

## Family Enterprise Utilization of Revocable *Inter Vivos* Trusts

### Summary

*Inter vivos* trusts present owners of private and family enterprises a powerful estate planning tool. Among the compelling benefits of the *inter vivos* trust are:

- facilitates the professional management of the enterprise
- avoidance of probate in most cases
- avoidance of ancillary probate
- intergenerational business continuity
- trustee governed by “prudent investor rules”
- preservation of family control and management
- shields the confidentiality of the provisions of the trust
- accelerates estate settlement
- avoids commingling of assets
- preserves stepped up basis in separate property states
- facilitates fiduciary administration in incompetency
- limits beneficiary options to accord with settlor’s intent
- unlikely to be contested
- jurisdictions may be selected for optimal compatibility with objectives
- often the centerpiece of comprehensive estate and tax planning

### Background and History

This paper introduces the revocable *inter vivos* trust as a powerful tool for family enterprise estate management, and explains its compelling benefits. These benefits apply generally to closely held, non-public enterprises, for which “family enterprise” serves here as synecdoche.

The *inter vivos* trust was developed by Professor A. James Casner, of Harvard University, who first described the structure in his 1953 book, *Estate Planning*.<sup>1</sup> Casner became a persistent and scholarly advocate for revocable *inter vivos* trusts in presentations to the Massachusetts bar and law review articles. His advocacy ultimately overcame resistance within the legal community and by the end of his career the revocable trust had become a standard estate planning device in all states.<sup>2</sup>

Norman Dacey’s 1965 book, *How to Avoid Probate!* became a runaway best-seller, adding the phrase *living trust* to popular vocabulary. Dacey’s shrill advocacy was particularly hostile to the legal community, which he accused of “plundering” estates with “extortionate” legal fees, and being generally adversarial to the interests of their supposed clients.<sup>3</sup> Dacey’s book, and the cottage industry in living trusts which it spawned, served as a catalyst for probate reform. To date, however, the reforms have not deprived the revocable *inter vivos* trust of its advantage in bypassing probate. Probate remains costly, time consuming, and public.<sup>4</sup>

The *inter vivos* trust, also known as the living trust, grantor trust, and revocable trust, is created during the life of the settlor (or “grantor” or “trustor,” who is the original owner of the property, thereby “settling” his estate). The settlor then places property in the trust (“funding” the trust) by assigning title to each property to the trust. The trust property is also referred to as the *corpus, res*, trust principal, or trust estate. The settlor must also select a trustee, typically himself, and a successor trustee to manage the trust and distribute the trust’s assets following the settlor’s death or incapacitation. The trust document (or instrument) provides instructions to the successor trustee for the management and disposition of the assets upon his death or incapacitation. Through the terms of the trust instrument, the settlor identifies the beneficiaries for whose benefit the trust’s property is held, and to whom the trusts assets shall be distributed.<sup>5</sup>

The resultant *inter vivos* trust is revocable, and it may be modified and amended without limitation during the life of the settlor, after which it may not be revoked or altered. The settlor may retain extensive use of and control over the trust property without jeopardizing the trust’s validity.<sup>6</sup> Upon the death of the settlor, the trust estate is exempt from probate, though not from estate taxes. *Inter vivos* trusts are governed and interpreted by the laws of the state named in the trust document.

There are two methods for creating an *inter vivos* trust. A *declaration of trust* is used if the settlor is to become the trustee of the trust property. The death beneficiary is typically named as the successor trustee. At the settlor’s death, the successor trustee automatically takes over, without a court order, and distributes the property to the trust beneficiaries.<sup>7</sup> An *inter vivos* trust can also be created by a *deed of trust*, naming a third party as trustee. The settlor may opt be the co-trustee. However created, an *inter vivos* trust may be funded at the time it is created, or it may be left unfunded, with the intent of funding it at the settler’s incapacitation or death.<sup>8</sup>

The terms of an *inter vivos* trust may comprise all of the provisions of a will, and achieve all of the dispositive objectives of a will, without the necessity of probate. If some of a settlor’s non-probate assets do remain outside the trust, the settlor may designate the trust as a beneficiary, and also execute a will pouring over all probate assets to the trust (a “pourover” will). In so doing, the settlor will have consolidated under the trust instrument his dispositive plan for all his assets, functioning as the will did in the days before the proliferation of will substitutes.<sup>9</sup> The settlor may still require a will for non-dispositive purposes, such as appointing guardians for minor children.

