ALL YOU NEED TO KNOW ABOUT LIVING TRUSTS AND PROBATE

By Attorney Paul T. Czepiga, JD, CPA

A. 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, friend or bank as a Co-Trustee. If you are the only Trustee, then you will name a spouse, child, friend or bank as your successor trustee to serve upon your death or disability.

B. Is a living trust revocable?

Yes, a living trust is revocable, meaning that you can end it at any time. You, as the creator of the trust (the "Grantor"), 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 personal 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. 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.

C. Can I reduce my estate tax liability with a living trust?

A living trust is revocable and because you can obtain access to all of 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.

D. What are the benefits of a living trust?

1. Avoiding probate

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. The Probate Court has jurisdiction only over an estate to the extent that a person owned assets in his or her sole name at the time of death. 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 grantor'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 grantor's death, that the Trust will end and the assets will be distributed by the Trustee to the beneficiaries, or the Trust may say that the Trustee will continue to hold the assets--it all depends upon what the Grantor stated in the document. The bottom line--Upon the Grantor'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 (See page ____). Probate fees are one of the ways that the Probate Courts are funded to pay staff and operating costs.

2. Privacy

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.

3. A planning tool for incapacity

A 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.

4. Out-of-state real estate

For out of state real property, a living trust owns such property, and as such, it will not be necessary to go through that state's probate procedures or to pay a lawyer from that state to handle the probate, usually at considerable cost, for just the one asset.

5. Family friction

If there is a second marriage, or if you have 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 says--remember that it is a private document.

E. How to reap the benefits of a Living Trust

You will realize the above benefits only if you actually fund your living trust. Some people will have 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 according to the terms of 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 either fund it at that point or have someone holding their Power of Attorney fund it. 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 stock certificates, doing new deeds to your real estate etc.).

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.

F. What about probate-is it so terrible?

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 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 of the assets are accounted for and that all of 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, and it gives 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. Filing the Inventory

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 of the 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" or "parent or child) 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 named beneficiary.

4. Liabilities

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 appointment of executor.

5. Connecticut Succession Tax Return

The Executor will need to file a Connecticut Succession Tax Return six months from the date of death, and any tax due must be paid at this time. This tax return will indicate 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. 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 Probate Court fee and a succession tax will be assessed against the taxable estate reflected on the return.

6. Federal Estate Tax Return

Nine months after the date of death, the Executor may need to file a federal estate tax return, depending on the size of the estate, and any pay any federal tax. This tax return will show, like the Succession Tax Return, everything in the estate, and it 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. The Final Account

After the State and Federal taxing authorities have reviewed their respective tax returns, and concluded that all inheritance taxes have been paid, they will send the Executor a statement that will show that all taxes have been paid. Upon receipt of the statement, the Executor can start to prepare a Final Accounting and Proposed Distribution of the estate for Probate Court purposes. The final account shows all of the activity that occurred in the Probate estate, using as the starting point, the total assets shown on the Inventory that was filed with the Probate Court at the beginning of the process. After filing the accounting and proposed distribution, the Court will hold a hearing and 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. If the Executor makes such advanced distributions before filing the state death tax return, it may be necessary to obtain consent from the Connecticut Department of Revenue Services. The Executor 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 Probate Court 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 creditor 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.

G. What makes probate expensive?

Probate is not an inherently expensive process. In my practice I have found that probate becomes expensive for three reasons.

1. Dysfunctional family

This is the situation 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 one child over another, etc. Items of relatively insignificant value suddenly take on added significance after the parents have died. In such disputes, people tend to act in a manner not economically justified, and they resort to retaining attorneys, although the lawyers are often reluctant to get involved. Counseling is often needed more than lawyering in such circumstances.

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. You will incur these professional fees if you use a Living Trust or a Will. 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!

2. Poor Choice for Executor

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.

3. Poorly-drafted Will

A third reason probate becomes expensive is due to an ambiguous or inconsistent scheme that the decedent left behind to dispose of his or her 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. This is the classic "I have titled my $100,000 bank account jointly with my daughter, so she can help me pay my bills, 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 person, the probate court judge, 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.

H. How to fund your Living Trust

Since one of the major purposes of using a Living Trust as the main dispositive instrument of an estate plan is to avoid probate of the assets of the trust at death, it is critically important that any assets as to which probate is to be avoided BE OWNED BY THE TRUSTEE OF THE REVOCABLE TRUST AT DEATH AND NOT IN THE GRANTOR'S NAME.

