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ESTATE PLANNING BASICS

Why do Estate Planning?

Dying Intestate:

We need to do estate planning to avoid dying "intestate". Dying intestate means dying without having created either a will or a trust which provides instructions for passing your estate on to your heirs. Dying intestate is like taking your property and attempting to throw it to your heirs on the other side of a deep chasm, a chasm which is filled with hazards. These hazards (probate, creditors, con-artists, lawsuits, judgments, lawyers, and death taxes) can damage much of the value of your estate and allow your property to go to unintended heirs and in unintended ways.

All property owners have done some estate planning for the distribution of their estate to their heirs whether they are aware of it or not. Without a will or a trust the inheritance laws (laws of intestacy) of your state will determine how your property will pass to your heirs. If you have no heirs that fit the state's formula, the assets will be taken by the state. Often times the state's formula and rules for moving assets to your heirs will not be what you would have chosen if you had done some planning.

One of the best ways to get your estate over the intestate chasm is to build a bridge to your heirs, otherwise known as a trust. This provides for the estate to be taken safely over the financial risks which are posed by probate, creditors, con-artists, lawsuits, judgments, lawyers, and death taxes. Let's evaluate some of these financial risks to better understand how and why to avoid them.

Problems

Problems With Probate:

If you die with any property titled in your personal name, there must be a probate process for that property (assuming the estate is above a minimal size). Probate is the state's legal procedure for handling three major functions for your estate. (1) A final and definite identification of and appropriate payment to the estate's legitimate creditors and claimants, (2) Identification of the rightful heirs to the estate and the share size that each heir will receive, and (3) getting the legal title of the property out of your

name and into the name of the heirs. Having a will drawn up in advance of your death will take care of the second function, identification of the rightful heirs and their share. With no valid will for your estate the state will use its own formula for determining heirs and their share.

But even with a will, the creditor/claimant identification and the re-titling of your property still must be handled through a court administered probate procedure. When an estate owner dies the only way that their property can be legally re-titled in the heirs' names is by a court order in a court supervised process, or probate.

Avoiding probate is desirable because it can be a time consuming and expensive process. Reliable estimates are that on a national average probate costs run from 4% to 10% of the value of the estate. This means that an estate worth only $200,000 could cost $8,000 to $20,000 to probate. These costs are based on the fair market value of the property, and not on just the net worth or equity. In other words, an estate with debt against it will cost the same to probate as one without debt. In some cases probate ends up in litigation that drags on for years. Probate encourages creditors and claimants to appear who might not otherwise, whose claims may be inaccurate or fraudulent but only the deceased estate owner would be able prove otherwise. Probate frequently leads to family battles, and it often causes or allows the decedent's wishes to be ignored. In addition, probate procedures are made public, causing family privacy to be lost.

One good way to avoid probate is through the use of a family estate planning trust, either a living trust or a life estate trust. Think of the trust as a bridge that will allow a trustee to move your assets safely across the intestacy and probate chasm to your heirs on the other side. The way a trust avoids probate is by titling your property in the name of the trust before your death. You retain complete control of the property during your life, but the trust is considered to be the legal owner of the property for title transfer purposes. Upon your death a trustee that you pre-selected will simply handle the transfers or payments to your heirs which you specified in the trust. You have a great deal of flexibility in specifying the details of these payments and transfers (see the "Estate Transfer & Heir Planning" topic below). After your death the trustee can handle everything quickly and simply without lawyers, court supervision, excessive costs or delays.

Problems With Joint Tenancy Ownership:
Most married couples, and many parent-child combinations, choose joint

tenancy with rights of survivorship as their method of holding title. This may be done with both real estate and financial assets. The idea is that when one joint owner dies, the surviving joint owner or owners will automatically receive the decedent’s interest in the property without probate.

As a probate avoidance technique, this approach does work, but there are several potential problems:

1. The whole amount of the estate held in joint tenancy is subject to all of the liabilities of all joint owners. If one owner gets a judgment, tax lien, etc., the lien holder can take the entire property to satisfy the judgment. (There are some exceptions to this problem with personal residences in some states, but those exceptions don’t hold up when the asset is either sold or when both tenants die.) If a parent holds a home in joint tenancy with a child, and that child gets a divorce, the divorcing spouse of the child can potentially take the whole house in the divorce settlement.

2. When a spouse dies and leaves assets to the surviving spouse through joint tenancy, the surviving spouse then has outright control of the assets. The danger is that the surviving spouse may give some or all the assets away to a new spouse or lover, leaving the original heirs cut out of the estate.

3. Often times the surviving spouse doesn't do any formal estate planning, so that probate was avoided on the death of the first spouse, but isn’t on the death of the second.

