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2024 Estate Planning

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Introduction to Estate Planning

What is estate planning?

Simply stated, estate planning is a method for determining how to distribute your property during your life and at your death. It is the process of developing and implementing a master plan that facilitates the distribution of your property after your death and according to your goals and objectives.

At your death, you leave behind the people that you love and all your worldly goods. Without advance planning, you have no say about who gets what, and more of your property may go to others, like the federal government, instead of your loved ones. If you care about (1) how and to whom your property is distributed, and (2) ensuring that your property is preserved for your loved ones, you need to know more about estate planning.

As a process, estate planning requires a little effort on your part. First, you'll want to come to terms with dying, at least to a degree that you can deal with the necessary planning. Understandably, your death can be a very uncomfortable subject, but unfortunately, the discussions in this area are full of references to your death, so it really can't be avoided. Some statements may seem too businesslike and unfeeling, but tiptoeing around the subject of dying will only make the planning process more difficult. You will understand the process more easily and implement a more successful master plan if you approach it in a straightforward manner.

Who needs estate planning?

Not just for the wealthy

Estate planning may be important to individuals with a wide range of financial situations. In fact, it may be more important if you have a smaller estate because the final expenses will have a much greater impact on your estate. Wasting even a single asset may cause your loved ones to suffer from a lack of financial resources.

Your master plan can consist of strategies that are simple and inexpensive to implement (e.g., a will or life insurance). If your estate is larger, the estate planning process can be more complex and expensive.

Implementing most strategies will probably require you to hire professional help of some kind, an attorney, an accountant, a trust officer, or an insurance agent, for example. If your estate is large or complex, you should consult with an estate planning expert such as a tax attorney or financial planner for advice before the implementation stage.

In deciding on your course of action, you should always consider whether the benefit of the strategy outweighs the cost of its implementation.

May be especially needed under certain circumstances

You may need to plan your estate especially if:

- Your estate is valued at more than the federal gift and estate tax applicable exclusion amount or your state's death tax exclusion amount
- Your income tax bracket is in excess of 10%
- You have children who are minors or who have special needs
- Your spouse is uncomfortable with or incapable of handling financial matters
- You're a business owner
- You have property in more than one state
- You intend to contribute to charity
- You have special property, such as artwork or collectibles
- You have strong feelings about health-care decisions
- You have privacy concerns or want to avoid probate

How to do it

Designing a plan is a process that is unique to each estate owner. Don't be intimidated or overwhelmed at the prospect. Even the most complex plan can be achieved if you proceed step by step. Remember, the peace of mind that comes with developing a successful estate plan is worth the time, trouble, and expense.

Understand your particular circumstances

Begin the estate planning process by understanding your particular circumstances, such as your age, health, wealth, etc.

Understand the factors that will affect your estate

You will also need to have some understanding of the factors that may affect the distribution of your estate, such as taxes, probate, liquidity, and incapacity.

Clarify your goals and objectives

When your particular circumstances and the factors that may affect your estate are clear, your goals and objectives should come into focus.

Understand the strategies that are available

With these goals and objectives now clear, you can begin to consider the different estate planning strategies that are available to you.

Seek professional help

Seeking professional help (an attorney or financial advisor) will help you understand the strategies that are available and formulate and implement your master plan.

Formulate and implement a plan

Finally, after following these steps, you can formulate and implement a plan that works for you. Here are a few basic tips: (1) make sure you understand your plan, (2) rely on people you trust, and (3) keep your documents and information organized and within easy reach.

Perform periodic reviews

When you have implemented your master plan, be sure to perform a periodic review and, if necessary, make revisions that reflect any changing circumstances and tax laws.

How do you begin?

There are many estate planning strategies, including some that are implemented inter vivos (during life), such as making gifts, and others post-mortem (after death), such as disclaimers. Before you choose which strategies are right for you, you need to understand your particular circumstances.

Gather and analyze the facts

Understanding your particular circumstances results from gathering and analyzing the facts. The following questions may help you to accomplish this. If they are not easy to answer, you may have to make some estimates based on reasonable assumptions and expectations.

