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Ten Good Reasons Not to Avoid Colorado Probate

by Thomas L. Stover

Newspaper ads appear almost daily for "Free 'Living Trust' Seminars," promising information on how to "protect your loved ones from the frustration and heartbreak of probate." However, living (or "revocable") trusts are not the only tonic proffered to the would-be probate victim. A host of other techniques (often very beneficial when taken in prescribed doses) exist under Colorado law for avoiding probate.(fn1) While a full discussion of nonprobate transfers is beyond the scope of this article, common arrangements include outright gifting; owning property with another person as a joint tenant; creating payable on death ("POD") checking and savings accounts and transfer on death ("TOD") directives on bank accounts, mutual funds and brokerage accounts; and putting beneficiary designations on life insurance policies, annuities, individual retirement accounts ("IRAs") and qualified retirement plans.

The best estate plan often consists entirely of nonprobate transfers. It is not the purpose of this article to suggest that every estate needs to be probated. In fact, many who die with wills do not leave estates that require probate, and the will is never consulted. The purpose of this article is to examine the benefits of probate, lay to rest some myths and urge the reader to consider the following ten good reasons not to avoid probate.

1. The Need for a Will

Even in the most simple and tidy of financial lives, it is rarely possible to guarantee that property will pass to those intended without a will. Despite the best of intentions, the most carefully planned nonprobate arrangements often fail to carry out the intent of the decedent. One of the joint tenants on any asset (such as a bank account, mutual fund, brokerage account, real estate deed or ditch stock certificate) will survive the other. The survivor needs a will to avoid intestacy (disposition of the property under the Colorado statutes of intestate succession(fn2)).

Similarly, if the named beneficiary or beneficiaries on an insurance policy, IRA, pension plan, annuity, TOD or POD account predecease the owner, and the new Colorado antilapse statutes do not apply (see "Insure Certainty and Fairness," below), the asset will pass by intestacy if the owner did not leave a valid will on his or her death. Even where the plan is to avoid probate (such as on the first death of a husband and wife with a non-estate-taxable estate), both need wills so that the second to die avoids intestacy.

One of the most common mistakes for those who have undertaken the creation of a revocable trust is the subsequent failure to fund it (that is, to transfer all of the settlor's assets to it). Without a will, assets not transferred to the trust prior to death will, again, pass by intestacy.

Any powers of appointment held by a decedent must usually be exercised by a will, duly admitted to formal or informal probate.

The terms of a nonprobated will may even be controlling in identifying successors to the property of a decedent using a small estates affidavit, where the fair market value of property owned by the decedent less liens and encumbrances does not exceed $27,000.(fn3)

2. Avoid Unnecessary Capital Gains

An all-too-common probate-avoidance device is the outright conveyance of some asset owned by the parent to the children. A related maneuver involves the creation of a joint tenancy relationship between the parent and children. The asset is often the family home, but also can be such things as commercial, vacation or farm real estate; shares of stock; bonds; or brokerage accounts.

Where the transfer in joint tenancy is one that is unilaterally revocable by the parent, such as a joint bank account, U.S. savings bond, or so-called "street name" brokerage account, the transfer is not a gift until the nondepositing joint tenant withdraws some of the property.(fn4) However, in almost all other cases, the creation of such a joint tenancy results in a taxable gift. The outright transfer of any asset will almost always be a completed gift.

On the death of the donor joint tenant, the entire value of joint tenancy property, held with any person other than the donor's spouse at the time of death, will still be includible in the donor's taxable estate.(fn5) Thus, under the Internal Revenue Code of 1986 ("Code") § 1014, the surviving joint tenant or tenants will be entitled to a

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stepped-up date of death cost basis in the value of the entire asset. However, any property transferred outright

to children, or any other third parties, prior to death will typically not be included in the donor's taxable estate and will not be entitled to a stepped-up date of death basis.(fn6)

Due to the unified credit under the federal estate and gift tax, which allows $600,000 worth of property to pass free of estate and gift tax, there will often be no gift or estate tax due. However, a Form 709, United States Gift Tax Return, must be filed if the annual value of outright transfers or joint tenancy interests passing to any one donee exceeds $10,000 (or $20,000 if gift splitting is available).

