ESTATE AND TRUST PLANNING

I. OVERVIEW OF ESTATE PLANNING

A. Coming to Terms – The term *estate planning* is somewhat vague and ambiguous. It can mean different things to different people in different contexts; moreover, estate planning is often confused with *financial planning*.

1. Financial Planning – *Financial planning* refers generally to the investment of assets with the focus on preserving and growing those assets so as to assure that you have sufficient wealth and income to support you through the remainder of your life.

2. Estate Planning – As we use the term, *estate planning* refers to the process of making thoughtful arrangements for the care and provision of yourself and your family members and for the management and disposition of your assets and in the event of your incapacity or death.

   a. This is a *process*, not an event.

   b. Planning for two scenarios:

      (1) Possible incapacity; and
      (2) Death

   c. Estate planning is concerned with the people in your life, not simply your assets. Ultimately, estate planning is "others-centered."

B. Primary Estate Planning Tools

1. Last Will and Testament

2. Trusts

3. Power of Attorney

   a. Financial

   b. Health Care

4. "Living Will"

II. TRANSFER OF ASSETS AT DEATH

A. Three Primary Methods

1. Form of Ownership – In many cases, the manner in which an asset is owned determines (by operation of law or by the terms of the ownership document) to whom the property is transferred in the event of death.

   a. Joint ownership *with right of survivorship*.

      (1) Joint tenancy.

      (2) Tenancy by the entireties.

   b. Living Trust – The trust instrument specifies the intended recipient.

      (1) Revocable Trust.

      (2) Irrevocable Trust.

2. Beneficiary Designation – A contractual asset that by its terms permits the owner to identify those who are to receive the proceeds at the owner's death.

   a. Life insurance.

   b. Qualified Retirement Plans and IRAs.

   c. P.O.D. accounts (bank accounts).

   d. T.O.D. accounts (securities/brokerage accounts).

   e. T.O.D. Deeds.

3. Probate – Probate involves the transfer of assets passing by Will or by state intestacy laws. Essentially, there are four categories of assets that constitute "probate property."

   a. Property owned in the decedent's individual name.

   b. Decedent's share of property owned as a tenant in common with one or more other persons.

   c. Property owned in joint tenancy or tenancy by the entireties form where the other joint owner (or owners) has predeceased the decedent.

d. Beneficiary designation property (*e.g.*, life insurance, IRAs, etc.) where (i) the owner has failed to designate a beneficiary or all of the beneficiaries designated have predeceased the owner; and (ii) the governing contract provides that the proceeds are distributable in that event to the owner's estate.

B. Importance of Coordination – It is extremely important to assure that property passing outside of the probate process (*e.g.*, by form of ownership or beneficiary designation) is coordinated with property passing by way of probate (*i.e.*, your will) and with your overall estate plan.

1. **Example 1** – If you have established a testamentary trust for your minor children, it is important that the trustee of that trust (and not the minor children themselves or their guardian) be designated as the beneficiary of your life insurance proceeds. Otherwise, the carefully planned testamentary trust may go largely unfunded.

2. **Example 2** – Joint ownership arrangements between you and one or more of your adult children should be avoided or eliminated for two reasons: (a) to prevent a disposition that would be inconsistent with your dispositive intentions as articulated in your Will; and (b) to protect you from liability exposure to the child's (children's) creditors.

3. **Example 3 –** If a trust is to be funded in whole or in part with life insurance, it is essential that the trustee of that trust (and not some individual such as the surviving spouse) be designated as beneficiary of such insurance.

III. PROBATE AVOIDANCE AND THE EMPEROR'S NEW CLOTHES

A. Overview – The popular press has made much of the important topic of probate avoidance. Unfortunately, as is true of most estate or financial planning concepts that become "hot" topics, the hyperbole surrounding probate avoidance has resulted in a caricature.

The authors of countless newspaper and magazine articles, as well as many self-help books, view and present probate as a consumptive disease, contact with which is to be avoided by all means available. Meanwhile, many of these same authors suggest that probate avoidance techniques are "wonder drugs" to be administered universally and, preferably, in liberal doses. Such a bandwagon phenomenon has resulted from (and perpetuates) a simplistic and superficial view of probate avoidance that exaggerates its genuine benefits and obscures (or ignores) its real costs.

In some states and in some individual circumstances, the anticipated expenses and delay of the probate process may warrant aggressive probate-avoidance planning. However, in many states such as Maryland, the probate process has been relatively streamlined, and for many of its residents the much-feared expense and delay of probate may be nominal.

