Estate Planning: Introduction

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When most people hear the words "estate planning" they usually think that wealthy individuals are the only ones who need it. But they couldn't be more wrong. Regardless of how much money you have, you need to think about what will happen to your assets and who should receive the things you own after you pass away.

An estate plan can be as simple as having a will and naming a beneficiary for your 401(k), or as complicated as having several trusts for different purposes in addition to your will. Let's explore why you need to think about having an estate plan regardless of the value of your assets.

For basic information on estate planning, read *Getting Started On Your Estate Plan*.

For more estate planning dos and don'ts, read *Six Estate Planning Must-Haves* and *Top 7 Estate Planning Mistakes*.

Estate Planning: Estate Planning Basics

Estate Plan Defined

An estate plan is the process of planning for the orderly administration and disposition of property after the owner dies. The goals of your estate plan may include the following:

1. Avoiding confusion when it comes to your final wishes.
2. Ensuring that your children have the legal guardian of your choice.
3. Protecting loved ones by ensuring that they receive your assets.
4. Helping to reduce or avoid conflict among family members.
5. Minimizing taxes and legal expenses associated with your estate.
6. Wealth preservation for your intended beneficiaries.
7. Flexibility for you before you die.

If you die without an estate plan that includes a will, you are considered to have died intestate, and the state where you live will determine who gets your assets as determined under the state's inheritance laws. This may mean that some of the people you love are left out of the distribution. Worse yet, if there is no one that fits the criteria, guess who keeps your assets? The government itself.

Estate planning is a must especially if you are in a non-traditional relationship, you have chosen to cohabitate without being married, you have been married more than once and/or you have children. If you have children from a previous marriage, your estate planning is even more important, as your current spouse may not be inclined to share your estate with them unless that spouse is required to do as based on the provisions of your will. The last thing you want to do is to unintentionally disinherit someone you love because you failed to implement a plan for the proper disposition of your estate. (For related reading, see *Estate-Planning Must-Haves For Unmarried Couples*.)

Estate Planning Terms You Should Know

Estate

The estate includes all the property that was owned by a decedent (deceased person) before it is distributed by a will, trust or under inheritance laws. An estate also includes all of the decedent's assets and liabilities.

Property

Property is divided into two categories:

- Real property usually refers to land, including permanent structures and minerals.
- Personal property refers to everything other than real property, and includes automobiles, jewelery, household items, patents, loans, bank accounts, cash, insurance policies, securities and insurance policies.

Grantor

The grantor is the person transferring property to another party (referred to as grantee) under a trust that he or she created.

Beneficiary

The beneficiary is the person who inherits property from the grantor. The beneficiary can be one or multiple parties. (Read more about the importance of keeping your beneficiaries current in *Update Your Beneficiaries*.)

Trustee

The trustee is the person or entity who administers the property on behalf and for the benefit of the beneficiaries in accordance with the trust document. The trustee is also considered a fiduciary, because he is charged with the duty to act for the benefit of other individuals, which in this case is the beneficiaries of the trust. (*Can You Trust Your Trustee?* provides more information on choosing a competent trustee.)

Successor Trustee

A person or entity that takes over the duties assigned to the original trustee when necessary. The terms of the trust usually define the circumstances under which the successor trustee would assume the responsibilities of trustee under the trust.

Probate

Probate is the legal process the state takes through the court to identify your rightful heirs, as well as their share, and also transfer the title of property from your name to theirs. Not all property is subject to probate, but the property that is subject to probate can possibly go through an expensive and time-consuming process. (*Skipping Out On Probate Costs* can help you take some of the stress out of the probate process.)

Estate Transfer
This is the process by which property interests are legally transferred to another person. It may occur either during an individual's lifetime, when these transfers can be done as a gift or through a sale, or after a person's death.

Who Needs Estate Planning?
In general, anyone who has ownership in real or personal property should perform estate planning for those properties. This includes the following:

- Anyone who owns property alone, as tenants in common (TIC), or as community property.
- Anyone owning assets in multiple states.
- Anyone who has dependents.
- Anyone who owns a small business.
- Anyone who may become incapacitated prior to death.
- Anyone who wants to make a transfer of wealth.
- Anyone who owns assets that may be subject to tax and want to reduce the taxes involved in transferring these assets.

The question really becomes not "Who needs estate planning?", but "How simple or complicated does the estate planning really need to be?" The answer will depend on your particular financial, marital and family situation. Keep reading to learn how to apply these planning tools.

Estate Planning: Introduction To Wills

A will is a document that describes how you want your property and owned interests distributed after your death.

Why You Need a Will
There are many reasons why you need a will. A will is especially crucial if you have young children and would like to make the decision of who will take care of them, both financially and physically, in the event of your death. You also need a will if you care who receives your property after you die. Whether make a will or not, you are making a choice. If you don't have a will, your choice is to allow your state to take care of making these decisions for you. If you do make a will, your choice is to make sure your loved ones are taken care of according to your wishes.

Requirements for a Valid Will
For a will to be considered valid, the following criteria must be met:

- The will has to be executed according to your state laws.
- You must be of sound mind at the time the will is prepared.
- You must understand the results of preparing your will.
- You must understand the nature and extent of the property you own.
- Generally you have to be at least 18 years of age, or the age of majority as defined under the laws of your state.
- The will has to be signed, dated and witnessed by the number of people required under the laws of your state.
- Some states require that your signature and those of your witnesses are notarized.

A will can be amended to change the provisions. The amendment, referred to as a codicil, is subject to the same requirements as the original will.