1. Your "Pour-Over Will"

As previously mentioned, if you have executed a Living Trust, you will also need to execute a "pour-over" Will. A pour-over Will provides that in the event that you own any assets in your name at the time of your death, those assets (other than tangible, personal property) are to be added to the assets of the trust, so that they will be distributed as provided for in the trust. However, all such assets will be subject to probate at death before they are added to the trust, unless, under the applicable state law in effect at the time of your death, they are of such nature or value that they are either exempt from probate or eligible for some form of summary probate proceeding.

Because any assets which you may own in your own name at the time of your death will be subject to probate, even though they will ultimately be added to the assets held in your 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 the time of your death.

Legal title (record ownership) of any assets as to which you desire to avoid probate at death, and which are therefore to be owned by the Trustee of your Living Trust, MUST BE TRANSFERRED TO THE TRUSTEE, either upon creation of the trust or some time thereafter, during your lifetime.

2. Transfer of Assets to the Trust

Specifically, with regard to transferring ownership of assets to a Trustee, please note the following:

a. Bank Accounts

With regard to any bank (or other savings institution) accounts or certificates, the name on the account or certificate must be changed to reflect its ownership by the Trustee, and a new passbook or certificate (if applicable) must be issued in that name. You should check with any such institution before attempting to transfer an account or saving certificate to verify that there will be no penalty for early withdrawal because of the transfer.

b. Corporate Stocks

Any corporate stocks (whether of publicly held or privately held corporations) or any mutual fund shares issued in certificate form must be registered in the name of the Trustee, and a new certificate or certificates issued reflecting that ownership. Please note that you may be able to combine all certificates representing shares of one corporation into one new certificate registered in the name of the Trustee of the trust. However, you might want to consider asking for a series of new certificates registered in the name of the Trustee, one corresponding to each old certificate, so that you will be able to trace your income tax basis in any shares which might be sold by the Trustee during your lifetime. Be aware too, that transfers made by using a Power of Attorney typically take longer because of the procedural safeguards insisted on by some transfer agents.

For corporate stock, bonds or mutual fund shares which are held in "street" name by a broker or in bookkeeping entry form, the name on the account must be changed to reflect its ownership by the Trustee. Many brokerage houses will request a copy of the Trust Agreement (or the first and signature pages only) before re-registering the account in the name of the Trustee.

c. Bonds

Any registered bonds or debentures (whether issued by a publicly held corporation, a privately held corporation, the United States Government, an agency, any state or subdivision thereof) must be registered in the name of the Trustee and a new bond or debenture reissued in the Trustee's name.

Unregistered or bearer bonds or debentures (typically issued by the United States government, an agency or a state or municipality) can generally be converted into registered form and a new bond and debenture issued in the name of the Trustee.

For unregistered or bearer bonds or debentures, which are not to be converted into registered form, there must be some other indication that they have been transferred to the Trustee in order to avoid probate of them at your death. Typically, this is done by executing and delivering to the Trustee a transfer document, listing the bearer securities being transferred to the Trustee, which is retained by the Trustee with the permanent records of the trust.

Any new such instruments ought to be purchased directly in the name of the Trustee, and the confirmation or other purchase slip retained with the instrument, to prove its ownership by the Trustee.

d. Tangible Investment Assets

A similar problem exists with respect to any tangible investment assets (such as gold bullion, silver coins, art objects, etc.) which are to be owned by the Trustee of your trust, since there is likewise no proof of registration or ownership of those assets. Their transfer to the Trustee ought to be handled by an instrument of assignment in the same way as bearer bonds or by a Bill of Sale for no consideration. Again, any new such investment ought to be made by the Trustee and the purchase confirmation in the Trustee's name retained to prove ownership.

e. Partnership Interests

Any partnership interest (whether in general partnership or in a limited partnership) must be registered in the name of the Trustee and a new certificate of partnership interest issued or an amendment to the partnership agreement be executed to reflect ownership of the interest in the name of the trustee. Be certain you or your client obtain a copy of the underlying partnership agreement and comply with any transfer restrictions.

Note that some partnerships will require that you pay for the preparation of the amendment and related certificate. In some cases, such fees are substantial and, accordingly, you should determine any such cost in advance of a transfer of a partnership interest to your trust.

f. Real Estate

With regard to real property or any interest in real property (whether your personal residence or investment real estate), legal title must be transferred to the Trustee by means of an executed, notarized and recorded deed. It is important to carefully comply with any state law requirements of the state where the realty is located in any such transfer.