The principal distinction between an *inter vivos* trust and a will is that a will is inactive until the time of death, while a trust may be funded and may actively manage trust assets during the lifetime of the settlor. Additionally, the period of time governed by a will is the six months to two years following death, whereas the trust may continue to be operative in perpetuity, or as long as state laws permit.<sup>10</sup>

### Applications and Advantages to Private and Family Enterprises

Perhaps the core attraction of *inter vivos* trusts to family enterprises is business continuity. The successor trustee’s fiduciary responsibility ensures the continued operation of the enterprise following the death of the settlor, for the benefit of the trusts’ beneficiaries. The enterprise need not be sold, taken public, nor must asset sales or divestitures be made in order to assure continuity as a going concern. The ownership of the capital shares of the

enterprise(s) continues to be held by the trust; it is only managerial control which devolves to successor trustees. By this technique the enterprise itself, not just the wealth it represents, is preserved for future generations.

Because trustees are governed by “prudent investor rules” in most jurisdictions, they can take an active role in managing the family enterprise, and are not limited to cautious, conservative investments, as would executors of wills, whom most courts consider “caretakers.” An *inter vivos* trust enables a trustee to handle the responsibilities of an ongoing business, including, *inter alia*, exercising options, borrowing money, and participating in acquisitions, divestitures, and reorganizations<sup>11</sup>

If the family enterprise comprises real property located outside the domiciliary state, any will passing title to that property must be probated in the state where the land is located. To avoid this “ancillary probate,” which may be cumbersome and expensive, land in another state can be transferred to a revocable *inter vivos* trust. Through this device, title to the land is transferred to the trustee prior to the owner’s death.<sup>12</sup>

But *inter vivos* trusts facilitate the management of a settlor’s enterprise during his life as well, by assigning fiduciary responsibility to a professional trustee with access to broad professional services. While the settlor may retain trusteeship, it is common to appoint a co-trustee either to augment professional expertise (e.g., real estate management), or as a contingency against incapacity.<sup>13</sup>

*Inter vivos* trusts enable a trustee to disburse income and principal to beneficiaries much more quickly than would be possible under a probated will. A typical family enterprise estate may take eighteen months to two years to settle. An *inter vivos* trust may be settled immediately.<sup>14</sup>

*Inter vivos* trusts protect the privacy of the private company. Whereas probate is a court procedure, with wills entered into the public record, *inter vivos* trusts avoid probate, and, in most cases avoid public disclosure of the terms of the trust. This is because it is only the control of the trust property which changes upon the death of the settlor, not ownership.<sup>15</sup> Tax calculations must be disclosed, but tax records are confidential.<sup>16</sup> There are various ways in which the confidentiality of an *inter vivos* trust may be pierced, and they are addressed under the *Legal Considerations* caption, below.

*Inter vivos* trusts are useful in isolating family enterprise property which the settlor does not wish to become commingled with other assets unrelated to the enterprise. In fact, family members may wish to establish separate revocable trusts to prevent ambiguities of ownership from developing after death or divorce.<sup>17</sup>

*Inter vivos* trusts facilitate fiduciary administration in the event of incompetency. Even the modern Uniform Probate Code stipulates an elaborate court procedure protecting the alleged incompetent.<sup>18</sup> In this application, the *inter vivos* trust provides an alternative to a durable power of attorney, with the exception that the trust survives the death of the settlor.

