the decedent resided. Even though a probate will not be required if all assets are in the trust, the will should be filed. Many jurisdictions require filing of the will to prevent people who are aware of a will from destroying it for any reason.
- If the trust document requires an accounting, we will create an accounting which begins with the inventory listing all assets existing on the date of death, shows all additions of any type, subtracts all disbursements, and shows current assets on hand. This must balance. The accounting may then show how current assets on hand are to be distributed to beneficiaries based on the plan of distribution specified in the trust agreement. When the accounting is near completion, it is easiest if assets are placed in a noninterest-bearing account so values are not constantly changing. Our trust account may be used for this purpose. We do want to be certain that the period of time during which assets are held in noninterest-bearing accounts is short, however.
- We will prepare a receipt and release form for each beneficiary to sign, stating that they have received their inheritance and that they release the trustee from further responsibility or liability. Funds are distributed to the beneficiaries when they have signed the receipt and release form. (Once distributions are made, it is much more difficult to obtain signatures, since it is no longer a priority for beneficiaries.)

Estate settlement involving a revocable living trust is generally easier than going through the probate process -- in part, because it's faster. Also, the successor trustee can access accounts immediately, which is more convenient than waiting for authorization from the probate court. However, even with a trust, settlement includes many details and completion of all items including taking advantage of all tax benefits and maintaining detailed information to present to beneficiaries. Professional help can expedite the trust termination process, insure that all tax

benefits are utilized, minimize potential liability for the acting trustee(s), and help in maintaining records to share with beneficiaries.

Following are answers to commonly asked questions about trust termination.

QUESTION: Why do we need to do anything to terminate the trust? The trust was set up to avoid paperwork!

It's important to establish date of death value of assets, for income tax purposes.

Upon death in most cases, all capital gain on inherited assets is forgiven. The 'step up in basis' (terminology for the rule forgiving capital gain upon death) is a tremendous tax benefit for those holding appreciated assets. Assets which receive the stepped-up basis may be sold, and the only tax due will be on gain which occurred between the date of death and the date of the sale. If the asset is retained and is a depreciable asset, depreciation may be taken on the new basis, providing an additional tax deduction annually, even if the same asset had already been depreciated at an earlier time by the decedent.

In order to determine how much depreciation may be taken, or to determine how much tax is due at the time of a future sale, it is important to establish the value of assets on the date of death. Otherwise, after time passes, it is very difficult to verify what values were as of the date of death. Preparing an inventory listing assets owned on date of death and establishing values of those assets can be extremely helpful in future income tax filings, and will insure that beneficiaries receive the tax benefits to which they are entitled.

Additionally, an inventory is used as the basis for the trust accounting, which is utilized to determine amounts to distribute to beneficiaries pursuant to the provisions of the trust.

Preparing an inventory and trust accounting is also an excellent method of verifying that everything is actually titled in the name of the trust, and if some assets aren't titled in the name of the trust, to determine how they are titled, to determine how they are to be handled and to whom they are to be distributed (probate required, transferred to named beneficiaries, transferred to joint tenants, etc.).

In preparing the inventory of assets, we will contact each institution holding assets to obtain date of death value, owner, beneficiary (if any), and other pertinent information in regard to the assets. In this way, specific ownership, any beneficiary designations, and other pertinent information can be determined before distributions are made. It is *not* acceptable to take values off of statements, since the IRS has specific requirements for ascertaining date of death values, including calculating income earned to date of death even if that income has not yet been credited to the account or paid to the decedent. Written verification of values from institutions holding the assets or calculations made through our office will be extremely helpful in the event of an audit. A formal inventory created by our office prevents errors, and keeps tax records clean. When actual values are determined, any income, refunds, or other additions added, and any taxes or expenses paid, a trust accounting may be prepared to show all activity, determine the final distribution of assets, and to show that assets on hand on date of death, plus additions,

minus disbursements, equals assets on hand for distribution. Even if an accounting is not required by the trust agreement, it is very beneficial to have clear records in this organized format, for tax preparation purposes, and to show that the trustee has acted responsibly in managing and accounting for assets.

Steps may be necessary to show, on real estate records, that the grantor is deceased, and to be certain that all real estate desired to be held by the trust is in the trust.

If the deeds conveying real estate to the trust have not yet been recorded, they should be recorded now. It is important to record a Certificate of Trust (which includes the legal description of assets so the document will be picked up in any title search) which shows that, upon grantor's death, the successor trustee has authority to manage, control and convey trust assets. (This requirement may be avoided in some states, where trustee powers are shown on the face of the deed.) An affidavit of death generally needs to be filed, which shows that the grantor is deceased. In this way, record title of real estate shows that real estate is in the trust, that the grantor is deceased and that the named successor is now acting trustee of the trust. This is what allows the trustee to sign deeds or anything else necessary in connection with the real estate.

Income tax may be saved by promptly terminating the trust and transferring assets to beneficiaries.

Income tax is saved by terminating the trust before December 31st of the year of grantor's death or within one year of the date of grantor's death, by distributing income so it is taxed to the beneficiary rather than to the trust. While a grantor has power over the trust property, all trust income is simply reported on the grantor's personal 1040 individual income tax return. Upon the grantor's death, the trust must use a trust taxpayer ID number. The grantor's social security number can no longer be used as the trust's taxpayer ID number. After the date of the grantor's death, a separate tax return must be used to report income generated by the trust. If the trust is terminated by year end or if income is passed out to beneficiaries, income tax liability can be passed through to trust beneficiaries and taxed on their individual 1040s. Provided that an election is made, the trust may be taxed as an estate and may opt for a fiscal year for tax filings. In this case, as long as the trust is terminated within one year of the date of death or income is passed out to beneficiaries, the income tax liability can be passed through to the beneficiaries. This is usually beneficial because trust tax rates accelerate significantly faster than individual rates. Efficient termination also minimizes the number of required tax filings and reduces the time during which accounting records need to be maintained.

QUESTION: If all of these steps are necessary, was it worth it for the grantor to execute the trust? Wasn't the trust supposed to eliminate paperwork?

It's true that, even with a revocable trust, paperwork is required. Realistically, none of us would want conveying our assets to someone else or authorizing management to be done with no paperwork or authorization! Even the trust must have some provisions and some paperwork requirements so assets are only managed by those who are authorized by the owners of the assets. Tax filing requirements and tax planning techniques would be required whether probate

was utilized or not. Those can't be avoided, although the shorter length of a trust termination may eliminate tax filings in more than one year. Other requirements are as specified in the trust agreement, for the purpose of keeping beneficiaries informed. Assets aren't frozen, so the trust makes it easier to begin transactions such as sale of assets and payment of bills, and probate notices to interested persons who could inherit due to state law are not required. Avoiding court paperwork and expense of complying with the requirements can be quite beneficial. The trust termination is typically shorter than a probate, and is private except for tax filings and accountings to those designated by the grantor. Additionally, analysis and steps taken at the time the trust was put into effect typically coordinate titling and beneficiary designations with the overall estate plan. This planning is to make certain that the estate plan results in distribution of assets to the beneficiaries of the grantor's choice, while utilizing all possible tax planning opportunities appropriate for the grantor.

