Misconceptions About Estate Planning

by Robert H. Feldman

Estate planning involves three inevitable factors—death, taxes and clients' misconceptions. The Taxpayer Relief Act of 1997 has modified planning for estates. This article will review some of the recent developments and then clarify some of the more persistent notions held by clients. This article is based on federal and Arizona law, and the laws of other jurisdictions may differ.[1]

Estate and Gift Tax Changes

Important changes have been made in the federal Taxpayer Relief Act of 1997 ("Act")[2] and through IRS policies, including the following:

- The amount exempt from federal estate tax has increased from $600,000 for decedents dying or gifts made in 1997 to $625,000 in 1998 and $650,000 in 1999, with further increases to $1,000,000 in 2006.[3]
- Up to $1,300,000 of a qualified family-owned business may be excluded from the taxable estate.[4]
- A lower interest rate, and installment payments over 14 years, are available for a qualified family-owned business.[5]
- Gifts from revocable trusts within three years of death escape inclusion in the gross estate, even if the trust becomes irrevocable by the grantor's death.[6]
- Gifts after enactment for which the gift tax statute of limitations has passed can no longer be revalued by IRS for estate tax purposes.[7]
- The generation-skipping tax has been liberalized in cases where the decedent has no living lineal descendants.[8]
- Gift tax returns generally are no longer required for charitable gifts.[9]
- Trust throwback rules for taxing income have been repealed.[10]
- Excise taxes on excess accumulations and distributions from a retirement plan have been eliminated.[11]
- Several income tax rules have been made more alike for estates and trusts.[12]
- Several exclusions have been indexed for inflation.[13]
- IRS has moved to limit valuation discounts and is actively auditing discounts taken for fractional interests.[14]
- IRS has targeted abusive trust arrangements that seek to avoid income, self-employment or transfer taxes, without a meaningful change in the taxpayer's control over the benefits from the assets.[15]

Misconceptions

Wills

If I die without a will, the state gets my property. Not so. States have statutes on intestate succession, leaving an estate to the closest relatives, in a certain order. The state takes only if there are no qualifying relatives.[16] When a person moves, the law of the new domicile may change how the estate is left.

Having a will means that probate will be required. Not necessarily. Probate may or may not be required, with a will or without a will, depending on what a person owns and how title is held. Personal property of up to $30,000, and real estate with equity of up to $50,000, can pass by affidavit, without probate.[17] Small estates may be distributed through a summary administrative procedure.[18] Assets may pass through survivorship, payable-on-death provisions, or a trust.

A will can be changed by notations in the margin. Such changes would not qualify under the witnessing requirements for a formal will, and the document would not qualify as a holographic will because the material provisions are not the testator's writing. A codicil or a new will must be prepared to make changes.[19]

Wills should provide for all debts to be paid on death. It may be impractical to pay certain debts, such as a mortgage or other installment obligation, or a debt that is disputed.

Wills must be formally signed and witnessed. That is usually preferable, but some states, including Arizona, recognize holographic wills, prepared in the testator's handwriting.[20]

Probate[21]

Probate is time-consuming, costly, and must be avoided. Probate can be time-consuming and costly, but it usually is not to the extent reputed. In Arizona, most probates are handled through an informal system that is fairly simple, with most of the work done by the personal representative. Probate also has benefits, such as cutting off the claims of creditors and resolving disputes. Partial distributions can be made to the extent not needed for debts or expenses, without waiting for closing of the probate. Probate protects the personal representative, distributees and counsel through court approvals and limitations on actions.[22]

A beneficiary can be stuck with an unwanted inheritance. Where a person does not want an inheritance, perhaps because of tax or creditor considerations, a qualified disclaimer can be made within nine months after the decedent's death.[23] The disposition passes as if the disclaiming person had predeceased the decedent, and it cannot be directed by the disclaiming person.

Title Holding

Joint tenancy with right of survivorship is the best way to hold title to realty. This will avoid probate on all but the last death, but it has several pitfalls. People do not always die in the anticipated order. The property is subjected to the claims of creditors of any joint tenant. The last survivor takes all, rather than sharing. There is only a partially stepped-up basis for income tax purposes. Between spouses, community property with right of survivorship is preferable, because it affords a fully stepped-up basis upon the death of either owner.[24]

Trusts

Having a trust avoids probate. It can, but the trust must be funded during the trustor's lifetime, or his assets must bypass probate in another manner. Some trusts serve as a receptacle for property after it passes through probate. Testamentary trusts, included in a will, do not avoid probate, but they are a simple way of providing for managing property for young children.