*Inter vivos* trusts are less likely than wills to be contested. As with a will, the *inter vivos* trust can be contested for lack of mental capacity or for undue influence. In practice, however, it is more difficult to set aside a funded revocable trust than a will on such grounds. In the first place, the heirs of the decedent are not entitled to see the trust

instrument, which is not a public document, and which is available only to the trust beneficiaries. If the heirs bring suit, they will be able to learn the trust terms, but in doing so they are placed in the position of committing to legal and court expenses without a prior appraisal of their chances of prevailing. Moreover, if a trust has continued as an ongoing operation for several years, owning the capital stock of a family enterprise, generating monthly statements, selling assets, and handling reinvestments, a jury or a court would be reluctant to set the trust aside. Accordingly, if a will contest is foreseen, creating a revocable trust of the client's assets may be advisable.<sup>19</sup>

An *inter vivos* trust can be particularly useful in cases where the settlor wishes to pass control of the family enterprise to a spouse as a successor or co-trustee, but does not wish to accord authority for the disposition of family enterprise assets to the surviving spouse. This can be accomplished by making the trust revocable until the first spouse dies, and irrevocable thereafter.<sup>20</sup>

### Tax Considerations for Family Enterprises

There are no federal tax advantages to a revocable *inter vivos* trust *per se*; the assets of the trust are included in the gross estate of the settlor.<sup>21</sup> However, when such trusts are created as part of a comprehensive family enterprise estate and tax planning program, they can achieve virtually all the estate tax minimization objectives of other instruments. An example is combining an "AB trust" with the *inter vivos* trust.<sup>22</sup>

Under the federal income, gift, and estate tax codes, assets in a revocable trust are treated as still owned by the settlor. When the revocable trust is created, it is not treated as a completed gift to the beneficiaries under the federal gift tax. Because of the retained power to revoke, trust income is taxable to the settlor regardless of to whom it is paid.<sup>23</sup>

Spouses who move from a community property state to a separate property state may create a revocable *inter vivos* trust for their community property in order to obtain a stepped-up tax basis on all the property when one spouse dies.<sup>24</sup>

### Legal Considerations for Family Enterprises

No particular form of words is necessary to create a revocable *inter vivos* trust. The words "trust" or "trustee" need not be used. The sole question is whether the grantor manifested an intention to create a trust relationship.<sup>25</sup> As long as the trust creates some interests in some category of beneficiaries, courts will recognize a valid nontestamentary trust even though the settlor retains extensive powers. Another factor in determining whether an *inter vivos* trust exists is the formality of the transaction. In the landmark case of *Farkas v. Williams*, the appellate court upheld the validity of the trust, noting that it had been created in a "solemn and formal manner."<sup>26</sup>

*Inter vivos* trusts do not benefit from the short term statute of limitations on creditor claims, which is provided by probate. Under probate, if creditors do not file claims within a short period after the testator's death, the creditors are forever barred. Thus, where it is important to cut off the rights of creditors, as might be true with professionals such as doctors or lawyers where the statute of limitations on malpractice runs from discovery, probate holds an advantage over the revocable trust.<sup>27</sup>

A poulover will incorporate the revocable *inter vivos* trust by reference, and by making it part of the probated record, exposes it to public scrutiny.<sup>28</sup> Poulover wills should be avoided in cases where confidentiality is of paramount importance. It should also be noted that the poulover will refers to the trust instrument as it is comprised at the time the poulover will is executed, and therefore probate assets are disposed of without regard for amendments to the trust instrument made subsequent to the will's execution.<sup>29</sup>

In the event that the trustee of an *inter vivos* trust finds it necessary to incur a mortgage, or to modify the terms of an existing mortgage of trust assets, a mortgagee would typically require the recording of the trust instrument. Such registration clearly serves the purpose of making the terms of the trust instrument public.<sup>30</sup> Such piercing of confidentiality may conflict with the settlor's intent in creating the trust, and should be carefully considered.

