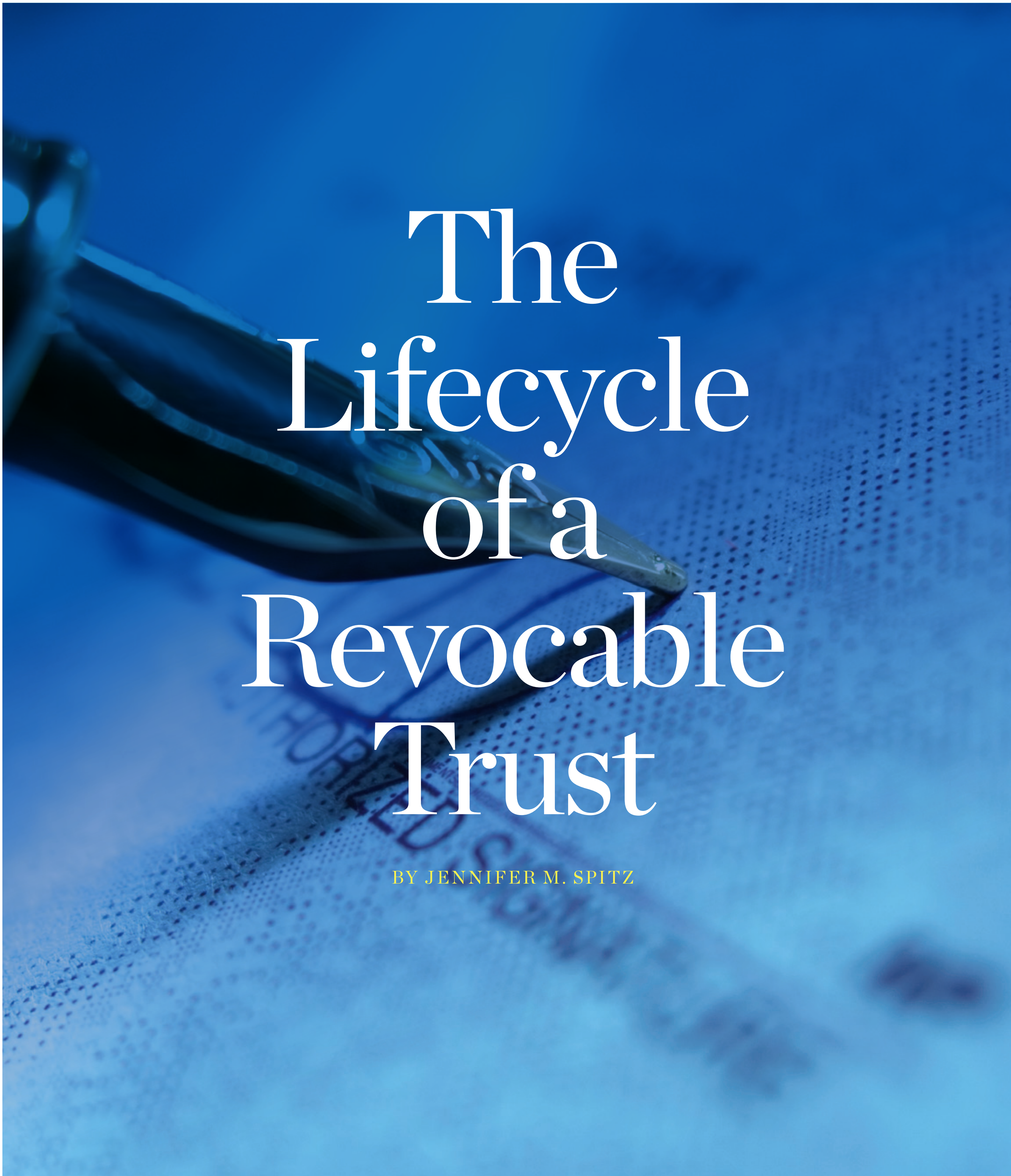

The Lifecycle of a Revocable Trust

BY JENNIFER M. SPITZ

This article discusses the creation, funding, administration, distribution, and termination of a revocable trust. It addresses salient Colorado Uniform Trust Code provisions, other relevant laws, and practical considerations.