The use of a family trust is one of the best ways to hold property title, because it can avoid the three problems mentioned above.

Problems With Beneficiary Arrangements:
Many assets may be transferred to heirs quite well with beneficiary arrangements. For example, beneficiaries may be specified on pension plans, insurance policies, annuities, bank and investment accounts. When the original owner dies, the remainder amounts or death benefit will be paid quickly to the named beneficiaries, in the amounts specified to each beneficiary and without probate. There are some problems and limitations with this system, however:

1. There can be no controlled or timed pay outs to the beneficiaries with most beneficiary arrangements.

2. There are no provisions for beneficiaries who become incapable of handling their financial affairs.
3. Beneficiary distributions will be subject to the lawsuits, liens, bankruptcies and divorce problems of the beneficiary.
4. There will often be problems if the beneficiary predeceases the original owner. One problem is the payment of the money to the spouse of the beneficiary, rather than the money being held for or paid to the beneficiary’s children.

Problems Due to Incapacitation:
When a property owner has either sole or joint tenancy ownership, and then becomes mentally incapacitated, the property is in legal limbo. This is due to the incapacitated owner being incapable of conveying legal title or signing legally binding documents. This can prevent the property from being sold or even being leased. Often times an expensive and time delaying court conservatory procedure is the only answer. A family trust is the most comprehensive and best detailed manner to deal with incapacitation issues. But, a simple device known as a durable power of attorney will also take care of many of the problems.

Protecting Estates From Divorce, Lawsuits and Judgments:>
Lack of formal and specialized estate planning leaves the estate owner(s) extremely vulnerable on this issue. This topic is known more simply as "asset protection". The use of a special type family trust is one of the best ways to achieve asset protection. This type trust will also deal with the problems of probate, method of holding title and incapacitation.

Protecting Estates From Con Artists And Dishonest Relatives:
As more and more people live longer lives, more of them are living beyond their ability to protect their own financial interests. These problems afflicting senior citizens are due both to the natural aging process and debilitating diseases. Con artists and opportunistic relatives look for these situations and, unfortunately, have made an industry out of fleecing the elderly who are no longer able to protect themselves. It is very common for these senior citizens to be left virtually penniless and even homeless. This issue is a variation on the topic above, asset protection. Generally the most formal and effective method for protecting yourself in your later years is through the use of a special type of family trust designed for asset protection.

Taxes

Death Taxes On Your Estate:
Many people think that estate taxes were abolished by the 2001 Tax Act. But actually, estate taxes at the federal level were scheduled by the 2001 law to stick around through 2009 (see Figure 3),
and then be replaced with some loss in step-up in basis. The loss in basis step-up means that your heirs will not receive your assets with a basis which is equal to the fair market value of those assets. As a result, when the heirs sell those assets they must pay capital gains taxes on the gain (profit). That gain is the difference between what you paid for the assets and what your heirs sell them for. Under pre 2001 tax law, heirs received a full basis step-up to fair market value, and never had to pay a capital gains tax. Further, estate and inheritance taxes at the state level are often quite significant, and they were not abolished by the federal Tax Act of 2001.

This is all very complicated, but the bottom line is this: If you as an individual expect to be worth upwards of $1 million by the time of your death, or the year 2010 if that comes earlier (and if you are married, that is upwards of $2 million), then your estate faces death taxation issues. And, if you did pre-2001 estate planning, your existing trust or other estate planning needs to be revisited and probably adjusted.

The 2001 Tax Act did increase the amount of exemption from federal estate taxes which is allowed to estates. But what if that exemption is not enough for your estate?
What if estate tax rates are allowed to return to pre-2001 law, as is presently scheduled in 2011?
Or what if your estate faces capital gains taxes due to the loss of basis step-up? There could be a problem considering the appreciation and growth that your estate will enjoy before your death, especially when you add in the inheritances you may receive, death benefits from your life insurance and remainder amounts of your pension plan. Good estate planning can easily increase death tax exemption amounts by several million dollars for married couples, but some type of trust is required for maximum reduction of death taxation. Neither a will, beneficiary arrangements nor joint tenancy ownership of property are sufficient to take care of death taxation issues for either married or single estate owners.

Gift Taxes:
Gift taxes were not eliminated from the 2001 Tax Act, though the Act allows larger gifts and lower tax rates. Anyone can make a gift to any other person of up to $11,000* per year with no federal gift taxes. A married couple can then give $22,000 to one person in any given year. A married couple can give $44,000 to another married couple or to two children.
For annual gifts within those limits there is little tax planning to do and no gift tax return to be filed. In many of the cases of gifts which exceed those limits, they are made because the estate is too large for estate tax purposes and the estate owner is likely to die before 2010 (die before the elimination of federal estate taxes). These extra large gifts then will usually be made to provide estate tax relief, by reducing the size of estate that will be left to the heirs. Gifts exceeding the $11,000/22,000* annual exclusion do require special planning and gift tax returns. Many of these larger gifts will need to be done with special trust or family limited partnership programs to reduce or avoid gift taxes altogether.