The creation of a joint tenancy in the personal residence may result in the loss of a portion of the one-time exclusion of up to $125,000 of capital gain on sale of a personal residence by persons over the age of fifty-five, as provided under Code § 121. The taxpayer may exclude only the gain on the sale of his or her fractional ownership interest in the qualifying property. The donee will not be entitled to any exclusion for his or her share if he or she has not met the ownership and residence requirements of § 121 (three out of the last five years) and is not under the age of fifty-five.

Finally, by transferring an interest in assets to third parties (yes, even good and faithful children), the donor parent subjects his or her property to the donee's potential creditors, including their spouses and accident victims or other tort plaintiffs.(fn7)

3. Expenditures May Exceed Savings

The living trust advertisement quoted from at the beginning of this article warns the individual of losing his or her "hard-earned wealth" to the government and probate lawyers. Other trust advertisements have suggested that anywhere from 5 percent to 22 percent of a decedent's estate will be lost to court costs and other legal fees.

Since Colorado adopted the Uniform Probate Code in 1974, most Colorado estates are probated informally. The court costs of an informal probate consist of an $80 filing fee and $5 for each copy of certified letters. Institutional personal representative's fees may reach as much as 3 percent of the probate estate, but these fees are often much less or are entirely waived when family members serve voluntarily. Attorney fees in Colorado are normally charged on an hourly basis.(fn8)

In most instances, the same fees will be incurred when a person dies with a revocable trust. Trusts do not magically self-terminate and distribute themselves on the settlor's death. A successor trustee must step in, collect assets, obtain valuations, file tax returns, pay creditors and make distribution. As in probate, if an institutional trustee does the work, it will charge a fee; the same is true of attorneys. All that is saved in many cases is the $80 filing fee.

In addition, a "probate lawyer" will get paid for drafting the living trust and the pour-over will, special powers of attorney to fund the trust, and often extensive conveyancing documents necessary to fund the trust (see the section immediately following). The probate lawyer thus gets paid twice.

4. Realities of Funding A Living Trust

A revocable trust will effectively avoid probate without most of the legal uncertainties

inherent in other common non-probate arrangements. However, the question remains: Is the cure worse than the illness?(fn9) If there is out-of-state real estate or a real need for management of the settlor's assets, the revocable trust may be a good choice. There may be other good reasons to use a revocable trust in Colorado, but if neither of these factors is present, the client should take a hard look at the realities of living with a revocable trust.

For starters, to avoid probate, all of the settlor's assets (except personal property with a total net value of less than $27,000) must be conveyed to the new trust. This means title searches and deed preparation in the case of real property interests; waivers of due-on-sale provisions in deeds of trust encumbering the property, new division orders in the case of oil and gas interests; and ditch stock transfers, together with accompanying transfer fees where there are water rights. It also is necessary to change ownership of all certificates of deposit, stocks and bonds, bank accounts, mutual funds and brokerage accounts.

The proper wording for conveyances to trusts is far from clear due to inconsistent Colorado statutes on the subject.(fn10) This and other complications involving trust titling have led some advisors to recommend the creation of yet another entity, the "nominee partnership," to simplify the transfer of titles to and from trusts, especially after the death of the original trustee (usually the same person as the settlor). If the assets are partnership interests, LLC memberships or corporate shares, the controlling agreements between the owners also will need to be reviewed prior to transfer to avoid violation of transfer restrictions.

Where the settlor is relatively young, it is unlikely that all of his or her assets will end up in the trust on death, if for no other reason than that assets are constantly being acquired and disposed of.

Finally, no greater estate tax savings can be obtained with a revocable trust than can be obtained with a will.

5. Insure Certainty and Fairness

The decedent's spouse, the decedent's creditors and, in

very limited cases, the decedent's children may make claims against the estate. Otherwise, an individual may leave property to anyone he or she pleases. It all may be left to charity, the neighbors or a favorite niece. A decedent may generally cut out all of his or her children. The way to make this happen is to die with a well-drafted will, clearly spelling out the decedent's directions regarding the disposition of the assets, together with specific provisions for contingent dispositions in the event of an unexpected death. The person nominated in the will as personal representative has the highest priority for appointment.(fn11) It need not be the spouse or the children.