Valid Forms of Wills
There are three generally acceptable forms of wills. These are:

1. *Typewritten or Witnessed Will*: This type of will is authorized in every state, and more often than not they are drafted by attorneys. They must satisfy the state's witness requirements; for instance, a state may require that the witness be at least a certain age and must be considered 'credible'.
2. *Holographic Will*: This is a will that is completely handwritten, dated and signed by the person making the will, and is not witnessed. This type of will is legal in only some states, and it should be used as a last resort.
3. *Nuncupative Will*: This is an oral will and is only allowed in a few states and under very limited circumstances. For instance, it may be considered valid only if the testator was unable to create a written will because of sudden illness that led to his or her death. An example that is often used is a soldier dying in combat. Nuncupative wills are usually limited to personal property, and state law may place a cap on the value of the property that it can cover.

State law should be consulted to determine the types of wills that are considered valid within the state. Some may allow less than the three listed above, some may allow all three and others may even have a more expansive list of what they consider valid wills.

Important Will Terminology You Should Know

Testator
One who has died leaving a testament or will. The testator must satisfy requirements as defined under state law. For instance, a state may require that the testator be considered to be of sound mind when the will is made, must not be an infant, must not have been under duress when the will was made and must not have been in a state where he or she was deprived of his or her free will when the will was made.

Executor
The executor is the party named by the testator to carry out the terms of the will, which includes settling outstanding debts and distributing the assets to the beneficiaries. (Read about the importance of this role in *Choose The Right Executor*.)

Bequest or Bequeath
Also sometimes referred to as a legacy, this is the act of giving personal property by will.

Guardian
Person who has been named in a will or appointed by a judge to take care of minor children or a special-needs adult. Naming one person as the executor and another as the guardian can make sense in some cases if the guardian is not well equipped to handle financial matters. The court is not required to honor the guardian named in a will, but usually does unless there is evidence that the individual is incapable of handling the role. (Read *Special Trusts For Special Needs* for more information on how to ensure your loved ones with special needs are taken care of.)

Residuary Estate
This is what's left in the estate after all gifts are made and debts, taxes and other costs associated with the estate are paid.

Probate
Probate is the process used to make an orderly distribution of property from a decedent to a group of beneficiaries. The court essentially supervises the transfer of property, filing of claims against the estate by creditors and the publication of a last will and testament.

Assets subject to probate include the following:

- "Singly", or individually, owned assets.
- Property held by tenancy in common.
- Community property.
- Assets where the beneficiary is designated as the "estate of the insured".

Assets not subject to probate include the following:

- Property conveyed by deeds of title.
- Property held by joint tenancy with rights of survivorship (JTWROS).
- Government savings bonds.
- Trusts.
- Payable-on-death accounts.
- Annuities.
- Retirement accounts.

Ancillary Probate
This is a second probate process for real estate located in a state other than that of the decedent's state of residence. This is necessary because a will can only dispose of the

decedent's personal property located in the state of the decedent's residence.

Benefits of a Will

A will gives you the opportunity to make sure certain matters are handled in accordance with your wishes after your death. These include:

- Allowing you to choose in advance how you want your property to be distributed.
- Appointing a guardian for your minor children or other individual who requires guardianship.
- Choosing the executor of your estate.
- Designating a successor custodian in cases where you are serving in a custodial capacity for a minor or special-needs adult.
- Providing for individuals who would otherwise not have been eligible to receive property you leave behind.

A will can also allow you to donate property to charities of your choice and choose the assets that would be used in the donation.

What You Cannot Accomplish With a Will
Here are some things that a will cannot accomplish:

- Disinheriting a spouse. Spousal rights are protected in common-law states under spousal elective share statutes and in community-property states under community-property statutes.
- Transferring title to property held in JTWROS.
- Bequeathing all or most property to a charity when the decedent is survived by a spouse or children.
- Avoiding probate.

If you are drafting your will without the assistance of an attorney, be sure to check to ensure the provisions that you include in the will are valid under the laws of your state of residence.

Dying Without a Will
If you die without a will, you are considered to have died intestate and the inheritance laws of the state in which you live will determine who gets your property. These laws vary among states.

There are many disadvantages to dying without a will, including:

- You do not get to decide how your property is disposed of.
- A judge may decide who will be the guardian of your children if their other parent or legal guardian does not survive you.
- It may cost your heirs time and money by having to go through a lengthy probate process. This includes legal fees and court costs.

- If you are in a non-traditional family situation, such as a same-sex or common-law marriage, it is possible that your partner will not be considered to be your family by the state and will be disinherited.

While a will cannot resolve all your estate planning needs, it can serve as an integral component of a sound estate plan when used with other estate planning tools. Our next section will discuss the types of wills you may wish to consider.

Estate Planning: Other Types Of Wills

In addition to the traditional types of wills discussed in Part 2, there are other types of wills, which include the following:

1. *Simple Will*: A simple will is usually used for small estates and is often used to avoid the complications involved with trusts and large estates, as well as minimize taxes that may apply. A simple will is usually executed using a single document .
2. *Joint Will*: A single document executed by two parties. The parties make the will together, agreeing to leave their property to beneficiaries identified under the will. Typically, the parties agree to leave their assets to each other, but they can also agree to leave property to third parties. The will dictates what happens to the assets after the second party dies, and can be used by married couples to protect children from previous marriages. Joint wills can be revocable during the testator's lifetime.
3. *Mutual Will*: A single or multiple documents by multiple parties who have agreed to dispose of their property in a manner agreed upon by all parties. Similar to joint wills, the parties agree to leave their assets to each other, but they can also agree to leave property to third parties. Mutual wills are intended to be irrevocable. Joint and mutual wills may not be advisable since these may in some cases disqualify the property for a marital deduction.
4. *Reciprocal Will*: A type of mutual will in which each spouse names the other as the beneficiary of his or her property. In this case a couple will draft separate wills containing the same information, resulting in their property being left to each other. Reciprocal wills are commonly referred to as "mirror wills". Reciprocal wills are often discouraged for couples with large estates, as they can result in an increase in estate tax, or cause the individual to be subject to estate tax when they otherwise would not have been.

The importance of working with a competent estate planning attorney or other professional cannot be overstated. Incorrect language in a will can produce results that are different from the intent of the testators.

