Insight on Estate Planning

February/March 2009

Is your estate plan challenge-proof?
Minimize postmortem disputes over your estate plan

Watch out for gift-splitting tax traps

Using "just-enough" funding for a credit shelter trust

Estate planning pitfall
You don't have a succession plan for your estate plan

Is your estate plan challenge-proof?

Minimize postmortem disputes over your estate plan

The goal of estate planning is to gain the peace of mind that comes with knowing your family will be provided for and your wishes will be carried out after you're gone. Few things can disturb that peace of mind as quickly as the fear that someone will contest your plan.

No protection is absolute, but with thorough planning you can minimize the chances that an assault will pierce your armor. Let's take a closer look at several tips for "bulletproofing" your estate plan.

Risk assessment

The first step is to evaluate your risk. There's no reason to invest in protection you don't really need. If your estate plan distributes your wealth to the "natural objects of your bounty" — such as your spouse and children — in roughly equal shares, you probably have little reason for concern. But if you plan to disinherit a family member or leave most of your assets to charity, you might want to shore up your defenses.

There also may be a heightened risk of litigation over your estate plan if you own a family business or have children from a previous marriage.

Protection for your estate plan generally falls into two categories: 1) strategies that discourage others from contesting your plan, and 2) those that make it more difficult for a challenge to succeed.

Conflict avoidance

There are several strategies you can use to avoid disputes over the terms of your estate plan:

Treat everyone fairly. It may seem obvious, but if your plan makes everyone happy, there's no reason for anyone to contest it. Remember, though, that *equal* doesn't necessarily mean *fair*. Suppose you have a young child from your current marriage and a financially independent adult child from a previous marriage. If you divide your wealth between them equally, the younger child — who likely needs more financial help — may perceive your plan as unfair.

Talk it over. If your estate plan is atypical, you can avoid misunderstandings and potential disputes by sitting down with your family and explaining your motives. Perhaps you're leaving the bulk of your estate to a family-run private foundation to get your children involved in philanthropy. If so, the time for them to learn this is now, not at the time of your death.

If you own a family business, you might plan to leave equity interests to family members who work in the business and use other assets to provide for those who don't. Or you might use voting and nonvoting shares to divide the business equally while preserving management control for family members who work in it. Whichever approach you use, it's important to discuss your reasoning with those affected and solicit their input.

Create a revocable living trust. Using a will as your primary testamentary instrument guarantees that your estate will go through probate. That means your plan will become a matter of public record and your named beneficiaries — as well as anyone legally entitled to a share of your wealth — will be notified and given an opportunity to object in probate court.

In most states, you can avoid probate by using a revocable trust. Without probate, there's no

notice requirement or opportunity to be heard in court, so someone would have to file a lawsuit to challenge your estate plan. For a revocable trust to be effective, you must transfer title to all of your assets to the trust, including any assets you acquire after you establish the trust.

Use a no-contest clause. Consider making bequests that include a "no-contest" clause. Essentially, this clause says that, if a beneficiary challenges your will or trust, he or she forfeits the bequest. For a no-contest clause to work, the bequest must be large enough to deter the person from risking an unsuccessful challenge.

Strong defenses

If your estate plan is unconventional or you plan to disinherit one or more family members, it may be difficult to avoid a challenge. And even if your plan is the epitome of fairness, it's not always easy to predict who might feel slighted.

Most wills that are contested involve claims of undue influence or lack of testamentary capacity (though fraud and invalid execution also may be grounds for a challenge). Strategies for thwarting these attacks include:

Have your head examined. Seriously, one of the best ways to establish your testamentary capacity is to undergo a "mini mental state examination" or have a medical practitioner attest to your competence. The examination should be conducted near the time you execute the will — on the same day, if possible.

Choose the right witnesses. Witnesses should be people you expect to still be alive and easily located years or even decades later — and they shouldn't be beneficiaries of the will. Ideally, they will be familiar enough with you and your family that they can attest to your testamentary capacity and freedom from undue influence.

Put it on tape. Videotaping the execution of your will can be an effective way to demonstrate your competence. It also gives you an opportunity to discuss the reasoning or motives behind your estate plan and refute any potential claims of undue influence. Obviously, no one who stands to benefit from your will should be present.

Be sure to plan your statements carefully so that nothing you say can be misinterpreted. Also, for this strategy to work, you should be comfortable with the recording process. The last thing you want is viewers mistaking discomfort for duress or confusion.

Arm yourself

If you're concerned that postmortem challenges might derail your estate plan, strategies like the ones described can provide the ammunition you need to fend off would-be attackers. Ask your estate planning professional which combination of techniques is right for your situation.