As mentioned above, heirs may also pierce the trust's confidentiality if they were to bring suit. This option may not be likely, however the settlor and the beneficiaries should be aware that confidentiality is not a certainty.<sup>31</sup> Similarly, in some states, registering the contents of a trust, such as real estate, securities, or a safe deposit box creates a public record of its contents, piercing confidentiality. Nominee trusts may be employed to shield the trust from public scrutiny.<sup>32</sup>

The revocable *inter vivos* trust may not shield trust assets from spousal "elective share." In many states the surviving spouse is given by statute an elective share in the decedent's probate estate only. The elective share does not extend by statute to revocable trusts created by the decedent spouse. Even so, courts in many jurisdictions, exercising "equity powers," have permitted the surviving spouse to reach the assets in a revocable trust created by the decedent spouse. As equity powers vary by state, it may be possible to create a funded revocable trust in a state not recognizing the spouse's right to reach the trust, and thereby defeat a spouse's elective share. Similarly, an *inter vivos* trust may be used to put assets beyond the reach of an illegitimate child, protected by a "pretermisison" statute, whom the settlor does not wish to mention in his will. Pretermisison statutes apply only to probate property.

Creditors, too, may reach trust assets over which the settlor had control at the time of his death. It was held in *State Street Bank and Trust Co. v. Reiser* that where a person places property in trust and reserves the right to amend and revoke, or to direct disposition of principal and income, the settlor's creditors may reach, in satisfaction of the settlor's debts to them, those assets owned by the trust over which the settlor had such control at the time of his death as would have enabled the settlor to use the trust assets for his own benefit. However, assets which pour over into such a trust as a consequence of the settlor's death over which the settlor did not have control during his life are not subject to the reach of creditors.<sup>33</sup>

The settlor of an *inter vivos* trust can create a trust in one of the states with a relatively permissive "period of perpetuities." Delaware, Illinois, Maine, New Jersey, Rhode Island, South Dakota, and Wisconsin, for example, have abolished the application of the "Rule against Perpetuities" to trusts, providing the trustee has the right to sell the trust assets. A "perpetual dynasty trust" for the settlor's descendants, which incurs no federal estate or generation-skipping transfer taxes at the expiration of each generation, can be created in these states. Persons domiciled in other states can take advantage of these permissive laws by creating *inter vivos* trusts in these states.<sup>34</sup>

Proper drafting is essential to ensure that the trust is not subject to challenge by being either “testamentary” (created at the death of the settlor), or “illusory” (a fraudulent trust). The “illusory transfer test” and the “intent to defraud test” are the most widely adopted of the judicial tests for subjecting non-probate property to the elective share. The Uniform Probate Code introduces the concept of the “augmented estate,” comprising both probate and specified *inter vivos* transfers made during the marriage.<sup>35</sup>

To avoid the uncertainties attendant to beneficiaries predeceasing the settlor, it is important to name “contingent beneficiaries.”<sup>36</sup> However, if the court determines that the settlor truly intended to create a trust but failed to name a trustee, a court will appoint a trustee to carry out the trust. This rule is sometimes stated: *a trust will not fail for want of a trustee.*<sup>37</sup>

### Compound Trusts

Most *inter vivos* trusts for family enterprises will be created in combination with other trusts designed to achieve objectives in addition to avoiding probate. Some of the obvious examples are as follows:<sup>38</sup>

Qualified Subchapter S Corporation Trust	Avoids double taxation of dividends
Grantor Retained Annuity Trust	Reduces the accounting valuation of gifts in two ways, enabling more efficient gifting. Also produces positive cash flow for grantor. GRATs are used only for beneficiaries who are lineal descendants of the grantor.
Intentionally Defective Irrevocable Grantor Trust	Employs the tax code to oblige the grantor to cover the trust’s income tax, thereby increasing the effective benefit of gifting and enhancing trust economics.
Voting Trust	Used principally with divorce, it prevents a potentially disgruntled spouse from voting shares contrary to the interests of the family enterprise, while transferring value in accordance with <i>equitable distribution</i> .
Charitable Remainder Trust	Can be used to convert highly appreciated, non-dividend paying capital stock into a diversified portfolio of income-producing assets without triggering capital gains.