Clauses Within a Will

There are five main parts to a will, each containing specific clauses describing the administrator of the estate, legal powers, witnesses, distribution of assets and other important information. Here is a brief summary of each section along with a description of the clauses within each section.

1. Preliminary

- *Introductory or Exordium*: The exordium clause identifies the testator of the will, declares that the document is meant to be the testator's will and that the testator of the will intends to revoke prior wills.
- *Death Tax*: This clause establishes the source of funds for payment of taxes that may arise as the result of testator's death. Examples of these taxes include federal tax, estate tax, inheritance tax and generation-skipping tax.
- *Family Statement*: This clause identifies the testator's spouse and family at the time of execution of the will.

2. Dispositive

- *Devise*: A provision transferring title to real property.
- *Bequest or Legacy*: a provision transferring title to tangible and intangible personal property.
- *Residuary*: This clause distributes assets that are not otherwise distributed by other clauses in the will.
- *Distribution to Trusts*: This clause will describe how, when and what trusts will be funded.
- *Distribution to Classes*: This section describes how the assets will be distributed within a given class of beneficiaries.

For example:

a. *Per Capita*: Distributing assets per capita means giving equal shares to the number of beneficiaries. For example, John dies and leaves his assets per capita to his daughter Mary and son James. If James dies before his father, leaving two sons behind, then James' two children and Mary will inherit the 1/3 of the estate each.
b. *Per Stirpes*: Per stirpes distribution, also known as distribution "by representation," is done according to the "line" by which the beneficiary is related to the decedent. In the example given above, Mary will receive 1/2 of the assets and James' two sons will split their father's 1/2 of the inherited estate by right of representation.
c. *Per Capita at Each Generation*:This type of distribution is similar to per stirpes distribution, except it guarantees that beneficiaries in the same generation will receive equal amounts.

3. Appointment

- *Fiduciary Appointment Clause*: This clause names the fiduciary, the person or people that the testator would like to administer the estate and serve as guardian to any minor children.
- *Fiduciary Powers Clause*: This clause grants and/or limits the powers given to the fiduciary.

4. Concluding

- *Testator's Signature*: This clause establishes that the document is intended to be the will maker's last will and that the formal statutory signature requirement has been met.
- *Attestation*: This clause acknowledges that the witnesses have witnessed the testator's signature for valid will execution.
- *Self-Proving*: This clause allows the will to be admitted to probate without requiring the witnesses to appear at a formal hearing of the probate court.

5. **Other**

- *No Contest*: This clause describes how a beneficiary may be penalized for contesting the will. A beneficiary can contest a will if he feels that the will was not properly executed, the testator lacked the mental capacity to create a valid will, the will contains a mistake or was the result of fraud. However, contesting the will can be costly and the will could have a no-contest clause, which may penalize the beneficiary for contesting the will by reducing or forfeiting the amount he/she was designated to inherit.
- *Disclaimer*: This clause will describe how disclaimed property is distributed.

How to Create a Will
There are many ways you can create a will, including paying an online service to create the document or hiring a competent legal professional to draft one. However, you have to remember that in order for your will to be valid, it must meet certain rules as outlined earlier in this tutorial.

If you have a small estate, you may be able to do this on your own, but because estate planning can be complicated, especially with second marriages, young children or non-traditional unions, it is worth considering paying a visit to an estate planning attorney or other estate planning professional. The last thing you want is to make a mistake and disinherit a loved one. The investment you make in an attorney may be worthwhile for you and your loved ones. (Read more about how to identify beneficiaries in *Problematic Beneficiary Designations – Part 1*.)

Estate Planning: Will Substitutes

A will substitute is a technique that allows you to transfer property at your death to a beneficiary outside the probate process. This will not only expedite the distribution process but also avoid any costs associated with probate. What are considered will substitutes?

Right of Survivorship
Joint tenancy with right of survivorship *(JTWROS)* and tenancy by entirety (TBE) transfer assets directly to the surviving tenant at the death of the other. However, tenancy by entirety can only be used by legally married husband and wife and is not recognized in all states.

Beneficiary Designation
Naming of a beneficiary can also be considered a will substitute. Examples of these include:

- *Payable-on-Death (POD) Accounts:* In states where it is allowed, this involves depositing funds for the benefit of another, payable on the death of the original depositor.
- *Transfer-on-Death (TOD) Accounts:* Similar to a payable-on-death account, except it is used for individual stocks or a stock account.
- *Contract Provisions Effective at Death:* This can include life insurance, annuity contracts, qualified plans, 403(b) plans, 457 plans and IRAs, where you designate a beneficiary to whom payments are made after your death.
- *Deeds of Title:* In some states a valid deed may be used to pass a present interest to the grantee during your lifetime to avoid testamentary formalities.
- *Funded Living Trusts:* Revocable living trusts is the most common form of will substitutes. These trusts are funded during your lifetime to avoid probate at death.

Advantages and Disadvantages
The following are many advantages to having will substitutes:

- You can avoid probate.
- They are easier to amend.
- They are usually revocable until death, which means that you maintain control.
- For planning tools like TODs or PODs, they are cheap (or free) to execute.

The following are some disadvantages of will substitutes:

- Set-up costs can be high (especially for living trusts) because they usually include attorney fees for setting up the trusts and contracts.
- You may incur some maintenance costs.
- You may also be on the hook for some taxes if the substitute you choose is not set up properly.

Estate Planning: Introduction To Trusts

A trust is an agreement that describes how assets will be managed and held for the benefit of another person. There are many types of trusts, designed for different purposes, so let's begin discussing the elements common to most types of trusts. (For related reading, check out *Pick The Perfect Trust*.)

Trust Terminology You Need to Know
Grantor
All trusts have a grantor, sometimes called a "settler" or "trustor". This is the person that creates the trust and is the one who has the legal capacity to transfer property held under the trust.

