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THINK ABOUT IT

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PROBATE AND LIVING TRUSTS

Two of the most often used terms in estate planning are "probate avoidance" and "living trusts." This issue of THINK ABOUT IT, is intended to help you explain to clients why there is a probate system; the advantages of probate; why a revocable living trust does not necessarily save any gift, income, estate or generation-skipping transfer taxes; why a revocable living trust cannot assure total avoidance of probate; the privacy factor in avoiding probate; and the real cost of probate (including legal fees).

PROBATE DEFINED

In the narrowest sense, "probate" is merely the process of "proving" that a will is the valid last will and testament of a decedent. But in the broader scope, "probate" refers to the entire process of the court-supervised administration of an estate, from the initial probate of the will to the distribution of estate assets, and the official discharge of the personal representative of the decedent (i.e., the executor named in the will, or the court-appointed administrator if there is no valid will, or no executor is named in the will).

The degree (and, therefore, cost in terms of time and expenses) of court supervision (or whether there is any court supervision at all) varies greatly from state to state, and estate to estate. In some states, the probate of a will may take 15 or 20 minutes at the local courthouse (and may not even require a lawyer), if the estate is relatively small and uncomplicated. In other states, or if the estate is large and/or there are complicating issues, the probate of a will can require a lawyer, advance notice to heirs, court hearing(s), and may take 30 days or more to complete the process. Some states may not require court supervision for routine estate administration, and the personal representative can collect the estate assets, pay the debts and taxes, and distribute the estate assets without court approval. In those states, the parties go to court only if there is a question or dispute that the court must resolve. In yet other states, the personal representative (i.e., the executor or administrator of the estate) cannot sell assets or even pay debts without prior court approval. This is where the administration of an estate can be a slow, complex

process of seemingly endless court pleadings and proceedings. Furthermore, the probate process is particularly prone to complications and additional expenses and lengthy delays if the decedent owned properties in several states, or held assets outside the U.S., or had heirs or relatives domiciled outside the U.S.

Whether or not there is an advantage to "avoiding probate," therefore, depends to a great extent on the laws of the state in which the client lives (and dies). If the client lives in a state in which probate procedures are simple and inexpensive, it may not be worthwhile to spend the time and money to create and administer a trust during his or her lifetime. However, if he or she lives in one of the very few remaining states in which probate procedures can be complicated and expensive, a revocable living trust might be of great benefit.

WHY PROBATE?

In spite of what the general public may have been led to believe by those who pander to "probate phobia" in order to sell their probate-avoidance books, or to market their products and services, (e.g., "trust in a box"), the probate process (as it exists today) is neither a state-designed device of punishment, a means of enriching lawyers, nor a form of indirect tax.

In fact, there are a number of legitimate and positive reasons for the probate process. Knowing those reasons may help clients to understand why – believe it or not – the probate process is not necessarily something they want to avoid. And, more importantly, even with the use of revocable trusts, it may not be possible to avoid completely, all possible court proceedings.

The most important reason for probate is to make sure those individuals and/or entities that have possession of the decedent's assets, or owe the decedent money, are notified to whom to deliver the assets or payments. It provides the legal procedures and identification of the person with whom third parties (e.g., financial institutions, debtors, creditors, etc.) can – and must – deal when settling the decedent's financial affairs. As an example, in order for the "personal representative" (i.e., an executor or administrator) of an estate to take possession of the decedent's assets, he or she must present a "short certificate" (or other documents, such as "letters of administration" or "letters testamentary," issued by the proper court official) certifying his or her legal authority to do so. Likewise, a financial institution would only release the decedent's assets to someone with proper court document and be legally discharged of its liabilities to the estate/heirs.

It also serves to consolidate the process of settling the decedent's estate, so that conflicting claims can be sorted out and resolved in an orderly manner. In the event of disputes among heirs (e.g., the decedent's widow or widower, and children from a prior marriage), or conflicts between the decedent's family and his/her business associates, and/or claims of creditors, the parties would file

their claims with either the executor (executrix), or the administrator (administratrix) and the probate court. The probate court will decide among the conflicting claims; and the executor or administrator will be able to distribute estate assets accordingly without fear of incurring personal liabilities for his or her actions.

Another purpose of probate is to protect the interests of creditors, and make sure that estate assets cannot be distributed to beneficiaries unless lawful debts (including taxes) of the decedent have been paid. Note that life insurance and retirement benefits typically have not been a concern, because these assets generally are not subject to the claims of creditors. (See below for more discussion on creditor-related issues.)