Information regarding your financial condition

- What is your current income?
- What is your income likely to be in the future?
- How much do you spend each year?
- What are your expenses likely to be in the future?
- What are your current assets and debts?
- Are your assets currently owned solely or jointly?
- What estate planning strategies have you already implemented?

Family information

- Who are the family members you intend to benefit?
- What are the needs of each family member?

What other factors need to be considered?

Decide what your goals and objectives are in light of your particular circumstances and in light of the factors that may affect your estate. The primary factors that may affect your estate are your beneficiaries, taxes, probate, liquidity, and incapacity.

Taxes

One of the largest potential expenses your estate may have to pay is taxes, which may include federal transfer taxes, state death taxes, and federal income taxes.

Federal transfer taxes — The federal transfer taxes include (1) the federal gift tax and estate tax and (2) the federal generation-skipping transfer (GST) tax.

- Federal gift tax — Gift tax is imposed on property you transfer to others while you are living. You need a basic understanding

of how the gift tax system works to minimize gift tax liability. Under the gift tax system, in 2023 you are allowed a $12,920,000 lifetime applicable exclusion amount that reduces your gift and estate tax liability (any (basic) applicable exclusion amount you use during life effectively reduces the amount that will be available at your death). Also, in 2023 you are allowed to give $17,000 per donee gift tax free under the annual gift tax exclusion (the annual gift tax exclusion is indexed for inflation, so this amount may change in future years). Further, certain other types of transfers can be made gift tax free. You need to understand what these types of transfer are and how they work to take full advantage of them.

- Federal estate tax — Generally speaking, estate tax is imposed on property you transfer to others at the time of your death. You need a basic understanding of how the estate tax system works for several reasons:
  - Saving your property for your beneficiaries — Estate tax rates could reach as high as 40% in 2023, which means that a large chunk of your estate may go to the federal government instead of your beneficiaries. If you want to preserve your estate for your beneficiaries, you'll need to know how to minimize estate tax with respect to your property.
  - Reducing estate tax liability — Under the estate tax system, you are allowed an applicable exclusion amount that reduces your estate tax liability. Also, there are exclusions, deductions, and other credits available that allow you to pass a certain amount of your estate tax free. You need to understand what these exclusions, deductions, and credits are and how they work to take full advantage of them.
  - Providing for the payment of estate tax — Generally, estate tax must be paid within nine months after your death. To avoid depriving your beneficiaries of what you intend for them to receive, you should provide that specific and sufficient assets be set aside and used for this purpose. In addition, these assets should be sufficiently liquid to pay these expenses when they are due.
  - Planning for estate tax expense — Although calculating estate tax can be complex, you should estimate what the amount of your estate tax may be (if any), so that you can arrange to replace that wealth.
- GST tax — Another federal transfer you need to understand is the federal generation-skipping transfer (GST) tax. The GST tax is imposed on property you transfer to an individual who is two or more generations below you (e.g., a grandchild or great-nephew). Not surprisingly, the IRS wants to levy a tax on property as it is passed from generation to generation at each and every level. The purpose of the GST tax is to keep individuals from avoiding estate tax by skipping an intermediate generation. A flat tax rate equal to the highest estate tax then in effect is imposed on every generation-skipping transfer you make over a certain amount. You are allowed a GST tax exemption of $12,920,000 in 2023. Currently, some states also impose their own GST tax. Check with an attorney or your state to find out what may be subject to your state's GST tax, and how and when to file a state GST tax return.

State death taxes — States also impose their own death taxes. You should be aware of what the death tax laws are in your state and how they may affect your estate. There are three types of state death taxes: (1) estate tax, (2) inheritance tax, and (3) credit estate tax (also called a sponge tax or pickup tax). Some states also impose their own gift tax and/or generation skipping transfer tax.

- Estate tax — State estate tax is imposed on property you transfer to others at your death, much like federal estate tax. The state estate tax calculation for most states is similar to the federal calculation.
- Inheritance tax — Unlike estate tax, the inheritance tax is imposed on your beneficiary's right to receive your property. Tax is due on each beneficiary's share of your estate. Beneficiaries are grouped into classes (generally based upon their familial relationship to you) and are taxed accordingly. Although inheritance tax is due on each heir's share of your estate, it's your personal representative who writes the check from your estate to pay it.
- Credit estate tax — Some states impose a credit estate tax (also referred to as a sponge tax or pickup tax).