Decedent
The person who has died. This person is usually the grantor of the trust.

Trustee
The trustee of the trust can be any legal individual or corporation that can take title to property on behalf of a beneficiary. The trustee is responsible for managing the property according to the rules outlined in the trust document, and must do so in the best interest of the beneficiary. This person may be the grantor, the spouse or adult child of the trust or a third party. It is important to note that the trustee must be prepared to be held accountable to the grantor and/or beneficiaries.

Beneficiary
The beneficiary is the person benefiting from the trust. The beneficiary can be one or multiple parties. Multiple trust beneficiaries do not have to have the same interests in the trust property. An interesting thing about trust beneficiaries is that they do not have to exist at the time the trust is created.

Property
Property is what gets put inside a trust and it is sometimes called the "principal" or the "corpus." Property can be any type of asset and can be transferred to the trust during the lifetime of the grantor (inter-vivos/living trust) or under the will of the grantor after death (testamentary trust). Property can include things like money, securities, real estate, jewelry, etc.

Surviving Spouse
The spouse who survived the decedent.

Trust Classifications
Trusts can have the following types of classifications:

Living Trust
A living trust is usually created by the grantor during his or her lifetime through a transfer

of property to a trustee. The grantor generally retains the power to change or revoke the trust. When the grantor passes away, this trust becomes irrevocable, which means that the terms of the trust cannot be changed and the trustee must follow the rules set forth in the trust concerning the distribution of property and the payment of taxes and expenses.

Testamentary Trust
Testamentary trusts, sometimes called trusts under will, are trusts that are created by a will after the grantor dies. This type of trust is designed to accomplish specific planning goals, such as:

- Preserving assets for children from a previous marriage.
- Protecting a spouse's financial future by providing lifetime income, available under a qualified terminable interest property (QTIP) trust.
- Skipping the surviving spouse entirely as a beneficiary.
- Ensuring that a special-needs beneficiary will be taken care of.
- Preventing minors from inheriting property outright when they reach the age or majority as defined by the state - usually from age 18 to 21.
- Gifting to charities.

Funded
A trust may be fully or partially funded by the grantor during his or her lifetime or after death. In the case of a funded trust, it means that property has been put inside the trust.

Unfunded
An unfunded trust is simply the trust agreement. Some trusts remain unfunded until the death of the grantor, or may just stay unfunded.

Revocable
A revocable trust (also called "modifiable") is a trust that can be changed by the grantor during his or her lifetime.

Irrevocable
An irrevocable trust (also called "non-modifiable"), by contrast, is a trust that cannot be changed by the grantor once the trust is deemed irrevocable. The grantor loses total control of the property and has to obey the trust rules. A trust can be revocable during the grantor's lifetime and becomes irrevocable upon death.

Goals of Trusts
There are many reasons why you may choose to have a trust as part of your estate plan, including avoiding probate, providing financial support to family members and gaining privacy advantages if the state where you live requires filing an inventory of assets.

Tax Implications
Some trusts, like irrevocable trusts, are separate taxpayers and must obtain a federal tax identification number and file an annual return on a calendar-year basis. However, some

living trusts (i.e., where the grantor and beneficiary are the same person) do retain the grantor's tax identification number.

Estate Planning: Marital And Non-Marital Trusts

Before we begin talking about these types of trusts, let's first begin by introducing the term "unlimited marital deduction." The unlimited marital deduction refers to the amount allowed by the federal estate-tax laws for all property passed to a surviving spouse who is a U.S. citizen. This deduction allows any individual to pass their estate to a surviving spouse without any deferral estate tax being assessed.

However, after the surviving spouse dies, it will be included in his or her taxable estate unless it has been spent. If the surviving spouse gifts the assets while living, a federal gift tax or a federal estate tax may be levied.

Now that we have identified the concept of unlimited marital deductions, let's review marital trusts and non-marital trusts.

Marital Trust
A marital trust (sometimes referred to as an A- trust) is a unique estate planning tool that allows you to provide for your spouse and at the same time ensure that your children also receive an inheritance. Why is this so important? It's difficult to control future circumstances after your death: wouldn't you like to know that if your spouse remarries, she will not leave your assets to the new spouse while disinheriting your children? This is the purpose of the marital trust. In essence you are protecting the assets from the claims of a subsequent spouse.

The property placed inside a marital trust qualifies for the marital deduction in the gross estate of the decedent. So even though the amount is included in the decedent's estate, it is not subject to estate tax. Married couples can pass unlimited amounts of money and assets to each other, either during life or at death, without any gift tax or estate tax implications.

The way these trusts usually work depends on the type of marital trust. In some cases, your spouse will receive the income generated by the trust throughout his or her lifetime. In other cases the trust will also allow for principal distributions for reasons, such as healthcare, education, maintenance, etc. The interpretation can be quite subjective, depending on the trustee or administrator of the trust, which is often the surviving spouse or the spouse and co-trustee.

Forms of Marital Trusts
Marital trusts can take one of the following three forms:

1. A general power-of-appointment (GPA) marital trust may be created for the sole benefit of the surviving spouse during his or her lifetime, with terms that provide the surviving spouse with an income interest for life. Typically, the spouse is also granted a general power of appointment of the assets remaining in the estate. This is the most liberal and least restrictive of the marital trust forms.
2. A QTIP trust may be used for the sole benefit of the surviving spouse during his or her lifetime, but its terms require that the surviving spouse have a qualifying income interest for life only. According to the Internal Revenue Code, this means that the property must be payable to the surviving spouse alone at intervals of at least once annually. The balance, or corpus, of the trust is often bequeathed to children or other heirs. QTIP trusts are typically used by individuals who have been married more than once and have children from a previous marriage they want to continue to provide for. The main advantage of this type of trust is that it allows you to retain control of the trust even after the surviving spouse dies, by allowing you to dictate who should receive the property after your spouse. But it's worth noting that in order for the property to be treated as QTIP property, the election must be made on the decedent's tax returns.
3. An estate trust may be used to provide discretionary distributions to the surviving spouse during his or her lifetime, but it requires that the remainder of the trust pass to the surviving spouse's estate at death.