In proper perspective then, probate avoidance is viewed best as a selective remedy. The discerning practitioner considers the costs and benefits of each probate-avoidance technique in light of the assets and circumstances peculiar to each client and recommends application of those particular techniques that are specifically suited to that client's situation.

B. Why Avoid Probate?

1. Removing Impediments – One of the primary goals of estate planning is to assure that the transfer of assets at death occurs with minimal expense and minimal delay. Both expense and delay characterize probate, the process by which property passing by will or the state intestacy laws is retitled. Hence, the motivating factor behind probate avoidance is the desire to minimize these two impediments to the asset transfer process.

2. Expenses of Probate

a. Assessments by the Register of Wills (the probate fee)

b. Personal Representative’s (Executor’s) Commissions – While Personal Representative's commissions can be a substantial expense of probate, one must remember that in many instances in which an individual is serving as Personal Representative, commissions may be waived. For example, if the Personal Representative is also the sole beneficiary of the estate (*e.g.*, the surviving spouse or an adult child), the Personal Representative will often elect to waive commissions, preferring to receive those assets by bequest or devise rather than as taxable income. Even where the Personal Representative is not the sole beneficiary but is a close friend or family member, he or she may well elect to waive commissions or, at least, take substantially less than the statutory amount. Thus, whether Personal Representative’s commissions, in fact, will constitute an expense of probate (substantial or otherwise) will depend as much on the identity of the Personal Representative as on the size of the estate. Stated differently, the avoidance of Personal Representative’s commissions may be accomplished more effectively through careful fiduciary selection than by probate avoidance.

c. Bond Premium – In a well-drafted will, bond for the Personal Representative typically will be waived; however, in any event

(except with respect to corporate personal representatives), a nominal bond may be required to secure the payment of debts, inheritance taxes, probate fees, etc.

d. Attorneys' Fees – Attorneys' fees will vary according to the complexity of the estate and the scope of duties actually performed by the Personal Representative. Presumably, therefore, the effect of probate avoidance (*i.e.*, reducing the size of the probate estate) will be to reduce attorneys' fees.

(1) Practical Consideration – It should be noted that those attorneys' fees specifically related to estate, inheritance or income tax reporting are not properly viewed as an expense peculiar to probate inasmuch as they would be incurred irrespective of the existence or the size of the probate estate. In fact, in some cases, probate avoidance actually can increase the amount of attorneys' fees because of the added complexity associated with tax reporting of non-probate assets (*e.g.,* preparation and approval of the Application to Fix Inheritance Tax with respect to a "joint trust" can be considerably more complex than the completion of a standard form for the more typical estate).

e. Appraisal Fees – All probate property (other than publicly-traded stock, debts owed by the decedent, bank and savings and loan accounts, and cash) must be appraised by a qualified and disinterested appraiser. Depending upon the number, nature and value of estate assets, the appraisal fees can become quite substantial.

(1) Practical Consideration – Even assets that pass outside the probate process often must be appraised for inheritance or estate tax purposes. Hence, appraisal fees are not peculiarly probate expenses and, therefore, are not necessarily eliminated or even reduced by probate avoidance.

3. Delay in Distribution

a. Statutory Delay Factors

(1) Creditors' claims period – A probate estate must remain open a minimum period of time to allow creditors of the decedent to file their claims.

(2) Caveat proceedings – Each state allows a minimum number of months for the filing of a petition to caveat (object to) a Will.

(3) Elective share – In most states, a surviving spouse has several months after the date of the first appointment of the Personal Representative within which to elect against the will.

b. Effect of Statutory Periods – Generally speaking, final distribution of the probate estate is delayed pending the expiration of these statutory periods.

c. Practical Considerations –

(1) Often the circumstances are such that substantial interim distributions (*i.e.*, distributions before the expiration of the claims period) may be appropriately and prudently made (*e.g.*, where all creditors are known and have been paid, there is clearly no estate tax liability, and no reasonable possibility for a caveat or an election against the will exists).

(2) In any estate for which a federal or state estate tax return is required to be filed, it is prudent not to make a final distribution of the estate until a closing letter for the estate has been received from the IRS and the state and any federal or state estate tax found to be due has been paid. Thus, for estates in excess of the federal or state estate tax exemption amount, the concern for potential tax liability—rather than the probate process—is an independent and more significant delaying factor.

4. Probate Avoidance vs. Tax Avoidance – Probate avoidance and tax avoidance are distinct concepts; avoiding probate does not necessarily reduce the transfer tax burden at all. Accordingly, before considering any probate-avoidance technique, it is important to give specific consideration to the tax consequences of that technique.