The best time to establish a trust is after one spouse dies. In this situation, the opportunity is lost to have a bypass trust. A bypass trust must be established while both spouses are alive, and it can save a large amount of estate tax.

Benefits to a disabled person can be protected by a trust. They can be; however, assets that are available for support, at the trustee's discretion, can disqualify governmental benefits.

All trusts should be bypass ("A-B") trusts. A bypass trust for a married couple avoids estate tax on the portion allocated to the trust of the first decedent. However, this is not always necessary, such as where the combined estates do not reach the taxable level.

The rule against perpetuities is a major obstacle. The rule seldom is a problem. It applies only to long-term trust holdings and has been modified in Arizona, with a savings clause for interests that vest within 90 years.[25]

International trusts are for the ultra-rich. Offshore trusts are becoming more common as clients seek to protect their assets.[26] An alternative is the Alaska trust, which protects assets to an extent, but not as much as an international trust.[27]

Estate Planning

Estate planning is just for the rich. Not so. Whatever a person accumulates during his lifetime is

important to him, and it should pass as the person intends.

I don't care what happens after I die. Most people should, because they spend a lifetime accumulating whatever they have at the time of death. A typical person works 80,000 hours during his lifetime, and it is worth his spending a few hours to plan his estate.

My spouse should not be bothered with estate planning matters. It usually is preferable to have some knowledge of what to expect, and to have each spouse involved in making estate planning decisions.

Once an estate plan is made, it lasts for a lifetime. It does last, but it usually is important to review an estate plan periodically. Changes should be taken into account in a person's desires, family and finances, and in tax law and other laws.

Gifts

Gifts can only be made in denominations of $10,000. Gifts can be made in any amount. The first $10,000 of a present gift is not subject to gift tax. The excess is, but no tax is payable until the lifetime exclusion has been exhausted.[28]

I'll give everything away and qualify for state aid. There are restrictions on what can be given away and when. Long-term care provisions may require repayment, and criminal sanctions may apply to improperly helping a person qualify for Medicaid.

Fiduciaries

The personal representative and trustee must reside in this state. It is permissible for an individual personal representative or trustee to reside elsewhere, although it may be less convenient. A corporate trustee must be authorized to do business in the decedent's state in order to carry out all functions.

Corporate trustees should always/never be used. They may be more expensive than an individual, and some may lack knowledge of personal family matters. However, a corporate fiduciary offers expertise, permanency and objectivity.

The same person should be named as personal representative, trustee, guardian and conservator. That is possible, but the requirements of each position involve different skills, and it may be preferable to select different persons for each. That also will provide checks and balances.

It is best to name all children as co-personal representatives. This may be inconvenient, especially when they do not live in the same vicinity, and it may generate friction.

Children

All children should be treated the same. This depends on personal preference. Some children may be more needy or more deserving than others. Some may need to be protected from their financial inexperience or from creditors' claims.

Funds should be left in a common pot, to be used for the children who need it most. It is possible to leave decisions up to a trustee or other administrator. However, it is possible that all of the funds will be used up for a child in unfortunate circumstances, leaving nothing for the others.

My children are spendthrifts, but my grandchildren should take at age 21. Provisions for distributions at the grandchild level often are less detailed and less restrictive than provisions for children, due to lack of attention in drafting. It may not make sense to provide for outright gifts at an early age to grandchildren.

Distributions to grandchildren save on transfer taxes. Large distributions to grandchildren may be subject to generation-skipping tax.

My latest spouse will take care of my children. Depending upon arrangements made through contract or a trust, the current spouse may not be bound to take care of the deceased spouse's children by a prior marriage. It may be best to leave those children something on the first death, or to leave them life insurance, or to make contractual or trust arrangements that are binding.

If I provide for my spouse, I deprive my kids. A spouse may receive needed benefits under a QTIP trust, qualifying for the marital deduction. The balance is preserved for the children or other specified beneficiaries upon the spouse's death.

Taxes

The recent tax changes make tax planning unnecessary for estates under $1 million. Not so. Although the

estate tax exemption is being raised over a period of several years, the estate may remain above the exempt level, especially when augmented by appreciation in assets, life insurance and retirement benefits. The exemption is raised gradually, and increments are smaller in the earlier years.[29]

Additional income/assets should be avoided, if they put a person in a higher tax bracket. Income tax and estate tax brackets are graduated, so that only the additional income or assets would be taxed at the higher rate. Brackets are to be considered but are not controlling.

On death, heirs pay an inheritance tax. This is true only in a few states, not including Arizona. The estate tax in Arizona represents a portion otherwise payable as federal estate tax, and it is not in addition to the federal tax.