All of the marital trusts described have a common thread: the value of the assets held by each trust will be included in the gross estate of the surviving spouse. In other words, bequests to these trusts do not eliminate federal estate tax, but instead merely defer it.

With regard to income taxes, for the assets inside the trust, income is taxed to the grantor under the grantor trust rules until the grantor's death. After the grantor's death, the income from a power-of-appointment trust or QTIP trust will be taxed to the grantor's spouse because of the mandatory distribution of income to the spouse. After the grantor's death, income from an estate trust will be taxed to the grantor's spouse if distributed, or to the trust if not distributed.

Non-Marital Trusts
A non-marital trust, also known as a bypass trust or credit shelter trust, is a type of trust that also allows you to take care of your spouse and ensure that your children will inherit your estate. It is called a bypass trust because in essence this trust bypasses both your estate and your spouse. Why is this important? Estate taxes! (For more information, read *Get A Step Up With Credit Shelter Trusts*.)

With a bypass trust, the grantor places the assets in a trust that names the grantor's spouse and other family members as income beneficiaries. The trust is typically irrevocable, or becomes irrevocable upon the grantor's death. This trust is funded with property transferred upon the decedent's death. Typically, the amount transferred to the trust is equal to the applicable exclusion of $2 million for 2008. This number may change depending on congressional actions or inaction. Upon termination of the trust or death of the surviving spouse, the trust's assets will pass estate tax-free according to its terms. This trust usually has a two-fold purpose:

1. To ensure that the grantor will fully use the available credit amount.
2. To allow the grantor's spouse to have access to the trust assets if needed, while allowing such assets to "bypass" the spouse's estate.

As long as a completed transfer of assets takes place that satisfies the three-year rule, assets in a bypass trust are excluded from the grantor's gross estate. Under this three-year rule, if the transfers were completed within a three-year period from the grantor's death, the assets will be included in the grantor's estate and the bypass will be voided unless an exception applies.

Irrevocable Life Insurance Trusts (ILIT)
An irrevocable life insurance trust (ILIT) is an integral part of a wealthy family's estate plan. In estates with more assets than the applicable exclusion amount, life insurance is usually a cornerstone of the estate plan. An ILIT provides the grantor a flexible planning approach as well as a tax-savings technique, since it enables the exclusion of life insurance proceeds from the estate of the first spouse to die and from the estate of the surviving spouse. This type of trust is funded with a life insurance policy. The trust becomes the owner of the policy and also becomes the beneficiary of the policy, but the grantor's heirs can remain beneficiaries of the trust itself.

In order for this planning to be valid, the grantor must live three years from the time of the policy transfer, otherwise the policy proceeds will not be excluded from the grantor's estate. If the trust is funded, any income that is or may be used to pay premiums on a life insurance policy on the grantor or the grantor's spouse will be taxed to the grantor under the grantor trust rules .This is because any income from the trust is reported on the grantor's personal income tax return.

Aside from ensuring the validity of the trust, the following are some negatives associated with an ILIT:

- It can be costly to establish the trust, as it may be necessary to engage the services of an estate planning professional to ensure that the trust satisfies the ILIT requirements.
- They are generally irrevocable, and there are narrowly defined exceptions under which provisions, including the dispositional terms, can be changed.
- Taxpayers often avoid ILITs because of the perceived high level of complexity.

Qualified Domestic Trust (QDOT)
Estate planning for non-citizen spouses has its challenges. Normally all property passing outright to a surviving spouse qualifies for the marital deduction, unless that spouse is *not* a U.S. citizen. Some of the limitations include:

- Limit for annual gifts between spouses is $128,000 (not unlimited as with two U.S. citizens).
- Property held jointly between spouses is not automatically considered one-half owned by the surviving spouse and is instead based on consideration.
- There is no unlimited marital deduction.

So, how do you deal with this challenge? A qualified domestic trust (QDOT) allows a non-citizen spouse to benefit from the marital deduction normally allowed to other married couples. Unfortunately, the unlimited marital deduction is denied for property transferred to a spouse who is not a U.S. citizen unless the property specifically passes to a QDOT. With this type of trust, the surviving non-citizen spouse must be entitled to all income from the assets held in the QDOT.

This trust allows for the surviving spouse to receive income for life, but not principal. This is done so as to avoid the surviving spouse removing the assets from the control of a U.S. taxing authority. For a trust to qualify as a QDOT, certain requirements must be met, including the following:

- A QDOT election must be made on the decedent's tax return by the executor.
- At least one trustee must be a U.S. citizen or domestic corporation.
- The trust instrument must require that no distribution of corpus from the trust may be made unless the trustee has the right to withhold from the distribution the QDOT tax imposed on the distribution.
- The requirements of all application regulations must be met.

A U.S. bank must serve as trustee for trusts with over $2 million in assets, unless the U.S. trustee furnishes a bond in favor of the IRS in an amount equal to 65% of the fair market value of the trust assets, or the U.S. trustee furnishes an irrevocable letter of credit (ILOC) issued by a bank in an amount equal to 65% of the fair market value of the trust assets.

If the estate-tax value of the assets passing to the QDOT is $2 million or less, the trust instrument must require that no more than 35% of the fair market value of the trust assets will consist of real property located outside the U.S., or the trust will meet the requirements for QDOTs with assets in excess of $2 million during the term of the QDOT.

Estate Planning: Charitable Trusts

Philanthropy through charitable contributions generates not only goodwill, but also has significant income and estate tax benefits for donors. For wealthy individuals, this may translate into hundreds of thousands of dollars in estate and income tax savings. A great way to accomplish this goal is through the use of charitable trusts.