There are several phases in the life of a revocable trust: creation and funding, the settlor's lifetime, the period following the settlor's death, and finally, termination. This article discusses considerations unique to each phase of a revocable trust's lifecycle.[1]

Creating a Revocable Trust

CRS §§ 15-5-401 and -402 provide the methods and requirements for creating a trust. Typically, a revocable trust is created upon execution of the trust agreement by the settlor and trustee, who are often, but not necessarily, the same person. The trust agreement contains terms applicable during the settlor's life and at his or her death.

The trust may or may not be funded during the settlor's life. Typically, the settlor executes a pourover will directing that assets passing under the will be added (poured over) to the trust at death, and a power of attorney that allows the agent to add assets to the trust during the settlor's life. The personal representative is usually the trustee (or successor trustee, if the settlor is the original trustee). In addition, the trust may be named as beneficiary of certain assets, such as life insurance policies.

To avoid any questions about revocability, it is advisable to specify in the trust agreement that it is revocable by the settlor. However, even without this language the trust is presumed to be revocable and amendable by the settlor unless the trust agreement specifies it is irrevocable.[2]

The trust agreement outlines amendment procedures. For example, the trust agreement may require that all amendments be in writing and delivered to the trustee. However, the methods specified in the trust are not the only ways to amend or revoke the trust, unless the trust provides that they are the exclusive methods.[3]

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While the settlor is living, the settlor's social security number can serve as the trust's tax identification number, and the trust income can be reported directly on the settlor's tax return. The trust does not need to file a separate tax return.

As long as the trust is revocable by the settlor, transfers to the trust will not be completed gifts for gift tax purposes. Therefore, the settlor can transfer assets to the trust without reporting the transfers on a gift tax return; the trust assets are included in the settlor's estate for estate tax purposes.

A revocable trust serves a valuable purpose if the settlor becomes incapacitated by allowing someone else to serve as trustee and directing the use of trust assets in that event. For example, the trust agreement usually authorizes distributions for the benefit of the settlor, and it may allow for gifts to others. Although a power of attorney can be used in place of a revocable trust to manage assets in the event of incapacity, a power of attorney has limited usefulness. For example, if the client wants to name a bank or trust company to manage the client's assets, the bank or trust company typically will refuse to serve as agent under a power of attorney but will agree to serve as trustee of a trust.

The trust agreement contains the meat of the settlor's estate plan at death. It may include directions for distribution of specific assets, cash distributions, and distribution of the balance (the residuary).

Funding the Trust

As noted above, in some cases the trust will not be funded during the settlor's life. However, there may be reasons to fund the trust during the settlor's life, such probate avoidance. Different types of assets present different challenges in transferring assets to the trust.

Real Estate

Real estate is transferred to the trust by the property owner (usually the settlor) signing a deed to transfer the property to the trust. The property can be transferred directly to the name of the trust, rather than showing the name of the trustee as the grantee,[4] through a quitclaim, bargain and sale, or warranty deed. If a quitclaim or bargain and sale deed is used, the settlor does not provide any title warranties, so the settlor cannot be held responsible for any title defects. But conveying with a warranty deed may preserve any title insurance coverage that the settlor obtained.[5]

In some cases, a property transfer is subject to a local transfer tax, such as the real estate transfer tax imposed by the Town of Vail on real property transfers. There are several exemptions from the tax, including "[a]ny gift of real property, where there is no consideration other than love and affection."[6] Therefore, a transfer to a revocable trust should be exempt. However, the Town of Vail requires documentation to establish that an exemption applies.[7]