C. Summary -- Generally speaking, the magnitude of expense and delay associated with the probate process is dependent upon several variables, including the size and complexity of the probate estate, the nature and location of the probate assets, and the identity of the Personal Representative. Thus, in many (if not all) states, a determination of whether the benefits to be obtained by any particular probate-avoidance technique are truly worth the cost requires a case-by-case analysis considering the individual's particular circumstances.

IV. THE ROLE OF TRUSTS IN ESTATE PLANNING

A. Trusts – An Overview

1. The Trust Concept – A trust is an arrangement whereby the ownership of property is divided into two component parts: legal title is vested in one or more "trustees," and actual enjoyment of the property is vested in one or more "beneficiaries." A trust involves three parties:

   a. "Settlor" or "Grantor" – the person establishing the trust.

   b. Trustee – the party responsible for managing the trust property.

   c. Beneficiary – the person for whose benefit the trust will be administered.

2. Types of Trusts

   a. Testamentary – A trust established under one's Last Will and "Testament." The testamentary trust comes into existence and becomes irrevocable at the time of the decedent's death.

   b. *Inter vivos* (or Living) Trust – A living trust is established by a person during his or her lifetime (by written agreement or declaration, rather than by Will).

      (1) Revocable – A trust that can be revoked by the settlor prior to the settlor's death or incompetency.

      (2) Irrevocable – A trust that cannot be revoked or amended by the settlor once it has been established.

3. Purposes of Trusts Generally – Different types of trusts serve different purposes. Some of the purposes that can be served by utilizing a trust (depending upon the particular type of trust employed) include the following:

   a. To protect beneficiaries from themselves (*e.g.*, trusts for minors and young adults).

   b. To protect beneficiaries from others (*i.e.*, creditor or tax protection).

   c. To preserve property for children from a prior marriage (*e.g.*, a QTIP trust).

d. To serve as an asset management vehicle in the event of incapacity (*i.e.*, an alternative to guardianship or a durable power of attorney).

e. To mitigate probate expenses (*e.g.*, the Revocable Living Trust).

f. To save taxes, especially federal estate tax (*i.e.*, an Irrevocable Trust).

4. Dispositive Provisions – The terms of the trust that are most unique to the client.

a. General Observations – The dispositive provisions will be determined by the particular purposes to be achieved with the trust and will be designed to meet the needs peculiar to each beneficiary or group of beneficiaries. These provisions will govern disposition of income, as well as principal.

b. Income Distributions – Some possibilities include the following:

(1) Mandatory distribution of current income (*e.g.*, QTIP).

(2) Discretionary distribution of income subject to an "ascertainable standard."

(3) "Sprinkling" or "spraying" among designated class of beneficiaries.

c. Principal Distributions

(1) Discretionary distributions subject to an ascertainable standard.

(2) "Wholly" discretionary distributions (*e.g.*, special needs trust).

(3) Right of withdrawal at certain ages.

d. Generation-Skipping Design

(1) Provides substantial enjoyment of the property by the settlor's children without having the property included in the children's estates for federal or state estate tax purposes.

(2) Avoids estate tax on the property at the children's level, thereby, preserving more for future generations.

(3) Provides a measure of creditor protection for the children.

(4) The use of a generation-skipping trust is limited by (a) the rule against perpetuities (unless the trust has been specifically exempted therefrom) and (b) by the generation-skipping transfer tax.

B. Testamentary Trusts

1. Receptacle for Probate and Non-Probate Assets

a. Receives the probate assets that pass under the Will of which the trust is a part.

b. Can be used to receive non-probate assets as well -- Death benefits (life insurance proceeds and retirement plan proceeds) may be made payable to the trustee named (or to be named) in a Will of the insured or the retirement plan owner, whether or not the Will is in existence at the time of the beneficiary designation.

c. Proper coordination of all assets (probate and non-probate) is essential.

2. Non-Tax Uses of Testamentary Trusts

a. Asset management vehicle for minor and young adult children (common fund and/or separate shares).

b. "Special Needs" Trust (for those suffering under disabilities).

c. Protection of the beneficiary from creditors, spouses, and taxes.

C. Revocable Living Trust (“RLT”)

1. Primary Purposes

a. Probate avoidance.

b. Asset management in the event of incapacity (the most significant benefit).

c. Privacy – Unlike one’s Will and probate assets, which become part of the public record, a Revocable Trust (and any assets owned therein at the time of the Settlor’s death) are not available for public inspection.