Watch out for gift-splitting tax traps

This year, the inflation-adjusted annual gift tax exclusion is $13,000, up from $12,000 in 2008. Annual exclusion gifts can be a powerful estate planning tool, and they're doubly effective if you and your spouse elect to "split" gifts.

Before you get out your checkbook, though, it pays to review your gifting strategies with your estate planning advisor. Gift splitting is more complicated than you might think, and mistakes can be costly.

A little goes a long way

When you're planning an estate worth millions, $13,000 may seem relatively insignificant. But a well-designed program of annual exclusion gifts

can generate substantial tax savings. The annual exclusion allows you to give up to $13,000 per year to an unlimited number of people tax free without tapping any of your $1 million lifetime gift tax exemption or $3.5 million estate tax exemption.

Let's say you have two children and six grandchildren. If you give all eight of them $13,000 per year for five years, you can transfer a total of $520,000 tax free. If you elect to split the gift with your spouse, that amount doubles to $1.04 million. (By splitting gifts, you can double your lifetime gift tax exemption, allowing you to make $2 million in tax-free gifts.)

When to split

Gift splitting allows you to maximize the amount you and your spouse can give tax free, regardless of whose assets are used to make the gift. For example, if you want to give your son $25,000 in stocks that are your separate property, your annual exclusion shelters $13,000 from gift tax, but the remaining $12,000 is taxable. If your spouse consents to gift splitting, the entire gift is tax free.

There are three basic requirements for splitting a gift:

1. You must be married at the time you make the gift.
2. You and your spouse must be U.S. citizens.
3. You must file a gift tax return in which your spouse consents to gift splitting.

Gift splitting allows you to maximize the amount you and your spouse can give tax free, regardless of whose assets are used to make the gift.

Be aware that, if the amount of the gift exceeds the $26,000 combined annual exclusion, both you and your spouse must file gift tax returns. Also, you can't split gifts to your spouse or gifts over which one spouse has a power of appointment.

After you check the box on your gift tax return and your spouse signs the consent, it applies to *all* gifts either of you made during the year. So if you or your spouse plans to use exclusions separately for certain gifts, you should think twice before electing to split gifts.

Trust issues

Gift splitting couldn't be easier, but it's critical to understand the tax implications before you check the box. Making a gift that you incorrectly assume is splittable can lead to estate tax liability. And, the most dangerous tax traps involve gifts to trusts.

For example, let's suppose you establish a family trust that gives the trustee unlimited discretion to distribute income and principal among your spouse and children. The trust also provides that, when your spouse dies, the assets will be distributed to your kids.

In 2009, you make a $2 million gift to the trust from your separate property, and you and your spouse elect to split the gift. In 2010, you receive

a $435,000 tax bill from the IRS. The reason for incurring the tax penalty? The gift wasn't splittable.

The $2 million gift benefits both your spouse and your children and, as previously noted, you can't split a gift to your spouse. Your children's portion of the gift can be split to the extent it's "ascertainable" at the time you make the gift and severable from your spouse's interest. But in this case your spouse and children may receive discretionary distributions from the trustee, so their interests in the trust aren't ascertainable.

The bottom line: The gift can't be split, so you can use only your own $1 million exemption. The remaining $1 million is subject to gift tax.

You can avoid this result, however, by designing the trust so the beneficiaries' interests are ascertainable. For example, you might provide your spouse with an annuity or limit distributions to an "ascertainable standard," such as health, education, maintenance or support.

Avoid splitting headaches

Splitting gifts is an easy way to increase the dollar amount you and your spouse can give as gifts, but watch out for the tax traps. To avoid unwelcome gift tax liabilities, be sure to consult your estate planning advisor before you check the box on your gift tax return. ∎

Splitting gifts of community or jointly owned property

If you make a gift of community or jointly owned property, gift splitting isn't necessary. Why? Because the gift is treated as if one-half came from each spouse. But be sure you know how property is classified before you give it away. Even in community property states, a spouse may own separate property, such as property acquired before marriage or received as a gift or inheritance during marriage.

Also, don't assume that a gift you make from a joint account is a joint gift. The IRS may still treat it as a separate gift — requiring gift splitting — depending on who contributed the funds to the account and certain other factors.

Using "just-enough" funding for a credit shelter trust

For many affluent couples, a credit shelter trust (also called a bypass trust) is a key component of their estate plans. This trust type allows spouses to leave as much of their assets as possible to each other while preserving each of their $3.5 million estate tax exemptions.

In recent years, changes in the exemption amount and uncertainty over the future of the estate tax have made it more difficult to design a credit shelter trust. One potential solution to this problem is "just-enough" funding, a technique that allows you to fund a credit shelter trust with just enough assets to avoid triggering estate taxes in the surviving spouse's estate.

Avoiding a credit crisis

Not every married couple needs a credit shelter trust. If your combined estate is well under the $3.5 million exemption amount and you don't expect it to reach that level, a credit shelter trust probably isn't necessary.