Legal systems evolve in response to perceived problems. The perceived problems in the probate system have led many people to avoid probate through increasing uses of revocable trusts and other devices to hold their assets. But many courts and legislatures now see the same problems in revocable trusts that led to the creation of probate systems. As a result, many states now require court supervision or other probate-like procedures for living trusts regardless of the terms of the trust. (We predict that more states will do so.) Once a trustee comes under the supervision of a court, there is little (if any) difference between probate and "avoiding probate."

ADVANTAGES (POSITIVE SIDE EFFECTS) OF PROBATE

As discussed above, the probate court provides a forum to resolve disputes, but in some states it also serves as an advocate for the beneficiaries of the estate, while it guides and supervises the personal representative in winding up the decedent's affairs. The probate court is meant to serve as an objective, disinterested party that oversees and safeguards the interests of the beneficiaries. Many probate courts (sometimes called orphans' or surrogates' courts) require a full accounting of fees charged by lawyers and executors. In many cases, the courts have struck down or cut back what were considered exorbitant legal, or accounting, or executor's fees even if there were no objections from the beneficiaries.

Court supervision of an executor also protects the executor from the claims of beneficiaries. Adult beneficiaries can review the actions of an executor and then sign "receipts and releases" that approve the accounts of the executor, and release the executor from any further liability to them. However, minor beneficiaries (and beneficiaries who might be born in the future) cannot review the actions of the executor and/or sign legally binding receipts and releases. The probate court can act on behalf of the minor beneficiaries (or appoint someone to represent them, usually called a guardian or trustee "ad litem") so that the administration of the executor can be terminated, and he or she can be released from any further liability to any minor beneficiary as well.

On the other hand, in the case of a trust and absent a court proceeding, the trustee of a revocable living trust may have to wait for years before he or she knows whether minor trust beneficiaries have any objections to his or her handling of trust investments, disbursements, or distributions. Therefore, a trustee might choose to have court supervision or oversight, even if it is not required by law.

The probate process can therefore serve to protect both the beneficiaries and executor of the estate. If the client opts to "avoid probate," the estate beneficiaries will likely not have the protection of a readily available forum to present their claims, and they may lose the protection of court oversight to safeguard their interests. Similarly, the trustee(s) probably will not have the same protection from liabilities, if and when there are conflicting claims of creditors and beneficiaries,

Nevertheless, if the client decides to "avoid probate," consider adding a provision in the trust document that requires the trustee(s) to account in writing annually (or more frequently) to the beneficiaries for all income, expenses, and other disbursements, so that they will have an opportunity to review the actions of the trustee(s). It will also be prudent to specify that the beneficiaries can require the trustee(s) to account to the court if they suspect that the trustee(s) is (are) not carrying out his/her (their) duties properly or acting in the best interests of the beneficiaries.

CREDITOR-RELATED ADVANTAGES OF PROBATE

Aside from those advantages described above, one major advantage of the probate process is that claims of creditors are usually cut off after a stated period (typically from six months to one year) following the advertisement of the probate process. Usually, executors must notify known creditors directly and unknown creditors by advertising the decedent's death, typically in one legal newspaper and one local newspaper. Creditors must make their claims within the statutory time limit (called a "statute of limitations"); otherwise, they may lose some or all of their rights in the estate. Stated from a beneficiary's perspective, once the statute of limitations period has run, he or she can take a decedent's property without fear that a creditor can reach it.

The assets of a revocable living trust are generally subject to the claims of the decedent's creditors (including lifetime income taxes), as in the case of assets that are owned by the decedent and administered through a probate proceeding. Absent court supervision and procedural guidance, the trustee may become personally liable to the decedent's creditors if the trustee were to make distributions to estate beneficiaries before taxes and debts were paid.

Without the legal notices to creditors that fix the statute of limitations as required by probate law, the "clock" on claims of creditors may not run out for many years. For example, the statute of limitations might be six years without probate and notice to creditors, but only six months with probate and proper notice. The trust (and in some cases the trustee) could therefore be liable for many years longer than necessary. (However, some states may have procedures to cut off the claims of creditors even if there is no probate.)

REVOCABLE LIVING TRUSTS SAVE NO TAXES

Contrary to what some clients have been led to believe, a revocable living trust does not – by itself – save any income, estate, or generation-skipping transfer taxes. Any estate or generation-skipping transfer tax that can be saved through a well-drafted revocable living trust can also be saved through a well-drafted will, or through alternatives to living trusts (such as life insurance).