It is better to live in a state without estate tax. Generally, it makes no difference, since the estate tax in most states, including Arizona, equals the federal estate tax credit, involving no additional cost to the taxpayer.[30]

Appreciated assets can be held in an IRA to get a step-up in basis. Not so. Assets in an IRA do not receive a step-up, and withdrawals are considered income in respect of a decedent, fully taxable as ordinary income.[31]

The $5,000/5-percent provision should be increased. The “five and five” provision allows distributions of principal to the surviving spouse, in excess of what is needed for support. As an exception to power of appointment provisions, the amounts are not taxable to the first decedent. However, if the limits are exceeded, a large amount may become subject to estate tax.[32]

It is best to accumulate income in a trust. There may be good reasons for doing so, but the income tax rate to a trust often is higher than that of a beneficiary. Where distributions of income are made currently, the income is taxed to the beneficiary, rather than the trust.

Asset Protection

Estate planning and asset protection are the same. Often this is not true. For example, when a doctor terminates his corporate pension plan, it may be good tax and financial planning to do a tax-free rollover to an IRA. In some states, this makes the plan assets more vulnerable to creditors, although IRAs are protected in Arizona.[33] Asset protection involves divestiture of assets, and the potential benefits must be weighed against the disadvantages.[34]

Living Will/Health Directives

A living will and a health care power of attorney are the same. Not so. A living will deals with a situation where death is certain, and the person does not wish to have artificial means used to be kept alive. The healthcare power is for a temporary incapacity, enabling the holder to make medical decisions on a person’s behalf.

The best time to sign a living will or healthcare directive is upon entering a hospital. Hospitals do provide forms, but the person may not be in the proper condition to sign at that time, and the form may not accurately state the person’s intentions.

Community vs. Separate Property

Moving to or from Arizona requires a new estate plan. Not necessarily, but Arizona is one of the few community property states, and the rights to property may be much different than in a separate property state, especially upon divorce or death. The differences should be taken into account.[35]

Community property is unimportant to persons bringing separate assets. It may be important. For example, if most of the property is in the husband’s name and he dies, Arizona laws afford less protection to the surviving spouse than the laws of the separate property state where they formerly resided. On the other hand, quasi-community property laws may be more generous to the spouse in a marital dissolution.[36]

Powers of Attorney

Business for an elderly person is best handled under a power of attorney. A 1998 change in Arizona law subjects the agent to greater risk of liability and to a possible loss of inheritance. Trusts often are a better

alternative.[37] As before, a power of attorney is revoked by the death of the principal.

Marital Agreements

Marital agreements must be done before marriage. Prenuptial agreements must be done before marriage, but postnuptial agreements also are possible, covering the same considerations; e.g., responsibility for prior debts, separate vs. community nature of income and arrangements in the event of divorce or death. The validity will depend on the fairness of provisions and the circumstances of execution.[38]

Business Succession

My partners will be fair to my widow, and vice versa. It is better to avoid disagreements by having a buy-sell agreement.

Charity

Charitable gifts are only for the rich. Charitable gifts are deductible on the individual income tax returns. Charitable remainder trusts may be beneficial from a financial standpoint for people with medium-sized estates, in addition to achieving worthwhile purposes.

Retirement Plans

Proceeds of a pension plan should be left to the trust. There are income tax advantages in leaving the death benefits of a qualified plan to the surviving spouse. The trust can be the secondary beneficiary.[39]

Dividing retirement plans in a divorce is difficult. A qualified domestic relations order (QDRO) can be used to assign a portion of a retirement plan to the non-participant spouse, without adverse tax consequences. A stand-alone QDRO is preferable, and it need not await the final decree.[40]

Insurance

Buy term insurance and invest the difference. This can be good financial strategy. However, term insurance premiums increase with age and the coverage may cease at a certain age. A permanent life insurance policy usually has a fixed rate and serves as a foundation in providing liquidity.

Lawyers

I don't need a lawyer, I've got a kit/computer. Do-it-yourself kits and programs are inexpensive, but they are hard to understand and properly utilize, they are not individualized, and they may not take local law into consideration. Therefore, they are likely to have unintended results.

The family should rush to a lawyer upon a person's death. Usually not. They should take care of personal considerations and preserving and safeguarding the property. A lawyer should be consulted as soon as it is more convenient.

The family must gather for the lawyer's reading of the will. This is seldom done, except in the movies.

If a will or trust is done by a lawyer, it must be alright. Estate planning is a specialized field, and some lawyers are more knowledgeable than others.