A charitable trust is not tax exempt, and its unexpired interests are usually devoted to one or more charitable purposes. A charitable trust is allowed a charitable contribution deduction and is usually considered organized as of the first day on which it is funded with amounts for which a deduction was allowed.

Charitable Trust Terminology You Need to Know

Corpus

Corpus is the Latin word for "body". In the case of a trust, the trust corpus is the assets with which the trust was funded. It does not include gains, income, etc. produced by the trust assets.

Donor

The person donating the assets to the charity.

Why Consider Leaving Assets to a Charity?

As a general rule, outright gifts to charity at death are deductible without limit and reduce the taxable estate.

The Charitable Remainder Trust

A charitable remainder trust (CRT) is an incredibly effective estate planning tool available to anyone holding appreciated assets with low basis, like stocks or real estate. Funding this trust with appreciated assets allows the donor to sell the assets without incurring a capital gain. CRTs provide investors with an efficient way to transfer appreciated property, benefit from the charitable income tax deduction and reduce estate taxes while still reaping the benefits of the underlying assets for income purposes.

There are two sets of beneficiaries: income beneficiaries, typically you and your spouse, and the charities that you choose to name in the trust. As the grantor, you will generally receive income from the trust during your lifetime or for a fixed number of years. If you are married and either you or your spouse dies, the surviving spouse continues to receive income. Provisions can also be made to continue making income payments to successor beneficiaries, and the charities will receive the residual principal of the trust when all the other beneficiaries die.

The following are two types of CRT than can be considered:

Charitable Remainder Annuity Trust

A charitable remainder annuity trust (CRAT) is used in situations where the donor wishes to provide a non-charitable beneficiary with a stream of income to last for a specific time period (i.e., for the life of the recipient or for a fixed number of years). If a term of years is used, it cannot surpass more than 20 years. The income stream must represent at least 5% of the corpus each year.

In this type of arrangement, the recipient receives an income tax deduction from the present value of the remainder interest. At the time the period ends, the remainder interest in the property passes to a qualified charity, or it can also remain in trust for the charity. However, the remainder interest is required to be at least 10% of the contributed amount. It should be noted that the donor can make only one initial transfer of property to the corpus and there can be no additions or increases to the corpus in later years.

Charitable Remainder Unit Trust
The charitable remainder unit trust (CRUT) is similar to CRAT with the difference that in the CRUT the donor can make more than one transfer to the trust. The other difference is that once the trust is established, the corpus must pay out a specific amount of income each year, as a fixed percentage of at least 5%. Depending on how the trust is set up, the payments will continue for a fixed period of time or until the death of the beneficiary.

Charitable Lead Trusts
The purpose of a charitable lead trust (CLT) is to reduce the donor's current taxable income. The way this type of trust works is that a portion of the trust's income is first donated to a charity, and after a specified period of time (usually until all taxes are reduced), it transfers the remainder of the trust to the trust beneficiaries. By doing this the beneficiaries will face lower gift taxes and estate taxes. The federal tax deduction you receive from this type of trust will be equal to the estimated value of the annual trust payments to the charity.

You can get a lot of help in setting up these types of trusts from different charities, universities and other organizations that would be interested in getting the income for a few years. A charitable lead trust works best for wealthier, estate tax-conscious individuals, as long as those individuals are willing to defer receiving substantial income and own highly appreciating assets.

Estate Planning: Estate Taxation

The estate tax is a type of "death tax", whereby taxes are imposed on the right to transfer or receive property at the property owner's death. This tax can come in the form of:

- Inheritance tax
- Estate tax, which is assessed on everything you own or have interest at the time of your death

The inheritance tax is generally imposed by some states on the recipient of inherited property as a *right to receive* wealth, while the estate tax, which is imposed at the federal level and in some states, is imposed on the decedent's estate for the *right to transfer* property. (*Tax-Efficient Wealth Transfer* can help higher net worth individuals reduce their estate taxes.)

The federal unified-transfer-tax system, which links the federal gift tax to the estate tax system, requires that all taxable gifts must be added to the taxable estate before calculating the estate tax due or applying any appropriate credits. In other words, if a decedent made taxable gifts above the annual exemption amounts of $14,000 per year (for 2015) it would have to be applied against their applicable exclusion amount, which is $5,430,000 million.

In general, a federal estate tax Form 706 must be filed for all decedents who are U.S. citizens or residents. The estate tax liability amount on Form 706 will be the total gross estate plus adjustable taxable gifts equaling or exceeding the amount of the applicable credit equivalent for the year of death. The executor of the estate is responsible for paying the tax.

An estate tax return for a U.S. citizen or resident needs to be filed only if the gross estate exceeds the applicable exclusion amount listed below.

Applicable Exclusion Amounts	
Year	**Exclusion Amount**
2015	$5,430,000
2014	$5,340,000

How are Taxes Calculated?
The calculation for the net estate tax due begins with the gross estate. The gross estate includes all of the assets owned by the decedent or the decedent's estate, including all probate assets (individual accounts, tenants in common, community property, etc.) and non-probate assets (joint accounts, life insurance, IRAs, etc.). The gross estate is then reduced by the following:

- Funeral expenses.
- Estate administration expenses.
- Claims against the estate.
- Unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest is included in the value of the gross estate.

These amounts are subject to the laws that govern the jurisdiction in which the decedent resided.

The net figure becomes the "adjusted gross estate". Once the marital deduction and charitable deductions are subtracted from the adjusted gross estate, we arrive at the "taxable estate" figure. Then any taxable gifts are added (i.e., cumulative gifts made to individuals that exceeded the annual exclusion amount) to arrive at a "tax base". The tax base is then multiplied by the appropriate tax rate. Once the tentative tax is calculated, the amount is reduced by the applicable credit amount and any gift or state death taxes already paid. The result is the "net estate tax".