"Despite the best of intentions, the most carefully planned nonprobate arrangements often fail to carry out the intent of the decedent."

A probated will allows the testator to be as fair, or unfair, as desired. A common example of unintentional unfairness, in the probate-avoidance context, is the creation by the decedent of several roughly equivalent joint tenancy accounts with all of the children. One of these accounts, invariably, gets spent down to pay the decedent's expenses (often the high costs of a last illness). The responsible child/joint tenant who spent funds out of his or her account ends up with a disproportionately small fraction of the estate. Postmortem efforts to equalize the amounts received can result in unintentional gifts between siblings.

Care also must be taken to avoid application of certain "rules of construction" contained in the Uniform Probate Code, as recently amended ("UPC II"), which apply to nonprobate transfers.(fn12) While lawyers can draft around these default provisions (such as the "antilapse" provisions) in a will or trust, the typical beneficiary designation on a nonprobate instrument (such as multiple-party accounts and TOD registrations) will not contain sufficient direction.

Apportionment and Payment of Estate Taxes

Unless otherwise provided by will or other dispositive instrument, estate taxes are apportioned by statute.(fn13) The personal representative is responsible for filing estate tax returns and paying estate taxes. If no personal representative is appointed, that responsibility falls on those persons actually or constructively in possession of the decedent's property. Cooperation among those persons may be difficult to obtain or might not be forthcoming at all. Moreover, if an estate consists of probate and nonprobate assets and the will directs that all taxes be paid out of the probate estate, the tax burden may fall on persons in a manner inconsistent with the decedent's intentions.

6. Real Deals

There are advantages to selling property out of an estate. Property can be sold with a personal representative's deed, which rarely contains warranties of title. Title insurance companies will usually relax their seller indemnification requirements on the theory that the personal representative has little, if any, personal knowledge about the property. Operating under the same theory, personal representatives can usually avoid completion of the ubiquitous "property disclosure" statement routinely insisted on by realtors. While there is never a legal obligation to sign this document, it is easier to "just say no" when selling the decedent's property out of an estate.

The costs of sale (realtor's commissions, closing costs and attorney fees) can create deductible losses for beneficiaries of the estate. Fix-up expenses may be deducted as expenses of administration on the estate's income tax return, Form 1041.

Under the right circumstances, the probate court can order the partition of a parcel of real property that is to be distributed from an estate to two or more heirs or devisees in undivided shares. As long as the partition petition is not for the purpose of evading the subdivision requirements of Senate Bill 35, the real property could be partitioned into parcels comprised of fewer than thirty-five acres.(fn14)

7. Eliminate Creditor Claims

Property that passes through a Colorado probate estate on the death of a decedent can be distributed to heirs and devisees free of claims of unsecured creditors if the statutory directives of the UPC are followed.(fn15) As long as the statutory notice provisions are complied with, creditor claims will be barred with certainty. There is no comparable mechanism to bar creditors of decedents who die with their property in revocable trusts.(fn16)

8. Avoid Environmental Cleanup Costs

Unfair or not, federal law provides for a so-called "inheritance defense" where property acquired by "inheritance or bequest" may be subject to toxic cleanup costs under the Comprehensive Response,

Compensation and Liability Act ("CERCLA" or "Superfund," codified at 42 U.S.C. § 9601). Property acquired by distribution from a revocable trust carries no such defense; neither does property acquired by gift or by surviving a joint tenant.

9. Hold S Corporation Stock Longer

A revocable trust may continue to hold S corporation stock for a period of only two years, commencing on the date of the grantor's death, without disqualifying the S corporation status.(fn17) A probate estate may hold such

stock for the full "reasonable period of administration."(fn18) This could be particularly beneficial where the estate is held open up to fifteen years for the purpose of paying estate taxes in installments pursuant to an election under Code § 6166 where the estate consists largely of interests in a closely held business.

10. Income Tax Advantages To Probate Estate

A number of income tax advantages are available to the probate estate that are not equally available to revocable trusts being administered after death of the grantor. A complete treatment of this subject is beyond the scope of this article.(fn19) Three of the most commonly encountered differences are as follows.

