

PROBATE VERSUS TRUSTS: WHY ALL THE FUSS?

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I have recently been bombarded by newspaper, magazine and radio ads extolling the virtues of a living trust. According to these ads, a living trust is the solution to everyone's estate planning needs. Although it is true that a living trust has several benefits, it is not the panacea for an allegedly inevitable and costly probate experience. This paper will discuss those benefits and compare them with a typical Probate experience in Connecticut.

First, what is a living trust? A living trust is a written document that you create with your lawyer during your lifetime. You may choose to fund it during your lifetime, or leave it unfunded until your death. By "fund it," I mean that you actually make it the legal owner of your assets, some or all of them, it is up to you to decide. For example, you might choose to retitle your bank accounts, brokerage accounts, or even your house into the name of your trust. If you do so, you will no longer be the owner of those assets-- the Trustee of your trust will be the owner.

Your trust will contain provisions for management of the transferred assets during your lifetime and will include, as well, what happens to those assets upon your death. In the latter regard, it functions as a Will substitute. The trustee will administer the trust in accordance with its terms. Most often you, the creator of the trust, will be the trustee, although sometimes the creator will name a spouse, child or bank as a Co-Trustee. If you are the only Trustee, then you will name a spouse, child or bank as your successor trustee to serve upon your death or disability.

A living trust is revocable, meaning that you can end it at any time. You, as the creator of the trust, reserve the right to amend it, revoke it, change the trustee, and generally alter the trust however you please. Because you retain such rights, you are treated by the Internal Revenue Service as if you still owned the property in the trust. Therefore, you will report on your Income Tax Return, Form 1040, any income generated by the transferred assets. And, so long as you are a Trustee or Co-Trustee of your trust, the trust will not have to file a separate income tax return. If you are not the Trustee or co-Trustee, the trust will have to file an information return, but you still report the income on your Form 1040.

In addition, because the trust is revocable and you can obtain access to all the assets at any time for any reason, then, upon your death, any assets in the trust will also be included in your gross estate for death tax purposes. This is an important point--a living trust does not of itself save any death taxes. Whatever death tax savings can be achieved in a Will can also be achieved in a living trust. One does not have a death tax advantage over the other. For this reason as well, there is no minimum net worth or wealth that is necessary to consider a living trust.

The revocability of a living trust by you, its creator, means that a living trust, in terms of your control over the assets, is no different than if you owned them

outright. A living trust is, in essence, your personal checkbook-- you can do with the assets whatever you wish. Although the trust is the legal owner, the IRS treats you as the owner because you really have not parted with control--you can take the assets out of the trust for your personal use at anytime and for any reason. You suffer no loss of control or of income.

So why create a living trust--what have you accomplished?

First, those assets that you have transferred to the trust prior to your death will avoid probate. A primary purpose of a Probate Court when someone dies is to facilitate the transfer of title from the person who died to the beneficiaries. In the case of a funded living trust, the trust, which is the legal owner of the assets, did not die and the Probate Court does not get involved. Upon the creator's death, the trustee of the trust will do with the assets whatever the trust says. The trust may say for example that upon its creator's death, that the Trust ends and the assets be distributed by the Trustee to the beneficiaries or the Trust may say that it continues to hold the assets--it all depends upon what the creator of the trust said in the document. The bottom line-- Upon the creator's death, the trust serves as a will to the extent that it has assets in it.

Avoiding Probate means that the assets can be transferred immediately after death to the intended beneficiaries without delay. It does not mean, however, that the assets avoid death taxes, as discussed earlier, or that you avoid Probate Court fees. Probate Courts charge fees based on the size of the taxable estate, not on the size of the probate estate. Probate fees are one of the ways that the Probate Courts are funded to pay staff and operating costs.

Second, you have managed to keep your affairs private. Unlike a Will which is a public document that must be filed with the Probate Court at death, a living Will is private and is not available for inspection by the public at your death. I have found that this privacy element is seldom a motivating factor for using a living trust.

Third, the living trust will ensure that your assets are managed for your benefit in the event that you become incapacitated. Should you become either physically or mentally disabled, then, if your assets are in a living trust, your successor trustee will continue to manage the trust and its assets in accordance with the terms that you established. There is no need to seek a conservator in the Probate Court and a probate Court, in the exercise of its discretion, can now refuse to appoint a Conservator if it feels other arrangements are in place, such as living trust, for the incapacitated person.