Tip: *Most states that imposed a credit estate tax have "decoupled" from the federal system (i.e., they're imposing some form of stand-alone estate tax.)*

Tip: *The federal system allows a deduction for state death taxes for the estates of persons dying in 2005 and later. Prior to 2005, a credit was available.*

Federal income taxes — In the estate planning context, you should be aware of three federal income tax considerations:

1. Income taxation of trusts — If your estate plan includes the use of a trust, you need to know that a trust may be an income tax-paying entity. The trustee may be required to file an annual return and pay income taxes on trust income.
2. Decedent's final income tax return — Your personal representative or surviving spouse has the duty of filing your last income tax return that covers the tax year ending on the date of your death.
3. Income taxation of your estate — Your estate is considered a separate income taxpaying entity. Your personal representative must file and pay income taxes on any income your estate receives (e.g., interest from bonds, or dividends from stock).

Probate

Probate is the court-supervised process of proving, allowing, and administering your will. The probate process can be time-consuming, expensive, and open to public scrutiny. Avoiding probate may be one of your most important goals. To develop a successful avoidance strategy, you'll need to understand how the probate process works, how to estimate probate costs, and what is subject to probate.

Liquidity

Estate liquidity refers to the ability of your estate to pay taxes and other costs that arise after your death from cash and cash alternatives. If your property is mostly nonliquid (e.g., real estate, business interests), your estate may be forced to sell assets to meet its obligations as they become due. This could result in an economic loss, or your family selling assets that you intended for them to keep. Therefore, planning for estate liquidity should be one of your most important estate planning objectives.

Incapacity

Planning for incapacity is a vital yet often overlooked aspect of estate planning. Who will manage your property for you when you can no longer handle these responsibilities? You need to ask and answer this question because the consequences of being unprepared may have a devastating effect on your estate and loved ones. You should include plans for incapacity as a part of your overall estate plan.

What are your goals and objectives?

Your goals and objectives are personal, but you can't formulate a successful plan without a clear and precise understanding of what they are. They can be based on your particular circumstances and the factors that may affect your estate, as discussed earlier, but your feelings and desires are just as important. The following are some goals and objectives you might consider:

- Provide financial security for your family
- Ensure that your property is preserved and passed on to your beneficiaries
- Avoid disputes among family members, business owners, or with third parties (such as the IRS)
- Provide for your children's or grandchildren's education
- Provide for your favorite charity
- Maintain control over or ensure the competent management of your property in case of incapacity
- Minimize estate taxes and other costs
- Avoid probate
- Provide adequate liquidity for the settlement of your estate
- Transfer ownership of your business to your beneficiaries

What are estate planning strategies?

An estate planning strategy is any method that facilitates the distribution of your assets and the settlement of your estate according to your wishes. There are several estate planning strategies available to you.

Intestate succession

Intestate succession is a strategy by default and is a means of transferring your property to your heirs if you have failed to make other plans such as a will or trust. State law controls how and to whom your property is distributed, who administers your estate, and who takes care of your minor children. Without directions, your opinions and feelings are not considered. Indeed, one of your primary goals in planning your estate may be to avoid intestate succession.

Last will and testament

A will is a legal document that lets you state how you want your property distributed after you die, who shall administer your estate, and who will care for your minor children. This is probably the most important tool available to you. Anyone with property or minor children should have a will.

Will substitutes

A will substitute, for example, Totten Trust and payable on death bank accounts, allows you to designate a beneficiary of certain property that will automatically pass to that beneficiary after you die and avoids passing through probate.

Trusts

A trust is a separate legal entity that holds your assets that are then used for the benefit of one or more people (e.g., you, your spouse, or your children). There are different types of trusts, each serving a different purpose, and include marital trusts and charitable trusts. You will need an attorney to create a trust.

Joint ownership

Joint ownership is holding property in concert with one or more persons or entities. There are different types of joint ownership,

such as tenancy in common and community property, each with different legal definitions, requirements, and consequences.