Keep in mind that, as of this writing, the estate tax is scheduled to be repealed next year and then reinstated in 2011 with an exemption of only $1 million. Most likely, however, Congress will preserve the estate tax and maintain the exemption amount at its current level or increase it. In addition, states may have different or smaller exemption amounts from state estate taxes.

If you and your spouse have a combined estate that substantially exceeds the exemption amount (or expect to in the future), a credit shelter trust can help you avoid a multimillion dollar estate tax bill. Here's how: Suppose you and your spouse each have an estate valued at $3.5 million. If you die when the exemption amount is $3.5 million and leave your entire estate to your spouse, there's no estate tax because of the unlimited marital deduction. But if your spouse dies with a $7 million estate, and the exemption amount remains at $3.5 million, his or her estate will owe $1.575 million in federal estate taxes (assuming a 45% marginal rate).

In the above example, by leaving your entire estate to your spouse, you essentially wasted your exemption. You could have avoided this result by leaving the entire $3.5 million to a credit shelter trust that provides your spouse with income for life and transfers the remaining assets to your children or other beneficiaries. The trust would take full advantage of your exemption amount, and it would bypass your spouse's estate, thus eliminating estate taxes.

Arranging flexible credit terms

Credit shelter trusts are ideal if you and your spouse can predict with reasonable certainty the size of your estates and your exemption amounts when you die. In the recent past, it was common for an estate plan to provide for an amount equal to the exemption amount to be placed in a credit shelter trust. But this strategy is less effective when the exemption amount is subject to change.

Suppose that you and your spouse each have an estate valued at $2.5 million. Conventional wisdom says that you should use a credit shelter trust to take advantage of your exemption amount and minimize taxes in your spouse's estate. But what if Congress raises the exemption amount to $5 million next year? That would allow you to leave your entire estate to your spouse without adverse tax consequences (unless you expect your spouse's estate to grow substantially in the future).

Credit shelter trusts are ideal if you and your spouse can predict with reasonable certainty the size of your estates and your exemption amounts when you die.

Of course, you could revise your estate plan regularly to reflect changes in the exemption amount and the size of your estate. But what if you forget or one of you becomes incapacitated? Some couples are using the technique of "just-enough funding" to build flexibility into their plans, minimizing estate taxes while maximizing the amount of assets left to the spouse outright.

Using the previous example, if the exemption amount remains at $3.5 million, a just-enough approach will fund the credit shelter trust with $1.5 million and transfer the remaining $1 million to your spouse, leaving him or her with a $3.5 million estate.

Be aware that you can achieve an identical result by leaving your entire estate to your spouse and permitting him or her to file a qualified disclaimer directing some or all of the assets into a credit shelter trust. But the just-enough technique avoids the risk that your spouse will make a mistake or otherwise fail to make the appropriate disclaimer.

Getting it "just right"

The IRS hasn't officially sanctioned just-enough funding, but in at least one request for a private ruling the agency suggested that the technique is sound. If you're looking for a way to minimize estate taxes without putting any more than necessary into a credit shelter trust, just-enough funding may be just right for you.

Estate planning pitfall

You don't have a succession plan for your estate plan

Some of the most important estate planning decisions involve naming people to act on your behalf after you die or, in the event you become incapacitated, during your life.

You'll want to select people you trust and who possess the skills, experience and temperament necessary to carry out your wishes. You should also choose at least one, and preferably two, successors for each of these representatives. If you don't, and one of them dies or is otherwise unable to serve, a court will make the decision for you (usually with some input from your family).

Common estate planning documents that should include successor designations include your:

- **Will.** Your will should designate a successor executor, especially if you've named your spouse as the executor, because he or she might decline the burden of administering your estate while grieving your death. Further, if you have children who are minors, the will is the place for you to designate guardians for those children.
- **Trusts.** Trustees often have considerable discretion to distribute funds and make decisions in accordance with your wishes, so selecting their successors is just as important as selecting the original trustees. Another option is to create a mechanism for the current trustee or beneficiaries to name successor trustees.
- **Health care documents.** A health care power of attorney — sometimes called a durable medical power of attorney or health care proxy — authorizes another person to make medical decisions for you, including decisions on life-sustaining treatment, when you're unable to make them yourself. Your spouse will probably be your first choice, but it's critical to choose one or more successors in the event he or she is unavailable or otherwise unable to make the decision.
- **Power of attorney.** This document authorizes your spouse or another representative to manage your financial affairs. If he or she is unable to act, you need to have a successor ready to take over at a moment's notice.

To avoid having a court make these decisions for you, review your executor, trustee, agent and proxy designations periodically to be sure you have replacements who are ready, willing and able to step in should the need arise.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2009 IEPfm09