Before transferring real estate to the trust, practitioners should consider the implications for the title insurance, property insurance, and mortgages. If the settlor obtained title insurance when acquiring the property, the settlor is the insured, but the trust may not be insured under the settlor's title insurance.[8] Therefore, it may be worthwhile to purchase a title insurance endorsement to extend coverage to the trust.[9]

If real property subject to a mortgage is transferred to the trust, the transfer could trigger the due-on-sale clause in the deed of trust, thereby giving the lender the right to call the loan due. Federal and Colorado law prohibit lenders from calling a loan due in some, but not all, cases, so it is good practice to obtain the lender's consent before the transfer.[10] In any event, once the trust holds the real estate, the lender may require that the property be transferred back to the settlor to obtain a new loan or to refinance.[11]

The settlor should advise the property insurance carrier of the change of ownership so the policy can be updated.

Bank and Investment Accounts

Transferring bank and investment accounts to the trust presents different challenges. The bank or investment company may not be willing to simply change the name of the owner on the account. Instead, they may require that a new account be opened. This may be inconvenient for the settlor, who may have automatic deposits and transfers set up for existing accounts. Further, it may be necessary to keep an account titled in the settlor's name because certain benefits, such as pensions, may require that automatic deposits be deposited into an account titled in the settlor's name rather than the trust's name.

> "A revocable trust is a grantor trust for income tax purposes and therefore can hold S corporation stock if the grantor is a U.S. citizen or U.S. resident."

As an alternative to transferring the accounts to the trust, practitioners should consider whether the planning goals can be achieved by keeping the accounts in the settlor's name and naming the trust as a beneficiary.

Partnerships, LLCs, and Closely Held Corporations

The governing documents for a business, such as the partnership agreement, operating agreement, or shareholder's agreement, may contain provisions that address whether a transfer of the business interest to a trust is permissible, or whether consent from the other owners is required. A transfer without proper consent could give the other owners the right to purchase the transferred interest, or a transfer may cause the interest to become a non-voting interest.

The transfer of a partnership interest or LLC interest is typically accomplished by preparing an assignment. Corporations have stock certificates, so the existing stock certificate should be submitted to the company and a new certificate issued in the name of the trust.

Strict federal rules regarding ownership of stock in Subchapter S corporations permit only certain trusts to hold S corporation stock. A revocable trust is a grantor trust for income tax purposes and therefore can hold S corporation stock if the grantor is a U.S. citizen or U.S. resident. After the grantor's death, the trust is permitted to hold the S corporation stock for up to two years from the grantor's death without terminating the S corporation's status.[12] If the stock needs to remain in trust beyond that time, consult the S corporation rules for possible elections to keep the assets in trust and maintain the S corporation status.

Tangible Personal Property

A bill of sale can be prepared to transfer untitled personal property to the trust, such as household items. To transfer vehicles to the trust, they need to be retitled with the Department of Motor Vehicles. The settlor should advise the property insurance carrier of the change of ownership so that the policies can be updated.

Operation During the Settlor's Life

The trust permits distributions to the settlor and may permit distributions to others, such as the settlor's spouse and dependents. While the trust remains revocable, the trustee's duties are owed exclusively to the settlor, unless the trust agreement provides otherwise.[13]

The revocable trust is essentially an alter ego of the settlor. As noted above, the trust uses the settlor's social security number, and transfers to the trust by the settlor are not completed gifts for gift tax purposes. The trust's income is reported on the settlor's income tax return (Form 1040), so any distribution to the settlor is a non-tax event. However, distributions from the trust to others are treated as gifts if they would have been gifts if made directly by the settlor.

Because the trust is amendable and revocable, the trust agreement may have amendments that amend only portions of the trust, or restatements that completely restate the terms of the trust. In either case, the existence of the trust itself continues. Therefore, assets titled in the trust should not need to be retitled upon an amendment to the trust agreement.