You should realize the above benefits only if you actually fund your living trust. Some people will create a terrific living trust and not fund it, either intentionally or by accident. If it is intentional, the person likely has a "pour over" Will so that in the event the person owns any assets in their name at the time of their death, their "pour-over" Will, which was prepared as a part of their estate plan, provides that

those assets are to be added to the assets of the previously created, but unfunded, living trust, so that they will be distributed as provided in the trust. However, all such assets will be subject to probate at death before they are added to the trust.

Because any assets which you may own in your own name at the time of your death will be subject to probate at your death, even though they will ultimately be added to the assets held in the Living Trust, you should carefully and continually review those assets held in your own name (whether now owned or acquired later) to be sure that such ownership is appropriate in light of your desire to avoid probate at death.

A person who has created a living trust may choose not to fund it initially. They may decide to wait until such time as they are unable to manage their affairs and fund it at that point or to have someone holding their Power of Attorney fund it at that point. The decision to delay funding could also be an outgrowth of wanting to avoid the one time administrative steps that have to be taken in order to fund it (dealing with all the banks that hold your CDs, your brokerage account or individual companies, doing new deeds to your real estate etc.).

The two strongest arguments for using and funding a living trust are if you have out of state real property or a family that argues. For out of state real property, a living trust that holds such property will avoid the need to go through that state's probate procedures and paying a lawyer from that state to handle the probate, usually at considerable cost for just the one asset. If there is a second marriage or children who do not get along, then a living trust may be best (if your Trustee is faithful to your wishes) because it will be harder for one of the other potential beneficiaries to cause trouble for trouble's sake if they do not know what the trust contains or say--remember that it is a private document.

In summary, a living trust has very practical applications, but this does not mean that everyone needs one. It is a very flexible planning tool and has lifetime and post death applications. The decision to use a living trust cannot, however, be made in a vacuum--it must be viewed in light of your assets, wealth, and family relationships.

One of the benefits of a properly drafted and funded living trust is that it enables a person to avoid probate upon their death. Whether probate avoidance is a "good" or a "bad" thing is highly subjective. To answer the question, we need to first define exactly what probate is and then to overlay the process on your financial and family situation to determine whether probate avoidance is in your best interests.

In general, when a person dies the function of the probate court is the following: to ensure that, if there was a Will, it is the decedent's true last Will, and not a forged or revoked version; to ensure that the decedent's assets are safeguarded and protected from waste, theft, or neglect; to ensure that valid bills and debts are paid, including death taxes, if any, and; lastly to make sure that what remains is paid to the intended beneficiaries in accordance with the decedent's valid Last Will and Testament. In

summary, the purpose is to oversee the transfer of title of the decedent's assets from the decedent's name to the decedent's beneficiaries, making sure along the way that all the assets are accounted for and all the bills are paid.

The more important steps in the probate process are described chronologically below:

1. Application for Administration or Probate of Will. This is the first form filed with the Probate Court, giving the court all pertinent information about beneficiaries and family members. The original Will, if there is one, accompanies this form. After the court receives this form it will set a hearing to accept the Will and also to appoint an Executor of the estate. The Probate Court will issue certificates to the Executor. These certificates will evidence the Executor's authority to act on behalf of the estate. In many situations, the Will can be accepted and the Executor appointed without the need for a hearing or for anyone to go to the probate court at all.

2. Certificate for Land Records. If the decedent owned real estate, the probate court will give the executor this form to be recorded on the land records showing the decedent died and that, if the property was owned jointly, that the remaining joint owners now own the property.

3. About two months after the Executor is appointed, the Executor must file an Inventory of the estate's assets with the probate court. This Inventory will contain all assets held by the decedent in his or her name solely. The purpose of the Inventory is to show what assets are subject to the Court's jurisdiction--the court only deals with assets in the decedent's own name. Assets that are payable by beneficiary designation (life insurance and IRAs, for example) or that are held jointly (such as a bank account titled "husband or wife") pass outside of the probate process because the court's intervention is not needed to transfer title. In the case of jointly titled assets, title passes automatically at death to the surviving named account holders and for life insurance, for example, title passes when the insurance company signs and delivers the proceeds check to the beneficiary named.

4. Next, the Executor must determine what bills were owed at the decedent's death. This will include any medical bills, tax bills, alimony, mortgages, etc. These bills will be set forth on a Return and List of Claims, which the Executor files with the Probate Court. This form must be filed by the end of the fifth month following the decedent's death.

5. A Connecticut Succession Tax Return will need to be filed by the Executor six months from the date of death and any tax due must be paid at this time. This tax return will show all property, whether solely owned or jointly owned by the decedent, any pensions or trusts, any gifts that might have been given during the last three years, funeral expenses, burial expenses, and any other bills that you might have received. Although this tax return is not part of the probate process, it is filed with the probate court and the court forwards it to the State Department of

Revenue Services. A tax will be assessed against the net taxable estate reflected on the return.