Individual taxpayers should work with a professional to ensure their estate taxes are computed accurately. Even the IRS has admitted that estate tax is one of the most complicated areas of the tax code, and encourages taxpayers to work with an estate tax practitioner who has considerable experience in the field.

Valuing Assets
Estate assets are valued at fair market value unless special-use valuation is employed (i.e., business interests, closely held companies, etc.). Most properties that are bequeathed through an estate receive a "step-up in basis", meaning that the cost basis of the inherited property assumes a date-of-death valuation. This is an incredible boon for the person who inherits property that once had a low cost basis, which would have subjected them to higher potential capital gains.

For example, Mary owns $200,000 of IBM (NYSE:IBM)stock in her portfolio, but her adjusted purchase price is only $40,000. Her potential capital gain, if sold, is $160,000. Let's say Mary dies and leaves her son Joe all the IBM shares, for which the date-of-death value is $200,000. Joe's cost basis now becomes $200,000, and not Mary's $40,000, so if he decides to sell the stock the next week when the stock is worth $205,000, his capital gain would only be $5,000! That's the benefit of receiving a step-up in basis.

In order for certain transferred or gifted assets to remain out of the estate, they must pass the three-year rule. This applies to transfers of life insurance by the insured and any gift tax paid out-of-pocket on gifts within three years of death.

Estate Planning: Life Insurance In Estate Planning

Uses of Life Insurance
Life insurance is present in almost every estate plan and serves as a source of support, education-expense coverage and liquidity to pay death taxes, pay expenses, fund business buy-sell agreements and sometimes to fund retirement plans.

For small estates, the amount of applicable exclusion ($2 million per person per estate), death taxes are not a significant consideration. For this reason, insurance ownership as a tax-savings device is not critical. The main item that policy owners should be aware of is to ensure that the beneficiaries are well provided for by the chosen insurance policy.

For larger estates with more assets than the amount of the applicable exclusion of $2 million, life insurance is an essential component of the estate plan.

Tax Implications of Life Insurance and Your Estate
Proceeds from life insurance that are received by the beneficiaries upon the death of the insured are generally income tax-free. However, there are three circumstances that cause life insurance to be included in the decedent's estate:

1. The proceeds are paid to the executor of the decedent's estate.
2. The decedent at death possessed an incident of ownership in the policy.
3. There is a transfer of ownership within three years of death (three-year rule must be observed).

An incident of ownership includes the right to assign, to terminate, to name beneficiaries, to change beneficiaries and to borrow against the cash reserves.

Planning Objectives for Insurance
Life insurance has many uses in an estate plan, including estate liquidity, debt repayment, income replacement and wealth accumulation. There are many different types of policies to consider, at different price levels, which are beyond the scope of this article. Policies can be owned in many ways, as outlined below. (To read more about different types of available life insurance, check out *Buying Life Insurance: Term Versus Permanent*, *Permanent Life Policies: Whole Vs. Universal* and *Variable Vs. Variable Universal Life Insurance*.)

Types of Insurance
First-to-Die Life Insurance Policy
Also known as joint whole life insurance, this is a group insurance policy where benefits are paid out to the surviving insured upon the death of one of the insured group members. The insurance policy can be designed as either a whole life or universal life policy. A first-to-die policy can reduce taxes upon the death of the first spouse if the unlimited marital deduction is not fully used.

Survivorship Life Insurance Policy
Survivorship life insurance, also know as second-to-die, is similar to joint life in that the policy insures two or more people. However, survivorship life pays out upon the last death instead of the first one. Because the benefit is not paid until the last insured dies, the life expectancy is greater and therefore the premium is lower. Survivorship policies are typically either whole or universal life policies and are usually written to insure husband and wife or a parent and child.

The proceeds of the policy can be used to cover estate taxes, to provide for heirs or to make a charitable contribution. The premium on a second-to-die policy is generally lower than for separate policies because the premium is based on a joint age and the insurance company's administrative expenses are lower with one policy.

Types of Life Insurance Trust Arrangements
Revocable Life Insurance Trust
In this arrangement the grantor names the trust as beneficiary of life insurance policies, retaining the right to revoke the trust and other rights of ownership.

This is often recommended for younger families with relatively modest assets but substantial life insurance policies.

Irrevocable Life Insurance Trust
The purpose of this arrangement is to exclude life insurance proceeds from the estate of the first spouse to die and from the estate of the surviving spouse. The spouse may be the life income beneficiary, but may not have any right to or power over trust principal except per the discretion of the trustees.

Ownership Considerations
The big question with regard to insurance in estate planning is who should own the policy. The following are some advantages and disadvantages of ownership scenarios:

- If a life insurance policy is owned by the insured, the advantage is that he has continued control of the policy and any ownership in the associated cash values of a permanent policy. However, the death benefit of this policy would be subject to estate tax and the three-year inclusion would apply if it's transferred out of the estate.
- If the spouse of the insured owns the policy, you could argue that the insured does have some indirect control of the policy and any associated cash value. The downside is that the replacement cost of the policy would be included in the estate of the spouse, and if the spouse dies before the insured, it's possible that the policy might revert to the insured and be included in his or her estate.
- If the children of the insured owned the policy, the advantage is that the death benefit would be included in the children's estate, not the parent's. But here again, the insured has zero control over the policy, and if the children are minors it would require the costly appointment of legal guardians before benefits can be paid.
- The policy might also be owned by a revocable trust, where the insured might still control the policy and the death proceeds are shielded from potential creditors of the insured. But, because the insured has an incident of ownership through the revocable trust, the death benefit is includable in the insured's gross estate and could be accessible to the estate's creditors.
- If the policy is instead owned by an irrevocable trust as mentioned above, there is no inclusion in the gross estate, and there is an embedded mechanism via the trust language for continuation of the policy if the insured becomes incompetent. The downside is that the insured does not regain any control over the policy and cannot revoke the trust.