It is important to inform the client that a revocable trust that is "transparent" for income tax purposes during the grantor's lifetime does not save any taxes. Any assets transferred to the trust during lifetime will still be considered to be owned by the grantor for income tax purposes. Therefore, any income earned by the trust must be reported on the grantor's personal income tax return.

Similarly, each and every asset in the revocable trust at the grantor's death will be part of his or her "gross estate" for federal estate tax purposes (and for the purpose of any applicable state death tax). Any tax savings that might be generated through a revocable living trust will be the result of effective uses of additional planning tools such as credit shelter trust, marital deduction formula and marital trust(s) for married couples, generation-skipping transfer trust, charitable bequest, or charitable split-interest trust that takes effect at death. And a will can contain the same marital deduction formula and the same kinds of trusts (through "testamentary" trusts). Therefore, the property subject to death taxes will be the same whether or not the client avoids probate, and whether or not he or she sets up a revocable living trust.

THE IMPOSSIBILITY (ALMOST) OF TOTALLY AVOIDING PROBATE

For purposes of avoiding probate, a living trust will only work if the estate owner transfers to it the full legal title to all of his/her assets. After which, the estate owner must maintain property title in the trust, and continue to title new assets to the trust in order to avoid probate. In determining the benefits of avoiding probate versus the costs of a revocable living trust, the client must therefore take the following into consideration: the time, cost, and aggravation of titling and re-titling property currently owned (or might be acquired in the future) in his/her sole name, or his/her spouse's name, or joint names. In some states, the client may be required to pay real estate transfer taxes for transferring a home or other real estate into a trust – even though it is revocable and even though federal income tax law treats the grantor as the owner of trust assets.

Even if the client puts every asset he or she presently owns into a revocable living trust and keeps all of the assets titled in the name of the trust, there may still be assets at death that he or she does not own currently. For example, the client might have claims for unpaid wages or personal injuries that arose immediately before (or at) death and could not have been transferred to the trust. So, no matter what the client does or plans to do, the possibility of a probate proceeding cannot be entirely avoided.

Another reason why all court proceedings might not be avoided is because of the uncertainties that can arise when the client/grantor dies. If the client/grantor serves as the trustee of his or her revocable trust (as many advocates of living trusts recommend), then another trustee must take over after his or her death to pay any death taxes and distribute the assets in accordance with the trust terms.

How will banks, stock brokers, and other third parties know that the person who claims to be the successor trustee is really legally authorized to take over administration of the trust? If the third parties do not have a copy of the trust, how will they know that the trust document that is shown to them is really the trust document? Even if they have a copy of the trust on file, how will they know it has not been revoked or amended before the grantor's death?

In a probate proceeding, the court issues a document (called "letters testamentary," "letters of administration," or a "short certificate") that identifies the person who is legally entitled to take over the property of the decedent, and third parties such as banks and stock brokers can rely on those court documents. Some banks and brokers have had conflicts or troubles after delivering trust property to the person they thought was the successor trustee without any court certification and, as a result, many banks and brokers are starting to require court certification of successor trustees before delivering any trust property to them. Court certification of a trustee means the trust document must be filed in court and proven to be valid, a process that is almost identical to the probate of a will. A revocable living trust therefore "avoids probate" only as long as banks, stock brokers, title insurance agents, and others concerned with the title to property are willing to accept the authority of the successor trustee without any certification or approval by any court.

PRIVACY AND PROBATE

Privacy is a bona fide reason to avoid probate. Once a will is probated, it becomes public record and any inventory or account that is subsequently filed also may become part of public record. So both the identity of the beneficiaries and the assets passing under the will can be discovered by anyone who goes to the courthouse and requests that information.

However, it is an overstatement to say that a revocable living trust will provide complete privacy. For example, suppose real estate is transferred to or from the trust. A copy of the trust may have to be recorded along with the deeds at the local courthouse. So the trust document becomes a public record and, to that extent, the much-touted privacy advantage of a living trust may not exist. Financial institutions such as banks, stock brokerage firms, life insurance companies, and retirement plan administrators that deal with trustees may also demand a copy of the trust. Paradoxically, a trust intended to provide more privacy after the grantor's death may provide less privacy during lifetime, because the grantor might have to provide copies of the trust to many different people and institutions while he or she is alive, but could have kept his or her will a secret until death.