The revocable trust does not provide the settlor with creditor protection benefits. Settlor's creditors can reach the trust assets to the same extent they could reach assets in the settlor's name.[14]

The revocable trust is also not a planning tool to qualify the settlor for Medicaid. In fact, any assets of the trust will be countable in determining the settlor's qualification for Medicaid, even if those assets would have been exempt assets if they were titled in the settlor's own name (such as a residence with equity up to a certain amount).[15]

One reason the settlor might create a revocable trust is to provide a mechanism for someone else to manage the settlor's assets if the settlor becomes incapacitated. The settlor may start out as the trustee and name a successor trustee to take over in case the settlor becomes incapacitated. A variation on this arrangement is to create the trust with the settlor and someone else as co-trustees, so that the co-trustee is already in a position to administer the trust. With co-trustees, it is important to specify whether they must act jointly or may act independently in making decisions.[16]

Operation Following the Settlor's Death

Death is an event that triggers several changes to the trust's operation and imposes obligations on the trustee. The trustee is often, but not always, the same person as the personal representative. It is important for the trustee and the personal representative to coordinate in carrying out the required tasks after the settlor's death. Some obligations imposed on the trustee were changed by the Colorado Uniform Trust Code, which became effective January 1, 2019.[17]

If the settlor was serving as trustee, a new trustee steps in as trustee. The trust agreement should designate a successor trustee. Otherwise, CRS § 15-5-704(3) provides for filling the vacancy. The successor trustee will need a death certificate and may need to provide a copy of the trust (or portions of it) to show that the successor has stepped in as trustee. Banks and investment companies typically require their own forms to be completed for the trustee to verify the trustee's authority, and they may require a certificate of trust.[18] In Colorado, to transfer real property held by the trust, the trustee must convey the property by deed and record a Statement of Authority in the real property records for the relevant county.[19]

The trust should not continue to use the settlor's social security number. Shortly after the settlor's death, the trustee should obtain a new taxpayer identification number from the IRS.[20]

Notice Requirements

Following the settlor's death, the new trustee must comply with notice requirements to beneficiaries, including:

1. The trustee has the option to provide notice pursuant to CRS § 15-5-604, which limits the time period to contest the validity of the trust to 120 days. A copy of the trust instrument must be sent with the notice. If the notice is not provided, a three-year time period to contest the trust's validity applies.[21]
2. Within 60 days after accepting a trusteeship, the trustee must notify the qualified beneficiaries of the acceptance and provide the qualified beneficiaries with the trustee's name, address, and telephone number.[22]
3. Within 60 days after the trustee learns that a formerly revocable trust has become irrevocable, whether by the death of the settlor or otherwise, the trustee must provide notice to the qualified beneficiaries with certain information about the trust, as set forth in CRS § 15-5-813(2)(c).

Each statute has particular requirements about the information that must be included. All of these notices can potentially be consolidated into a single notice.

Collection of Assets

An important role for the trustee after the settlor's death is the collection of assets. If the trust already holds assets, the trustee should inventory and secure these assets. For example, if the trust owns a house and personal property, the trustee should secure these assets by, for example, changing the locks on the house.

If the trust is named as beneficiary of assets, the trustee should contact the custodian to claim those assets. The trustee should be especially cautious with collecting retirement assets (such as IRAs and 401(k) plans) and annuities. There may be options to defer withdrawal from these assets, and therefore defer the income tax due on them. These options should be considered before the funds are withdrawn from the accounts.

Additional assets may be added by the decedent's will. If probate is opened, the personal representative will handle the transfer of probate assets to the trust. If no probate is opened, the trustee can collect the assets using a small estates affidavit if the probate assets are under the small estates limit (currently $68,000) and do not include real estate.[23] Any assets that are already held by the trust or with the trust named as beneficiary are not probate assets.

Creditor Claims

It is also important to understand how creditor claims work after death. These differ based on whether probate is opened.