### Disclaimer

Nothing in this article shall be construed as an offer to sell, create, structure, or document a trust. To create a trust, please consult a reputable trust company and a qualified attorney.

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## Endnotes

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- <sup>1</sup> Estate Planning, A. James Casner, Harvard University, 1953
- <sup>2</sup> Wills, Trusts, and Estates, Jesse Dukeminier and Stanley M. Johanson, Aspen Publishers, 2000, p. 386
- <sup>3</sup> How to Avoid Probate!, Norman F. Dacey, Crown Publishing, 1979, p. 15
- <sup>4</sup> Dukeminier, *Ibid*, p. 361
- <sup>5</sup> Estate Planning Basics, Denis Clifford, Nolo, 2002, pp. 5/3-5
- <sup>6</sup> Dukeminier, *Ibid*, p. 387
- <sup>7</sup> Dukeminier, *Loc. Cit.*
- <sup>8</sup> Dukeminier, *Loc. Cit.*
- <sup>9</sup> Dukeminier, *Loc. Cit.*
- <sup>10</sup> [www.illinoislawyerfinder.com/publicinfo/livingtrusts.html](http://www.illinoislawyerfinder.com/publicinfo/livingtrusts.html), p. 2
- <sup>11</sup> Dukeminier, *Ibid*, p. 390
- <sup>12</sup> Dukeminier, *Ibid*, p. 391
- <sup>13</sup> Guide to Wills and Estates, Second Edition, Brett Campbell, American Bar Association (ABA), Random House Reference, 2004, p. 114
- <sup>14</sup> Dukeminier, *Ibid*, p. 390
- <sup>15</sup> ABA, *Ibid* p. 115
- <sup>16</sup> Dukeminier, *Ibid*, p. 390
- <sup>17</sup> Dukeminier, *Ibid*, p. 388
- <sup>18</sup> UPC §5-406
- <sup>19</sup> Dukeminier, *Ibid*, p. 395
- <sup>20</sup> Dukeminier, *Ibid*, p. 394
- <sup>21</sup> Internal Revenue Code §2038
- <sup>22</sup> Clifford, *Ibid*, p. 5/8-9, pp. 9/6-14
- <sup>23</sup> Internal Revenue Code of 1986 §676(a)
- <sup>24</sup> Dukeminier, *Ibid*, p. 388
- <sup>25</sup> Dukeminier, *Ibid*, p. 567
- <sup>26</sup> Farkas v. Williams, 5 Ill. 2d 417, 125 N.E.2d 600 (1955)
- <sup>27</sup> Dukeminier, *Ibid*, p. 390
- <sup>28</sup> [www.oag.state.ny.us/seniors/living\\_trust.html](http://www.oag.state.ny.us/seniors/living_trust.html) (OAG), p. 2
- <sup>29</sup> Dukeminier, *Ibid*, p. 372
- <sup>30</sup> OAG, *Ibid*, p. 2
- <sup>31</sup> OAG, *loc cit*
- <sup>32</sup> ABA, *Ibid*, p. 115
- <sup>33</sup> State Street Bank & Trust Co. v. Reiser, 7 Mass. App. Ct. 633, 389 N.E.2d 768 (1979)
- <sup>34</sup> Dukeminier, *Ibid*, pp. 392-3
- <sup>35</sup> Dukeminier, *Ibid*, pp. 505-507
- <sup>36</sup> ABA, *Ibid*, p. 113
- <sup>37</sup> Dukeminier, *Ibid*, p. 560
- <sup>38</sup> The Complete Book of Trusts, Third Edition, Martin Shenkman, 2002, John Wiley & Sons, Inc., pp. 239-252.