6. Nine months after the date of death, a federal estate tax return (Form 706) may need to be filed, depending on the size of the estate, and any tax paid. This tax return will show, like the Succession Tax Return, everything in the estate and will include life insurance (which is not taxable by the State of Connecticut). This form is sent directly to the IRS who will then assess its own tax on the net taxable estate.

7. After the State and Federal taxing authorities have reviewed their respective tax returns, they will send the Executor an assessment which will show all taxes have been paid. Upon receipt of the assessment, the Executor can start to prepare a Final Accounting and Proposed Distribution of the estate. The final account shows all activity that occurred in the estate, using as the beginning balance, the total assets shown on the Inventory that was filed with the probate court at the start of the process. After filing the accounting and proposed distribution with the Court, a hearing will be held and the Court will accept the accounting and proposed distribution of assets to the beneficiaries. The executor will then distribute any remaining assets.

This ends the probate process. Was it long, lengthy or expensive? Were the assets "tied up" during this time?

The Executor may make distributions to estate beneficiaries prior to concluding the Probate Court process. For distributions made before the Executor files the state death tax return, you may need to obtain consent from the Connecticut Department of Revenue Services. You must always be careful, however, to retain sufficient assets to pay all creditors and any taxes (estate, income or otherwise) that may be found to be due. The Executor is personally liable if there is a shortfall. My practice is to make a cash needs projection early in the process, add a cushion to it to be safe, and to then assist the Executor in immediately distributing those assets that are not going to be needed for bills or other purposes.

The process is not a long one. The rule of thumb is that probate should take no longer than one year. During most of that time period, little work is being done-- usually the Executor is waiting for the 150 day claims period to end or is waiting until the last moment to file the death tax returns (why pay the government sooner than you have to). As mentioned earlier, the final account cannot be filed until there is evidence that all taxes have been paid. This often delays estates because it may take several months after filing the death tax returns to receive confirmation from the taxing authorities that the return is correct or to settle any disputes (such as over the value of real estate or the value of an interest in a family business) raised by the taxing authorities.

Probate is also not an inherently expensive process. In my practice I have found that probate becomes expensive for three reasons. The first is when the family was

dysfunctional to begin with and now that mom and dad have both died, the beneficiaries' (usually children) true nature is revealed and they argue over who gets what and how mom or dad always favored so and so. Items of relatively insignificant value take on added significance all of a sudden. In such disputes people tend to act in a manner not economically justified and end up hiring lawyers to resolve these matters, although the lawyers are often reluctant to get involved. Counseling is needed more than lawyering.

In any event, most of the costs incurred in probate, for accountants, lawyers, and appraisers, for example, result from tax issues that arise regardless of whether your assets avoid probate. These professional fees will result even if you use a living trust. Another fee that cannot be avoided is the probate court's fee. Probate courts in Connecticut are funded in part based on fees that they levy on a decedent's taxable estate. People who use living trusts have taxable estates as well and will have to pay a probate fee even though their assets pass outside of probate!

A second reason probate becomes expensive is because the named Executor is neither particularly trustworthy nor knowledgeable. The Executor "drags his feet" the entire time, tries to live in the decedent's house rent free for as long as he can, co-mingles his personal funds with those of the estate, fails to meet tax filing deadlines (thereby incurring interest and penalties), does not communicate with family members or beneficiaries (who then hire lawyers to find out what is going on which then forces the Executor to hire a lawyer), and for similar reasons. All of this delays the process and results in additional costs to everyone.

A third reason is due to an ambiguous or inconsistent scheme that the decedent left behind to dispose of his property. This can be due to a poorly drafted will (which is rare) or because the decedent had assets titled jointly with some children and not with others, but made promises to those other children that certain assets would pass to them under their will, but which don't end up passing to them. This is the classic "I have titled my \$100,000 bank account jointly with my daughter, but she knows that when I die she is to share it with my other two children." Right! This is a formula for trouble if ever there was one, unless there is very good trust among the entire family.

Assuming a harmonious family and a properly and thought out estate plan, there is no reason to fear probate. Probate may even be a beneficial process in that there is an independent and skilled entity, the probate court, overseeing the process to make sure that everything happens as you would like it to.

In summary, the probate process and probate avoidance through living trusts each have their pros and cons. There is no right or wrong solution. What matters most is that someone take the time to discuss with you how each method would work in your situation--what advantages of each might you gain from and what disadvantages of each might you suffer. This is where a lawyer who is versed in estate administration can play a valuable role.