Taxable Years

A revocable trust may not select a fiscal year after the death of the grantor, but must report on a calendar year. An estate may choose any fiscal year, as long as it elects on a timely return and the first fiscal year does not end more than twelve months after date of death.

With proper planning, the estate has a significant opportunity to defer the payment of tax on income taxable to the estate. This may be especially beneficial where the decedent was a shareholder of an S corporation or a partner of a partnership. In both cases, the entity income is taxable to the estate of the shareholder or partner only in the estate's year in which the entity's taxable year ends. By carefully choosing a fiscal year, it may be possible to defer payment of income tax on partnership and S corporation distributions to the estate beneficiaries for an additional year.

S corporations and partnerships must always use calendar years. By ending the estate's tax year prior to the end of the entity's calendar year, the entity income is taxed in the next year of the estate. This deferral is not available to trusts because trusts also must use calendar years.

Throwback Rule

After the death of the grantor of a funded revocable trust used to avoid probate, any post-death income that is accumulated and not distributed will be taxed to the trust as a separate taxpayer at the special rate schedule applicable to estates and trusts. When the accumulated income is ultimately distributed either as income or as part of a distribution of principal, the beneficiaries receiving the distribution will be subject to the throwback rule. This rule requires revision of previously filed personal income tax returns by trust beneficiaries who were over the age of twenty-one while the income was being earned. Post-death income accumulated in an estate will not be subject to the throwback rule.(fn20)

Related Party Rules

For purposes of determining the character of transactions involving a beneficiary of a trust, the trust and the beneficiary are considered to be related parties.(fn21) The rule does not apply to an estate and its beneficiaries. Thus, losses are disallowed for income tax purposes in transactions involving the sale or exchange of property between a beneficiary and a trust, but not between a beneficiary and an estate.

The difference in treatment has significance in cases where depreciated assets are used to fund pecuniary bequests or where an election under Code § 643(e) is made to treat a distribution as a sale. If a loss results, the estate can deduct it, but the trust may not.

Conclusion

The probate process can often be extremely beneficial. While there will always be a place for probate avoidance, it should not become an end in itself. The well-planned estate requires the careful consideration of all options available and will usually contain a mixture of probate and nonprobate transfer arrangements intended to cover as many contingencies as possible.

NOTES

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Footnotes:

1. Stover and Eichel, "Non-Probate Transfers," *Colorado Estate Planning,* Ch. 20 (4th ed. 1995).

2. CRS § 15-11-101 *et seq.*

3. CRS §§ 15-12-1201 *et seq.* and 15-10-201(51).

4. Treas. Reg. § 25.2511-1(h)(4); Rev. Rul. 68-269 (U.S. savings bonds); Rev. Rul. 69-148 (street name brokerage accounts).

5. IRC § 2040(a).

6. IRC § 1015.

7. While property acquired by gift is not marital property under the Colorado Uniform Dissolution of Marriage Act, any appreciation is. CRS § 14-10-113. The author recognizes that the risk of these transfers may be outweighed by public assistance benefits obtained in certain cases.

8. *In re Estate of Painter,* 567 P.2d 820 (Colo.App. 1977).

9. Kruse, "Twenty-six Reasons for Caution in Using Revocable Trusts," 21 *The Colorado Lawyer* 1131 (June 1992).

10. *See* CRS §§ 38-30-108 and 38-30-166.

11. CRS § 15-12-203.

12. *See* CRS Part 7, Art. II, Title 15, effective July 15, 1995, as part of what is commonly referred to as UPC II; *see also* "Highlights of the Uniform Probate Code, Article II," 23 *The Colorado Lawyer* 2279 (Oct. 1994).

13. CRS § 15-12-916.

14. CRS §§ 30-28-101(10) and 15-12-911.

15. CRS § 15-12-801 *et seq.*

16. *See Kruse, supra,* note 9.

17. IRC § 1361(c)(2)(A)(ii).

18. IRC § 1361(b)(i)(B); *see also* Rev. Rul. 76-23.

19. *See* CRS § 15-12-801 *et seq.* and Cornfeld, "Loving Trusts(fn*) or Hateful Wills," 27 *U. Miami Inst. on Est. Plan.,* Ch. 13 (1993).

20. IRC §§ 665-667.

21. IRC § 267(b)(6).

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