(Read *Shifting Life Insurance Ownership* to find out how to reduce your taxable estate and leave more to your heirs.)

Naming Beneficiaries for Life Insurance
If an individual is named as beneficiary of a policy, while cheap to execute since a trust was not used, it could lead to some challenges. The biggest problem with this strategy is that the decedent cannot exert any control over the death proceeds. The individual that inherits the death benefits can use the money for any reason, even if the money was earmarked to pay estate taxes or settlement costs. If the beneficiary is a minor, the challenges will likely escalate.

If an estate is named beneficiary of the policy, the death benefits are includable in the decedent's gross estate and are subject to the claims of the estate's creditors, and this will no doubt increase probate costs. If, however, the beneficiary is an irrevocable trust, the trustee can be given broad powers to distribute or withhold benefits available to the insured's estate, the assets are protected from creditors and oversight of the trust's assets can be assigned to professional money managers.

Individuals should consult an experienced financial planner to determine their needs for life insurance and the types of policies that are suitable for their estate planning needs.

Estate Planning: Health Problems, Money Matters And Death

Estate planning is not just about money and taxes. You may find yourself in end-of-life situations that require careful thought and planning to ensure your well-being and financial security. While unpleasant to contemplate, incompetency at some stage in your life is a distinct possibility. Who will take care of you if you cannot take care of yourself? These questions are effectively handled with proper planning, and there are many estate planning tools that can help you to execute your wishes. (Read *Three Documents You Shouldn't Do Without* for more information.)

Durable Power Of Attorney For Healthcare
A durable power of attorney for healthcare (HCPA), also known as a healthcare proxy document, allows you to name a specific person to make medical decisions for you in the event that you are unable to make those decisions on your own. The person you name will have the legal authority to make decisions about care, but this power does not authorize them to make decisions about life-sustaining treatments.

This form allows the person you elect as your healthcare agent to use your living will as a guide to making healthcare decisions and judgment calls for unexpected circumstances that are not addressed by your living will. If you do not appoint a medical power of attorney, the decision about your care defaults to your spouse. If you aren't legally married, decisions fall to your adult children or your parents.

Advance Medical Directives
An advance medical directive, which is sometimes called a healthcare directive, is a document that names a proxy and provides guidance about one's wishes for healthcare. This document will specify the individual or individuals who can make healthcare decisions for you if you can't make them for yourself.

Financial Power Of Attorney
A financial power of attorney (POA) is important so that your spouse, partner or another person can make financial decisions on your behalf. This document will dictate how the person should make decisions when managing your financial affairs.

When it comes to POAs, just because you have one does not mean that it covers both healthcare and financial decisions, unless it specifically says so. This is not a concern for married couples since they automatically have the right to make decisions for each other.

Living Wills
A living will lets you specify decisions about artificial life support in advance. It not only ensures your wishes will be considered, but also protects your loved ones from having to make these difficult personal choices for you. This document will detail your feelings on certain medical treatments and interventions but it does not cover every possible scenario.

Do not Resuscitate Order (DNR)
This is a request to not have cardiopulmonary resuscitation (CPR) if your heart stops or if you stop breathing. A DNR order can be put in your medical chart by your doctor.

Funeral Arrangements
In the absence of planning, state statutes usually give the next of kin the authority to make decisions regarding funeral arrangements and the disposition of your remains. Wouldn't it be better if you could plan this yourself? Some people may not want to be buried in a cemetery; others may wish to plan an elaborate funeral "party" celebrating their life. The best way to curb any unwanted end-of-life plans is to arrange them yourself ahead of time. For example, a person can state their desires in a legally acceptable document prior to death that outlines their wishes and can preplan and prepay funeral arrangements.

Post-Mortem Letter
The post-mortem letter, also referred to as a letter of instruction, is an often-overlooked estate planning tool. It provides executors and survivors with the locations of your assets, the identity of professionals consulted by you during life and the location of important records. This will be a tremendous help for whomever you appoint as your estate executor. You can also use this letter to summarize your life's goals and highlights and say your last goodbyes to loved ones. (For more information on this important document, read *Letter Of Instruction - Don't Leave Life Without It*.)

Planning ahead of time for unforeseen circumstances can not only save you and your loved ones considerable money down the road, but it can also make your life much more manageable at a time when peace of mind is critical, both for yourself and your family. (For more information of covering the costs associated with aging, read *Long-Term Care Insurance: Who Needs It?* and *A Look At Single-Premium Life Insurance*.)

Estate Planning: Conclusion

This tutorial covers the basic aspects of estate planning, one of life's most important processes. While you should now be equipped to understand the fundamentals, it is always recommended that you discuss your options with an estate planning attorney or other professional. Mistakes can be costly to your loved ones, and investing in hiring a professional will pay off in the long run for those you leave behind.

Let's take a look at what we've learned:

- Proper estate planning is the best way to protect your interests and those of your loved ones after your death.
- Everyone needs an estate plan, not just the wealthy, but larger estates will likely require more complex plans.
- Key components of any estate plan are a will, one or more trusts, life insurance and a variety of end-of-life documents, such as a living will, powers of attorney, etc.
- A will is a document that describes how you want your property and owned interests distributed after your death.
- What constitutes a valid will can vary by state, so it is important to verify your state's regulations before drafting your will.
- There are several types of will substitutes that can allow you to bypass the probate process, each with advantages and disadvantages.
- A trust is an agreement that describes how assets will be managed and held for the benefit of another person, and they come in many different forms.
- A properly set-up trust can create tax benefits for its beneficiaries, especially when it comes to charitable trusts.
- Life insurance serves as a source of support and liquidity for paying taxes and end-of-life expenses.

Other important end-of-life documents are an advance medical directive, healthcare and financial powers of attorney, a living will and a letter of instruction.

If you have all of these documents in order, you will have peace of mind in knowing that the important people in your life are being properly taken care of.