Before transferring any such real estate, you should be careful to determine whether any existing mortgage or deed of trust secured by that real estate would be affected by the proposed transfer and specifically whether the proposed transfer would trigger any "due on sale" clause in the mortgage or deed of trust. If there is a mortgage or deed of trust, you will usually need the written consent of the holder of the mortgage or deed of trust before you can transfer the property to the trust. Alternatively you can send a letter to the mortgage holder explaining why you are transferring the property and stating that unless you hear otherwise in ten (10) days, you assume consent.

g. Life Insurance

Ownership of life insurance policies is generally not transferred to a revocable trust, but the death benefits under insurance policies can be made payable to the Trustee of your trust, if desired. You must obtain change of beneficiary forms from the insurance companies, fill them out, then execute and record them with the insurer to name the Trustee as the beneficiary.

I. Operation of the Trust

Once an asset has been transferred to the Trustee of a Revocable Trust, all transactions regarding that property must be handled by the Trustee. For instance, once corporate stock has been transferred to the Trustee of a Revocable Trust, only the Trustee has the legal power to sell, mortgage or assign those shares of stock or vote them at a shareholder's meeting.

You may transfer additional assets to the trust at any time after the initial transfer, either by purchasing and/or registering those assets in the name of the Trustee or by delivering them to the Trustee with appropriate instructions of transfer for re-registration in the Trustee's name (or other transfer documents if the asset is of a non-registered type).

You may withdraw property from the trust at any time, but only in accordance with the provisions of the trust. In addition, the trust can typically be amended in any way or can be revoked in its entirety; again, in either case, only by complying with the procedural requirements specified in the Trust Agreement.

As previously mentioned, because the Trust Agreement is revocable, you will be treated as the owner of the trust for income tax purposes. Accordingly, you will continue to report all items of trust income, deductions and credits as if the client had received or paid them directly. The trust will be ignored for income tax purposes. If the grantor is a Trustee or Co-Trustee, the trust will not have its own taxpayer identifying number (instead, it will use the grantor's social security number) and no tax return will need to be filed for the trust. If you are not the sole Trustee or a Co-Trustee of the trust, the trust will have its own identifying number and will be required to file its own tax return, but again, you will report all income and deductions-not the Trust.

J. What about Joint Living Trusts?

If you and your spouse execute a joint living trust, each of you will be a Grantor and a Trustee of the Trust. You need to be wary, however, of the differences between a joint living trust and an individual living trust.

1.Problems with joint living trusts

a. Unintended Estate and Gift Tax Consequences

Ordinarily, there are no gift or estate tax consequences when one spouse transfers property to the other because the IRS gives married couples to an unlimited marital deduction; this means that married couples can transfer (during their lifetimes or at death) any sum of money between each other (please note that the rules are different foreign spouses) without estate or gift taxes. The marital deduction may not apply in a circumstance where, if the surviving spouse is deemed incompetent, he or she will not receive any income, and may not dispose of that portion of the estate intended to qualify for the marital deduction.

If a husband and wife contribute property to a joint living trust (i.e., they fund it), and all of the property is commingled, all of the trust property may be included in the decedent spouse's estate if the spouses retain a power to revoke the entire amount of the trust property. This is not the result that the couple intended if there is potential estate tax exposure. This problem can be avoided by establishing separate shares within the joint living trust, and enabling each spouse to revoke only his or her contributed share, but, at that point you are defeating the perceived objective of having a joint living trust: you are not simplifying your estate plan like you thought you would.

b. Portion irrevocable upon first spouse's death

Many joint living trusts provide that, upon the first spouse's death, some, or all of the trust property becomes irrevocable. Although the surviving spouse may enjoy the trust property during her lifetime, if she does not have the power to appoint the property (i.e., in her own Will), there may be a completed gift to the remainder beneficiaries (the children) with the resulting gift tax consequences.

2. Benefits of a Joint Living Trust

a. Income tax advantages

If each spouse has a revocable living trust, when the first spouse dies, the surviving spouse receives as his or her tax cost basis in any property with capital gain consequences, the fair market value of such property on the date of death of the decedent spouse; this is referred to as a "step-up" in basis. This is beneficial to the surviving spouse if he or she plans to sell such property. The surviving spouse, however, still retains his or her own cost basis in the remaining property. If a joint living trust is drafted so that upon the first spouse's death the amount of the entire property is included in the decedent spouse's death, the surviving spouse will receive a step-up in cost basis as to the entire amount of the property in the Trust. This can be problematic, however, if the couple has estate tax exposure.