If probate is opened, the decedent's creditors can present claims to the personal representative, or file them with the court, within the creditor claims period.[24] The creditor claims period is a date set in the notice by publication that is at least four months after the first date of publication.[25] However, notice to known creditors of the four-month bar date must also be given by mail to effectively limit claims by known creditors to the four-month bar date.[26] If the four-month bar date does not apply, all claims must be presented no later than one year from the decedent's death.[27] If the probate estate is not sufficient to pay the claims, the claimant can require the personal representative to recover assets from the trust to pay the claims.[28]

If no probate is opened, the decedent's debts are not legally required to be paid by the estate or the trust (unless the trust agreed to pay the debt). Therefore, absent probate, debts such as hospital bills and credit card bills may go unpaid even though the trust has sufficient assets to pay them. However, creditors are not without recourse. Forty-five days after the decedent's death, any creditor of the decedent has priority for appointment as personal representative.[29] Therefore, the creditor could petition to open probate and present its claim.

Note that if probate is not opened there is no way to run the four-month bar date, so the one-year bar date will apply. This is a potential disadvantage of avoiding probate.

There are some important caveats to a creditor's ability to reach trust assets. First, a secured creditor can recover against the secured asset regardless of whether a probate estate is opened and a claim is presented.[30] Second, if the trust itself incurs a debt, the creditor is not barred by the probate claims process because the claim is against the trust rather than the estate.

Taxes and Tax Returns

Various tax forms may be required to be filed and taxes paid following the settlor's death. For federal estate tax purposes, the trust assets are includable in the settlor's estate. If a personal representative is appointed, the personal representative has the obligation to file the estate tax return. If the personal representative and trustee are not the same person, they should coordinate reporting the trust assets on the return and determine if any estate tax is due from the revocable trust. The will and trust may direct the allocation of the payment of the estate tax. The Colorado Uniform Estate Tax Apportionment Act should also be consulted.[31] Further, there are estate tax reimbursement provisions in the Internal Revenue Code that may allow or require the executor to recover estate tax from assets passing outside of the will and trust.[32] If no personal representative is serving, the trustee is usually the "executor" in the eyes of the IRS, and has the obligation to file the estate tax return.[33]

Income up to date-of-death is reported on the decedent's federal income tax return (Form 1040). As with the federal estate tax return, if no personal representative is serving, the trustee may be responsible for filing the Form 1040.[34] Income after date-of-death is reported on a fiduciary income tax return (Form 1041). An election known as the "645 election" can be made to report the trust income on the estate's Form 1041.[35] If this is done, the trust uses the estate's fiscal year, which may or may not be a calendar year. Otherwise, the trust uses a calendar year.

In addition to federal estate tax, some states also impose estate tax or inheritance tax. Colorado does not impose estate tax, but if the decedent resided in another state or owned property in another state, state estate tax or inheritance tax may apply.[36]

The trustee must determine what state income tax requirements may apply. Different states use different methods to determine whether a trust is subject to income tax in that state as a "resident trust." Colorado taxes trusts as resident trusts if the trust is administered in Colorado.[37] In contrast, other states consider a trust to be a resident trust if the grantor resided in the state when the trust was created or when the grantor died.[38] For example, Illinois employs the latter rule.[39] However, even if a trust is not taxed as a "resident trust" the "source income" from that state may be taxed.[40] Other states impose no state income tax on trusts.[41] Because of these different rules, the trust may be subject to income tax in more than one state, or conversely, may escape state income tax entirely.

Distributions

Before making distributions, the trustee should be sure to account for all claims, taxes, and expenses that will be due from the trust. In this regard, the trustee should consider the creditor claims period, as discussed above.

Upon termination or partial termination of a trust, the trustee may provide a notice of proposed distribution, giving the beneficiaries 30 days to object to the proposed distribution.[42]

Various issues can arise with distributions. For example, if the trust devises a certain asset to a specific person, and the asset was disposed of before death, there is a question whether the devisee receives a substitute devise. This is an ademption issue governed by CRS §15-11-606, Colorado's non-ademption statute. This statute applies to wills but addresses this question because CRS §15-5-112 provides that rules of construction applicable to wills also apply to trusts, as appropriate.