* The $11,000 annual gift tax exclusion is tied to inflation, so that the amount is scaled up every few years. $11,000 is the amount in effect as of the year 2005.

Estate Transfer & Heir Planning

One of the big benefits of pre-death estate planning is the ability to name your heirs, specify the share of your estate they will receive, and dictate the manner and timing at which the heirs get their share. Generally speaking this part of estate planning may be done with either a will or a trust. But as mentioned above it takes a trust to avoid probate, protect the estate from legal problems and con artists, and to minimize death taxes.

Some of the heir planning issues to consider are as follows:

1. Whether the heirs are to receive equal or unequal shares. There are several factors that can cause the estate owners to vary the share sizes they leave to each heir. (W, T, B*)
2. At what age should the heirs get their share, or should their share be paid in two or three installments at different age milestones, paid out for life, etc. (T*)

3. Whether or not to leave specific property to certain heirs, such as the family home to one child and certain other property to another child. (W, T, B, JT*)
4. Whether or not to clearly omit or disinherit any heirs. (W, T*)
5. How to deal with situations where a married couple each have different children from former marriages, but they want to create one comprehensive estate plan. This may require dealing with issues such as one spouse having more children, or one spouse having a larger estate. (T*)
6. Dealing with cases where estate owners get married after they have built their own separate estate, which they may want their new spouse to benefit from, but then they want the remainder of the estate to go to their heirs and not to their spouse's heirs. (T*)
7. What to do in a case where a child has reckless spending habits or substance abuse problems, and the parents fear that child will quickly misuse the inheritance. (T*)
8. How to deal with mentally or physically disabled heirs. (T*)
9. Assuring that the heirs will use their share to pay for a college education, and do so in a prudent manner. (T*)
10. What happens if an heir predeceases the estate owner. (W, T, B, JT*)
11. How to deal with specific gifts to special heirs, such as grandchildren, nieces and nephews, charities, etc. (W, T, B, JT*)

* W=Will, T=Trust, B=Beneficiary Arrangements, JT=Joint Tenancy Arrangements. These codes indicate what estate transfer methods can possibly be used to accomplish this goal. Trusts are the only method which cover all situations listed, and which will work as desired in all cases. NOTE: Beneficiary and joint tenancy arrangements will not necessarily work, or work well enough, in your individual case. Be sure to see the above specific topics on these issues.

Trust VS. Wills, Which Is Best For You?

There are cases where a will is the best choice and cases where a trust is. Generally a will is indicated under the following circumstances (also see the 11 item list in the prior topic):

1. The estate is small enough that formal probate won't be required.
   -Or-
2. It is reasonable and safe to leave all of the estate through beneficiary and/or joint tenancy arrangements (see the earlier topic, "Joint Tenancy Ownership of Property")
   -And-
    1. There are no significant death taxation liabilities.
    2. There is no need to hold an heir's share of the estate in some type of scheduled or controlled payout (for college or handicapped heirs for example).
    3. Mental incapacitation of the estate owner isn't likely to cause problems with financial and legal transactions.

Some examples of where a will is likely the best choice are: (1) A young married couple whose net worth is less than approximately $50,000. Joint tenancy and beneficiary arrangements are desirable here, coupled with general purpose wills for each spouse. If one of the young spouses dies, the survivor is likely to live many more years and is likely to provide the best possible care for minor children the couple had together, making a trust unnecessary. A trust would probably be too cumbersome and costly in this situation. (2) Individuals or couples of any age whose estate is less than $75,000 to $100,000 total, and where the estate can avoid probate by safe beneficiary and/or joint tenancy arrangements (see the earlier topic, "Joint Tenancy Ownership of Property"). General purpose wills for each individual or spouse should be created.

Even though a will is not required for assets which are transferring by beneficiary and joint tenancy arrangements, a general purpose will should still be prepared. The will ensures that the non-beneficiary/joint tenancy property passes to the heirs of your choice, and that they receive the amounts or specific assets you wish them to have. The will handles the disposition of personal effects. The will serves as a catch-all, in the event that there are assets you forgot about, received after the will was prepared, or there is a problem or mistake with a beneficiary or joint tenancy arrangement. Most heirs will re-distribute their inheritance appropriately to

the other heirs if they realize the beneficiary arrangement you set up was wrong and your will indicates your real choice.
A trust is generally indicated under the following circumstances .