2. Mechanics of the RLT

   a. Drafting and execution of the trust document.

   b. Transfer of property to trust ownership.

   c. Settlor continues to deal with the property substantially as before.

   d. In the event of the settlor's disability or death, the successor trustee identified in the trust document steps in and continues the management of the trust property according to the terms of the trust.

   e. Often the same person will initially occupy all three positions involved in a living trust: he will be the settlor, transferring assets to himself as trustee, to be administered for his own benefit during his lifetime, as the beneficiary.

3. Tax Effects – **The RLT is entirely transparent for tax purposes**.

   a. Federal estate tax – Assets held in the decedent's revocable living trust at the time of death are fully includable for federal estate tax purposes. The RLT, as such, offers absolutely no federal estate tax savings.

   b. Federal gift tax – Transfers of property during the decedent's lifetime to a revocable living trust do not constitute completed gifts for federal gift tax purposes.

   c. Income Tax – The RLT is a "grantor trust."

      (1) All trust income and deductions are attributed to the settlor.

      (2) All capital gains benefits are preserved.

      (3) The property will receive the full step-up in basis upon the settlor's death.

   d. State estate and inheritance tax – Generally, the RLT produces no state estate or inheritance tax savings.

4. Advantages of the RLT

   a. Probate Avoidance – Assets transferred to the RLT before the settlor's death will pass at death to (or for the benefit of) the beneficiaries

outside of the probate process, thereby, potentially saving *some* expense and/or delay.

b. Property Management – In the event of incapacity (or before, if desired), the successor trustee can manage the assets owned by the RLT without interruption.

c. Avoidance of Ancillary Administration – For the decedent who, either in his individual name or as a tenant in common, owns real estate located in one or more states outside of the state of domicile, ancillary probate proceedings in those other jurisdictions can be avoided by transferring such "foreign" real estate to the RLT during the settlor's lifetime.

d. Privacy – See discussion above.

5. Disadvantages of the RLT

a. Expense – While possibly saving money in terms of probate, the RLT adds some expense to the planning phase. This added expense occurs because at least a short Will (typically, a pour-over Will) is still needed, and the funding of the RLT is likely to involve the preparation and recordation of deeds and other transfer instruments.

b. Time – Arranging for the transfer of assets to the RLT requires the expenditure of time by either the client or the attorney (or both).

6. Is the RLT for Everyone?

a. In some states and in some individual circumstances, the anticipated expenses and delay of the probate process may warrant aggressive probate avoidance planning. However, in many states such as Maryland, the probate process is relatively streamlined, and the much-feared expense and delay of probate are significantly reduced. Hence, the primary advantage for which the RLT is usually touted is substantially muted here.

b. Often, although not always, the issue of property management in the event of incapacity can be handled adequately (and more simply) by the use of a durable power of attorney.

c. Considering these factors and considering the extra expense that it entails at the outset, the RLT is not a planning tool suited to universal application. Nevertheless, in many situations, the RLT can be particularly valuable, and its advantages and disadvantages should be

weighed carefully in light of each client's particular needs and circumstances.

D. Irrevocable Trusts

1. Primary Uses of Irrevocable Trusts

a. Federal and Maryland Estate Tax Savings – Removing post-gift appreciation and income from the settlor's taxable estate.

b. Asset Protection – Limited protection from creditors in certain circumstances in some states.

c. Generation-Skipping Transfer Tax Planning.

2. Income Tax Effects

a. Grantor Trust – If a trust is classified as a "grantor" trust pursuant to federal income tax law, then the income of the trust will be taxable to the settlor regardless of the actual recipient of the trust income.

b. Non-grantor Trusts

(1) Conduit Principle – If the trust is not a grantor trust, then the income will be taxed either:

(a) to the beneficiaries to whom the income is distributed; or

(b) to the trust as an entity.

(2) The income tax treatment of an *inter vivos* irrevocable non-grantor trust is the same as the income tax treatment of a testamentary trust.

3. Gift Tax Effects

a. Unless by the terms of the trust the settlor has retained dominion over the trust property (*e.g.*, a limited power of appointment), a transfer of property to an irrevocable trust will result in a completed gift for federal gift tax purposes.

b. Generally speaking, gifts made in trust constitute gifts of future interests. As such, gifts in trust typically do not qualify for the federal gift tax annual exclusion, which is applicable only to gifts of present interests.

4. Estate Tax Effects – unified tax computation:

   a. The value of the property transferred (as of the date of the transfer) is included in the settlor's tax base for the purpose of determining federal estate tax due on death under the unified rate schedule.

   b. However, all appreciation (and income generated) subsequent to the date of the gift is excluded from the settlor's gross estate.

V. PROVIDING FOR CHILDREN – For a parent engaged in the estate planning process, providing for his or her children is a primary concern.