Another question that can arise is what happens to a share left to a person who predeceases the settlor. Colorado's antilapse statute applicable to trusts may provide for that person's share to pass to his or her descendants, depending on the person's relationship to the settlor and whether the trust overrides the antilapse statute.[43]

If the trust leaves a specific dollar amount to a certain person, the trustee should determine whether that person is entitled to receive interest on that amount if it is not paid promptly. In the case of wills, CRS § 15-12-904 requires interest at the legal rate to be paid on devises in a will if not satisfied within one year after appointment of the personal representative, unless the will provides otherwise. Based on a comment to CRS § 15-1-406(1)(c), a similar rule applies to trusts. The legal rate is 8% per annum, compounded annually.[44]

Other Duties

Several statutes impose duties on the trustee, notably

- the Colorado Uniform Trust Code,[45] which includes the duty to administer the trust in good faith,[46] duty of loyalty,[47] and duty to inform and report;[48]
- the Colorado Uniform Prudent Investor Act,[49] which provides that the trustee must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust;[50] and
- the Uniform Principal and Income Act, which contains directions to the trustee regarding allocation of receipts to principal or to income.[51]

Practitioners should understand each of these duties.

Termination

In some cases, all assets will be distributed outright to the beneficiaries after all claims and expenses are addressed, tax returns are filed, and assets are sold (if applicable). The trust then essentially ceases to exist. If a Trust Registration Statement was filed, an Amended Trust Registration Statement should be filed to show termination of the trust.[52]

In other cases, irrevocable trusts are created under the trust agreement, such as for the settlor's spouse and children. The revocable trust should close (e.g., file a final tax return), but the subtrusts will continue, potentially for many years or decades. Therefore, the trust agreement continues to be relevant.

The trustee may wish to obtain receipts and releases from the beneficiaries to document each beneficiary's receipt of assets. However, for a trustee to limit the time period to commence an action against the trustee for breach of trust, the trustee should comply with CRS § 15-5-1005(1). That statute provides that a beneficiary may not commence an action against a trustee for breach of trust more than one year after the date that the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding.

With respect to funding subtrusts, such as trusts for the settlor's spouse and children that become effective at the settlor's death, many of the considerations that apply when the settlor dies also apply. For example, typically each trust will need a new tax identification number. The trustees of the subtrusts should revisit whether notice needs to be sent to the qualified beneficiaries. Also, trustees must consider the income tax implications for the trusts. For example, the trustee of the subtrust may not be the same as the trustee of the revocable trusts and may administer the subtrust in a different state, in which case different state income tax rules apply.

Conclusion

A revocable trust is often the cornerstone of the client's estate plan. It is thus critical to draft it carefully and tend to it properly during each phase of its existence. CL