Another problem may arise if a trustee wants to resign and is unable to get (or is unwilling to accept) releases from all trust beneficiaries. The trustee might have to file a formal accounting with the court in order to obtain a complete release from all liabilities. In that case, the terms of the trust, the assets and liabilities of the trust become a matter of public record. Similarly, if there is any dispute between the trustees and beneficiaries, or among the beneficiaries, the trust and its financial history may become part of a court record and open to public disclosure.

The assumption that that all probate records are public while all trust records are private is incorrect. Some states have begun sealing inventories and other parts of probate records so that they are not available to the general public. Other states have begun requiring court filings for revocable trusts, with the result that the administration records of a trust may become as public as those records of an estate passing under a will.

In some states, inheritance tax returns may be a matter of public record, and the assets of a revocable trust and terms of the trust must be disclosed as part of the inheritance tax return. In those states, a revocable trust is completely useless as a technique to maintain privacy.

Finally, the entire issue of privacy may be overstated (or overrated) because, as a practical matter, the general public typically does not take much interest in probate records – unless the decedent is a celebrity or public figure such as a movie star, or politician, or known to be wealthy or notorious, or infamous. The client might, therefore, be disappointed to find that the disposition of his or her estate is not really of much interest to anyone outside of his or her family.

THE REAL COSTS OF PROBATE

The biggest "bogeyman" of probate is the purported costs. Here are the expected or projected costs for probating an estate:

- Filing fees for the petition for probate. These fees vary greatly from state to state (or even county to county within a state), but are rarely large enough to be a significant cost in the administration of an estate. Call the local probate court and request a written schedule of fees to find out.
- Bonding the executor. Many states require that personal representatives be bonded by an insurance company against mistakes or dishonesty by the personal representative. However, it is usually possible in an estate owner's will to waive the requirement that the executor post a bond.
- Filing fees for the inventory of estate assets. In almost all states, the personal representative (executor or administrator of the estate) must file a list of probate assets and their values. There is often a fee for filing this inventory with the court (although the fee is usually relatively small, or is included in the probate fee).

- Advertising the grant of letters. The personal representative must publicly advertise that "letters testamentary" or "letters of administration" have been issued, so that any outstanding creditors can file their claims against the estate – and the statute of limitations against creditors' claims begins to run. The cost of advertising is almost never more than a few hundred dollars, regardless of the size of estate.
- Executor's commissions. By law, an executor is allowed a fee or commission for his or her services. These fees may be set by statute or rule of court, or may be subject only to a standard of "reasonableness." Usually, an executor's fees are based on the value of the estate and the nature of the services rendered by the executor. However, there is often no fee paid when the executor is the surviving spouse, a child, or other beneficiary of the estate. So most estates pay no executor's commission at all. When compensation is paid to an executor (or trustee), the compensation is always subject to review by a court if any beneficiary objects to the amount of the compensation.
- Legal fees. These fees will also vary from state to state and from estate to estate. Like executor's commissions, legal fees are also subject to review by a court if any beneficiary objects to the amount of the fees. In a few states, the maximum amount of legal fees payable by an estate is fixed by statute, but most states tend to limit lawyers to what is "reasonable," based on the time spent by the lawyer, the nature of the services rendered, and other factors. Although it is usually not possible to administer an estate without an executor, it is often possible for an executor to administer a very small and simple estate without a lawyer.
- Accountant's fees. If an accountant is needed to prepare tax returns, prepare financial reports, or other tasks, the accountant's fees will be paid from the estate. The fees will obviously vary, depending on the tasks to be performed by the accountant and the size and complexity of the estate.
- Other expenses may include appraisal fees needed for inventories or tax returns, broker's commissions, and other expenses of selling real estate or other assets. Also included are investment advisor's fees, the expenses of operating any business owned by the decedent, casualty insurance premiums and property taxes, and other expenses of preserving, maintaining, and investing assets.

In some states, an executor may be able to obtain what is called "independent" or unsupervised probate. This would presumably reduce the costs compared to a trust.

The biggest expense in the total probate costs are typically the fees charged by the estate's executor and the executor's lawyer. If the executor is also the sole (or primary) beneficiary of the estate, then the issue of executor's commission is not important, because the money goes to the same person regardless of whether it is in the form of an executor's commission or part of the estate.