A. Guardianship – If the parent has one or more minor children (*i.e.*, children under the age of 18), identifying one or more persons to fill the parental role should the child be orphaned is paramount. The person filling this role is typically referred to as the child's "guardian" or "guardian of the person."

1. Appointment of a child's guardian is typically accomplished by designation in the surviving parent's Will.

2. The Will can designate one individual or a couple to fill the guardian role. In all events, it is best to identify a successor individual (or couple) to fill the guardian role should the first named individual (or couple) be or become unable or unwilling to serve in that role.

3. Considerations in selecting the appropriate person or persons to serve as guardian include the following:

   a. the guardian's temperament and parental qualities;

   b. the guardian's familiarity or relationship with the child;

   c. the guardian's capacity to assume this important responsibility;

   d. the guardian's geographic proximity; and, of course,

   e. the guardian's willingness.

4. The role of guardian does not need to be filled by a blood relative. In fact, in many instances, a close friend of the parent may well be the more appropriate choice.

B. Asset Management – Beyond filling the parental role, the next most important consideration in providing for an orphaned child is the creation of a secure, yet flexible, plan for the management of the child's inherited assets. This consideration applies to adult, as well as to minor, children.

1. <u>The Use of Trusts</u> – While there are other alternatives, the most effective and most flexible asset management tool for wealth inherited by children is the trust.

   a. One or more trusts can be created for this purpose, either under the parent's Will (a testamentary trust) or by some other stand-alone document (a living trust).

   b. The trust structure should be tailored to the particular circumstances of the family and the needs of the particular child or children. Potential designs include:

      (1) separate shares;

      (2) common fund;

      (3) special needs trust.

   c. In structuring a trust for a child, there are two primary concerns:

      (1) protection of the child from himself; and

      (2) protecting the child from others.

2. <u>Role of the Trustee</u> – One who administers the trust on behalf of the beneficiaries is referred to as the "trustee."

   a. The trustee role can be filled by one or more individuals or even by a corporate trustee (*e.g.*, a bank or trust company).

   b. If a corporate trustee is chosen, it is often helpful to have an individual serve as co-trustee. In all events, the trust document should provide some individual with the authority to remove and replace the corporate trustee should that become appropriate.

   c. An individual selected to be a trustee should have the following skill set:

      (1) trustworthiness;

      (2) diligence (not a procrastinator); and

      (3) good judgment (*i.e.*, the ability to make wise decisions and select appropriate professionals to assist as needed).

d. The individual selected as trustee:

(1) need not be a blood relative of the parent;

(2) need not be the same individual selected as the child's guardian; and

(3) need not be a professional or have financial investment skills.

Selecting one or more individuals with the skill set stated above is the most important consideration.

VI. PREPARATION OF DOCUMENTS – "The less you know, the easier it is."

A. "Do it Yourself" is a synonym for disaster.

1. I am often asked about the wisdom of one embarking on a do-it-yourself project (whether using online software, off-the-shelf software, or off-the-wall self-help books) to draft one's own Will, powers of attorney, or other estate planning documents. Uniformly and categorically, my advice is that do-it-yourself estate planning is an almost certain path to disaster.

2. While it is certainly true that some estate plans are less complicated than others, there truly is no "simple Will." The only thing that makes a Will (or other estate planning document) seem simple is a lack of understanding of the array of potential mistakes that can be made.

3. In our experience, the do-it-yourself approach generates dramatically more expense after the individual's death or incapacity (which is when the mistakes and omissions are revealed) than whatever modest savings might have been achieved by choosing not to engage competent professional help in the planning process.

B. Identifying a Suitable Attorney – Avoiding the dangers and expenses of a botched estate plan requires more than simply engaging a lawyer – any lawyer – to do the work.

1. Competence – Estate planning is a highly specialized area of law practice for which the general practitioner is generally not well-suited. It is always best to seek out a lawyer who devotes all or at least most of his or her practice to estate planning work.

2. "Fit" – Beyond competence, it is also important to find an attorney with whom you can establish a good rapport. This is especially important in the

estate planning context because the financial and family issues being addressed tend to be especially personal and sensitive.

C. The American College of Trust and Estate Counsel ("ACTEC") is a reliable resource. – ACTEC is a national organization of approximately 2,600 lawyers who have been elected to membership by demonstrating the highest level of integrity, as well as competence and experience, as trust and estate attorneys.

1. Each ACTEC attorney ("fellow") has a minimum of 10 years of estate planning practice experience.

1. The ACTEC website (**www.ACTEC.org**) offers a wealth of estate planning information, as well as a state-by-state directory of ACTEC fellows.