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NOTES

1. This article does not address all considerations applicable to revocable trusts, nor does it address joint revocable trusts, although many of the points are applicable to joint trusts. This article also does not cover trusts that are irrevocable upon creation, such as irrevocable life insurance trusts (ILITs).
2. CRS § 15-5-602(1).
3. CRS § 15-5-602(3).
4. CRS § 38-30-108.5. *See also* Johns et al., *Orange Book Handbook* § 17.1.7 (7th ed. CBA-CLE Books, Supp. 2019).
5. Clark, "Which Deed Should I Use?" 48 *Colo. Law.* 34 (Jan. 2019).
6. Vail, Colorado Town Code, tit. 2, ch. 6, § 2-6-5.B.
7. Vail, Colorado Town Code, tit. 2, ch. 6, § 2-6-6.
8. Under the ALTA Owner's Policy (June 17, 2006), "insured" includes a grantee under a deed without consideration "if the grantee is a trustee or beneficiary of a trust created by a written instrument established by the [insured] for estate planning purposes." This provision does not specifically include a transfer to the trust rather than the trustee. Note that prior ALTA policies did not include this provision.
9. Johns et al., *supra* note 4 at § 17.1.14.
10. *Id.* at § 17.1.13.
11. *Id.* at § 17.1.8.
12. IRC § 1361(c)(2)(A).
13. CRS § 15-5-603(2).
14. *Pandy v. Indep. Bank*, 372 P.3d 1047 (Colo. 2016).
15. Johns et al., *supra* note 4 at § 25.5.5.
16. If the trust agreement does not otherwise specify, CRS § 15-5-703(1) provides that co-trustees who are unable to reach a unanimous decision may act by majority decision. This seems to require both co-trustees to agree when only two are serving.
17. CRS §§ 15-5-101 et seq.
18. CRS § 11-105-111.
19. CRS § 38-30-172.
20. For helpful information about how to complete the application to obtain a taxpayer identification number for the trust, see IRS Publication 1635.
21. CRS § 15-5-604(1)(a)(I).
22. CRS § 15-5-813(2)(b).
23. CRS § 15-12-1201.
24. CRS § 15-12-804.
25. CRS §§ 15-12-803(1)(a)(I) and 801(1).
26. CRS §§ 15-12-803(1)(a)(II) and 801(2); *Tulsa Prof.'l Collection Servs. v. Pope*, 485 U.S. 478 (1988) (published notice is not an effective bar to the claims of creditors known to the personal representative; the Due Process Clause of the Fourteenth Amendment requires that the creditor be given notice by mail or such other means as is certain to ensure actual notice).
27. CRS § 15-12-803(1)(a)(III).
28. CRS § 15-15-103.
29. CRS § 15-12-203(1)(f).
30. CRS § 15-12-809. *See, e.g.*, *In re Estate of Blanpied v. Robinson*, 393 P.2d 355 (Colo. 1964) (secured creditor may disregard the estate and proceed against the security).
31. CRS §§ 15-12-1401 et seq.
32. IRC § 2206 (recovery from life insurance beneficiaries); IRC § 2207 (liability from property over which decedent has a power of appointment); IRC § 2207A (recovery from property subject to a Qualified Terminable Interest Property election); IRC § 2207B (recovery where decedent retained an interest in the property).
33. IRC § 2203 (if no executor is appointed, qualified and acting within the Unites States, any person in actual or constructive possession of any property of the decedent is the "executor").
34. IRS Publication 559 at 4 (if no personal representative has been appointed and there is no surviving spouse, the person in charge of the decedent's property must file and sign the return as "personal representative"), https://www.irs.gov/pub/irs-pdf/p559.pdf.
35. IRC § 645.
36. For more information about state estate tax, *see* Spitz, "10 Estate Planning Considerations for Out-of-State Property," 45 *Colo. Law.* 53 (Aug. 2016).
37. CRS § 39-22-103.
38. Nenno, "Let My Trustee Go! Planning to Minimize or Avoid State Income Taxes on Trusts" at ¶ 1501.2 (Heckerling Institute on Estate Planning, University of Miami School of Law 2012).
39. 35 Ill. Comp. Stat. 405/2 (2016); Nenno, *supra* note 38 at ¶¶ 1501.3, 1501.4.
40. *See, e.g.*, CRS § 39-22-403.
41. Nenno, *supra* note 38 at ¶ 1501.1.
42. CRS § 15-5-817(1).
43. CRS § 15-11-706.
44. CRS § 5-12-101.
45. CRS §§ 15-5-101 et seq.
46. CRS § 15-5-801.
47. CRS § 15-5-802.
48. CRS § 15-5-813.
49. CRS §§ 15-1.1-101 et seq.
50. CRS § 15-1.1-102(a).
51. CRS §§ 15-1-401 et seq.
52. CRPP 8.6.