(Although it rarely makes sense for a beneficiary to take a commission, which is taxable income, unless the commission, deductible by the estate, somehow saves more in estate taxes than it costs in income taxes to the beneficiary.) Even when the executor is only one of the beneficiaries (such as one of three children), there are rarely disputes, because the executor either serves without compensation or the family is able to agree on a reasonable fee. To avoid any potential dispute or false expectations, the client might stipulate in his or her will that the executor would serve for a fixed fee, or without compensation, as the case may be.

It is only when the executor is a bank or other third party that careful consideration must be given to providing that the commission will fairly compensate the executor without undue cost to the beneficiaries. If the estate is complex and requires the executor to devote hundreds of hours to carry out his or her duties, and make difficult or potentially dangerous financial decisions, we suggest setting a reasonable hourly fee based on the services to be rendered and the selected person's expertise. If the executor is to be a corporate fiduciary such as a bank, obtain a written contract with the bank for handling the estate, and that fee schedule can even be incorporated into the will. (For very large estates, it may even be possible to negotiate the executor's fee.)

Although many people believe that legal fees are always a fixed percentage of the estate, this is not correct. In most situations, an hourly fee should be negotiated with the attorney. Keep in mind that the executor is generally free to use any attorney he or she chooses – regardless of who drafted the will. Therefore, if the client has chosen wisely, the executor should be able to minimize the legal fees to the estate. For example, the legal fees are the largest when the executor simply turns over all aspects of estate administration to the lawyer, letting the lawyer (and/or his or her paralegal) collect the assets, do the bookkeeping, prepare all the tax returns, and handle all correspondence with beneficiaries, et cetera. If the executor is willing to spend the time necessary to take care of many of the time-consuming (but routine) aspects of estate administration, such as confirming date-of-death bank balances, transferring assets from the decedent's name to the estate, paying debts, and keeping the books and records, the lawyer's services can be limited to those for which a lawyer is really needed (such as minimizing death taxes and complying with state laws for opening and closing estates). In that regard, an able and willing executor can greatly reduce the legal fees otherwise payable.

The "bottom line" is that, although avoiding probate may avoid a few filing fees, it does not change the need for a fiduciary (executor or trustee) or legal counsel. And many of the time-consuming duties of the executor and the executor's lawyer (such as collecting the assets of the estate, settling debts and paying taxes, selling the assets that need to be sold, and distributing the estate assets) will be the same regardless of whether the assets pass by a will or through a revocable trust. Switching from a will to a revocable living trust might change the name given to those expenses ("executor's commissions" become "trustee commissions"), but will not necessarily reduce the overall expenses.

WHAT ARE THE EXPECTED LEGAL FEES?

The truth is that if an estate is large or complex some legal fees must be paid – for both estate planning and administration – whether or not the client's goal is to avoid probate. There are costs associated with various difficult and time-consuming tasks, such as valuing property and filing federal and state death tax returns, which an untrained person typically should not even attempt to tackle. Therefore, the need to obtain – and pay for – competent professional services is ever present – whether the estate assets pass by a will or through a trust. Likewise, whether it is the accountant or lawyer who prepares income tax returns, for example, returns must be prepared and filed for the decedent's last tax year and for the estate (or trust, as the case may be). Someone must be paid for these tasks, whether or not there is a trust.

An agreement may be set up in advance with the lawyer who prepared the will to administer the estate for a set hourly fee or a specified amount. However, the executor should not be required to employ that lawyer. Although the lawyer who drafts the will may be – and typically will be – the most appropriate person to advise/assist the executor through the estate administration process, we suggest that the executor should not be prevented from choosing his or her own legal advisor. It is important that the executor (who typically should not be the lawyer, in order to avoid conflicts of interest) should be able to negotiate for services and fees with the lawyer he or she feels will follow the "3 Cs," that is, combine competence with consideration and compassion. (If a lawyer does serve as executor, most states will allow either lawyer's fees or executor's fees, but not both.)

Keep in mind that selecting the lawyer to administer an estate is a lot like choosing a brain surgeon: The least expensive hourly fee is not necessarily the best choice. Experience, wisdom, knowledge, and performance are what count

NEXT ISSUE

Our next issue of THINK ABOUT IT will cover what is really saved by using a revocable trust to avoid probate, the relative costs of a will and revocable living trust, costs of creating and maintaining a revocable living trust, and tools or techniques other than trusts to avoid probate (and their advantages and disadvantages) including life insurance.