1. The estate which cannot safely be transferred by beneficiary and joint tenancy arrangements exceeds approximately $75,000 to $100,000.
2. There is some danger of a challenge by an heir, or would-be heir, to the estate transfer planning after the estate owner's death. (A trust generally can withstand the challenges better than probate, and often in shorter time, and for less money and hassle.)
3. Avoiding probate is an important goal.
4. The estate cannot simply be paid immediately and outright to one or more heirs, meaning there are minors or other heirs who should have their share paid in a controlled or scheduled manner.
5. There are significant death taxation liabilities.
6. There is a need during the estate owner's life to insulate assets from legal difficulties, or from a divorce with a non-owner spouse (needs for asset protection).
7. The estate needs formal or detailed handling procedures during any period of mental incapacitation of the estate owner.

What Is a Trust?
The major family estate planning functions that trusts are required for are:

1. Management of the estate during mental incapacitation
2. Probate avoidance
3. Reduction or elimination of death taxation
4. Controlled transfer of estate to proper heirs
5. Protecting the estate from lawsuits & seizures

In subsequent topics we will describe these functions and explain how trusts perform these tasks. But first, we will describe the basic characteristics and terminology of trusts.

A trust is a legal entity or device used to take care of property in special ways. Trusts are created by a legal agreement, basically a contract,

between two parties. These contracting parties are known as the grantor and the trustee. The grantor and trustee create the agreement for the benefit of a third party known as the beneficiary. (See Figure 5 and refer back to the definitions at the beginning of this Section.) This agreement is private and is not an arrangement created by state statutes (as are corporations, for example). This is an important feature because private agreements have tremendous flexibility in their provisions. Even though a trust is a private agreement, it is recognized by the laws and courts as an independent legal entity, an independent owner of property. In fact, trusts are independent entities much like corporations. Thru their trustee trusts may own property, may file tax returns and pay taxes, may own bank and investment accounts, earn income, distribute profits to the beneficiaries, conduct business activities, etc.

As stated above, trusts have three parties to them: grantor, trustee, and beneficiary. Grantors are the individuals who own property which they wish to have managed, controlled, protected and transferred to heirs by a trust. Once their property is in the trust the grantors no longer hold the legal title to the property, though they usually retain the exclusive rights to use the property or its income and usually retain full control of the property. The trustee is the legal administrator of the trust and the legal title holder of the property. The grantors' relationship to the trust is determined by the language which they put into the trust agreement. The beneficiaries are the individuals or charities that receive benefits or income from the trust property, and eventually receive the property itself. When the grantors retain for their lifetime the rights to the income and use of the trust property, then the beneficiaries will receive their benefits after the grantors die. In still other cases the grantors and beneficiaries both receive benefits from the trust simultaneously.

Living Trust

A family trust in which the grantors hold all three positions -- grantor, trustee, and beneficiary -- is known as a living trust. This trust category is almost always revocable (se topic below). This is the type trust which forms the NAFEP Premier I Living Trust. The living trust really isn't a trust though because it is not an agreement between two separate parties, grantor and trustee. There is in fact just one party in the living trust, the grantor or grantors. Since one party cannot write a legally binding agreement with itself, the living trust is not a contract, not a complete trust during the lives of the grantors (even if there are two grantors, legally they are still one party). Therefore the living trust arrangement is not recognized by the laws

and the courts as an independent entity. It is simply thought of as an extension of the grantors and as a special way the grantors have titled their property. However, if the grantors appoint an independent or separate trustee to administer the revocable trust and to hold legal title, there is then a real contract and a real trust regardless of who the beneficiaries are. If the grantor/trustees become mentally incapacitated, the pre-appointed successor trustee automatically assumes the trustee position, and then the living trust becomes a real trust.

Beneficiaries

If the grantors retain the rights to the benefit, use or income of the property in the trust, then the grantors are also the current or primary beneficiaries. In that case the heirs who are named to inherit the trust property after the deaths of the grantors are known as remainder or secondary beneficiaries. If the grantors do not retain economic benefit or control of the trust property, then their heirs are named as the current beneficiaries.

Revocable and Irrevocable

An arrangement where the trust may be revoked or canceled at will by the grantors is known as a revocable trust. If a trust cannot be canceled by a family member without permission of the other parties to the trust, the arrangement is called an irrevocable trust. Irrevocable trusts usually are recognized as independent legal entities whereas revocable trusts are not.

The well known living trust referred to above is almost always a revocable type. However the grantors may choose to have an irrevocable trust and then receive some special or extra benefits. For example, an irrevocable, grantor controlled trust is the basis for creating an effective asset protection strategy, such as the NAFEP Premier II Life Estate Trust.

Contact Fahim Muhammad “The Freedom Coach” Chartered Senior Financial Planner for Free Financial Consultation Call Now 708-704-7309