Lawyers charge a percentage of the estate. Lawyers are restricted to a "reasonable amount" for fees. This usually would be an hourly fee or a fixed fee, not a percentage.

Conclusion

Estate planning involves an understanding of choices. The lawyer needs to consider the changing rules, overcome the client's misconceptions, and consider all relevant factors, in order to arrive at decisions that best suit a particular client's situation.

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ENDNOTES:

1. See generally Weinstock, *Planning an Estate* (4th ed. 1995); and Westfall and Mair, *Estate Planning Law and*

Taxation (3d ed. 1995).

2. See Scholtes, "Estate and Gift Tax Provisions," 12 *The Practical Tax Lawyer* 51 (Fall 1997).
3. Act § 501(a); Internal Revenue Code of 1986 (I.R.C.) § 2010. The exemption becomes $675,000 for deaths and gifts in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1,000,000 in 2006.
4. Act 502; I.R.C. § 2033A. This figure includes the exemption otherwise applicable.
5. Act § 503; I.R.C. § 6601(j).
6. Act § 1310; I.R.C. § 2035.
7. Act § 506; I.R.C. § 2001.
8. Act § 511; I.R.C. § 2651.
9. Act § 1301; I.R.C. § 6019.
10. Act § 507; I.R.C. § 665.
11. Act § 1073; I.R.C. § 4980A.
12. These include provisions for separate shares, Act § 1307, I.R.C. § 663(c); and distributions during first 65 days of a taxable year, Act § 1306, I.R.C. § 663(b).
13. These include the annual gift tax exclusion, Act § 501(c); I.R.C. § 2503(b); GST exemption, Act § 501(d), I.R.C. § 2631; and the $750,000 value differential for farms, Act § 501(b), I.R.C. § 2032A(a).
14. See Toth, "The Family Limited Partnership Under Siege," 26 *Taxation for Lawyers* 196 (Jan/Feb 1998); *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982) (15 percent discount).
15. Notice 97-24, 1997-16 I.R.B. 6; Feldman, "Skepticism Protects Against Dangers of Abusive Trusts," 62 *Practical Tax Strategies* 81 (Feb 1999).
16. A.R.S. § 14-2101A.
17. A.R.S. § 14-3971.
18. A.R.S. § 14-3973.
19. A.R.S. § 14-2502.
20. A.R.S. § 14-2503.
21. Changes in the Arizona Probate Code, effective after 1994, are discussed in Fleming, "The Top Ten Changes in the New Uniform Probate Code," 31 *Arizona Attorney* 32 (Aug/Sept 1994).
22. A.R.S. §§14-3935, -3936. See generally, Geiser, Estes, Comus Jr. and ter Horst, *Ariz. Probate Code Prac. Manual* (3d ed. 1997).
23. A.R.S. § 14-2801; I.R.C. § 2518.
24. A.R.S. § 14-1201(28).
25. A.R.S. § 14-2901A.
26. Rupprecht, "The Increasing Use of International Trusts," 34 *Arizona Attorney* 22 (Nov 1997).
27. Parks, "Evaluating the Alaska Trust's Ability to Shield Assets from the Claims of Creditors," 35 *Arizona Attorney* 28 (Nov 1998).
28. I.R.C. § 2503(b).
29. Note 3, *supra*.
30. I.R.C. § 2011.
31. I.R.C. § 691.
32. I.R.C. § 2041.
33. A.R.S. § 1126C.
34. See Spero, "How to Arrange a Client's Property for Asset Protection," 22 *Estate Planning* 226 (Jul/Aug 1995).
35. Statutory allowances to a spouse, to avoid disinheritance, include a family allowance (generally $12,000), allowance in lieu of homestead ($18,000) and exempt property allowance ($7,000). A.R.S. §§ 14-2402, -2403 and -2404.
36. A.R.S. § 25-318A.
37. A.R.S. § 14-5506; Murphy, "Drafting Powers of Attorney to Comply with the New Legislative Changes," 35 *Arizona Attorney* 22 (Dec 1998).
38. A.R.S. § 25-201; Frazer, "Prenuptials—Take Another Look," 31 *Arizona Attorney* 10 (Jan 1995).
39. I.R.C. §§ 402(a)(7) and 408(d)(3); Weinstock, *supra* at § 13.13.
40. Kluwin, "Using QDROs to Fund a Divorce," 34 *Arizona Attorney* 26 (Nov 1997). See also Kluwin, "Arizona Wages or ERISA Benefits: The Treatment of Retention Bonuses and Severance Payments," 35 *Arizona Attorney* 32 (Mar 1999).