Life insurance

Life insurance is a contract under which proceeds are paid to a designated beneficiary at your death. Life insurance plays a part in most estate plans.

Gifts

A gift is a transfer of property, not a bona fide sale, that you make during your life to family, friends, or charity. Making gifts can be personally gratifying as well as an effective estate planning tool.

Tax exclusions, deductions, and credits

There are several important estate planning tools you can use that are offered by the federal government. These include the annual gift tax exclusion, the applicable exclusion amount, the unlimited marital deduction, split gifts, and the charitable deduction.

Wills: The Cornerstone of Your Estate Plan

If you care about what happens to your money, home, and other property after you die, you need to do some estate planning. There are many tools you can use to achieve your estate planning goals, but a will is probably the most vital. Even if you're young or your estate is modest, you should always have a legally valid and up-to-date will. This is especially important if you have minor children because, in many states, your will is the only legal way you can name a guardian for them. Although a will doesn't have to be drafted by an attorney to be valid, seeking an attorney's help can ensure that your will accomplishes what you intend.

Wills avoid intestacy

Probably the greatest advantage of a will is that it allows you to avoid intestacy. That is, with a will you get to choose who will get your property, rather than leave it up to state law. State intestate succession laws, in effect, provide a will for you if you die without one. This "intestate's will" distributes your property, in general terms, to your closest blood relatives in proportions dictated by law. However, the state's distribution may not be what you would have wanted. Intestacy also has other disadvantages, which include the possibility that your estate will owe more taxes than it would if you had created a valid will.

Wills distribute property according to your wishes

Wills allow you to leave bequests (gifts) to anyone you want. You can leave your property to a surviving spouse, a child, other relatives, friends, a trust, a charity, or anyone you choose. There are some limits, however, on how you can distribute property using a will. For instance, your spouse may have certain rights with respect to your property, regardless of the provisions of your will.

Gifts through your will take the form of specific bequests (e.g., an heirloom, jewelry, furniture, or cash), general bequests (e.g., a percentage of your property), or a residuary bequest of what's left after your other gifts.

Wills allow you to nominate a guardian for your minor children

In many states, a will is your only means of stating who you want to act as legal guardian for your minor children if you die. You can name a personal guardian, who takes personal custody of the children, and a property guardian, who manages the children's assets. This can be the same person or different people. The probate court has final approval, but courts will usually approve your choice of guardian unless there are compelling reasons not to.

Wills allow you to nominate an executor

A will allows you to designate a person as your executor to act as your legal representative after your death. An executor carries out many estate settlement tasks, including locating your will, collecting your assets, paying legitimate creditor claims, paying any taxes owed by your estate, and distributing any remaining assets to your beneficiaries. Like naming a guardian, the probate court has final approval but will usually approve whomever you nominate.

Wills specify how to pay estate taxes and other expenses

The way in which estate taxes and other expenses are divided among your heirs is generally determined by state law unless you direct otherwise in your will. To ensure that the specific bequests you make to your beneficiaries are not reduced by taxes and other expenses, you can provide in your will that these costs be paid from your residuary estate. Or, you can specify which assets should be used or sold to pay these costs.

Wills can create a testamentary trust

You can create a trust in your will, known as a testamentary trust, that comes into being when your will is probated. Your will sets out the terms of the trust, such as who the trustee is, who the beneficiaries are, how the trust is funded, how the distributions should be made, and when the trust terminates. This can be especially important if you have a spouse or minor children who are unable to manage assets or property themselves.

Wills can fund a living trust

A living trust is a trust that you create during your lifetime. If you have a living trust, your will can transfer any assets that were not transferred to the trust while you were alive. This is known as a pourover will because the will "pours over" your estate to your living trust.

Wills can help minimize taxes

Your will gives you the chance to minimize taxes and other costs. For instance, if you draft a will that leaves your entire estate to your U.S. citizen spouse, none of your property will be taxable when you die (if your spouse survives you) because it is fully deductible under the unlimited marital deduction. However, if your estate is distributed according to intestacy rules, a portion of the property may be subject to estate taxes if it is distributed to heirs other than your U.S. citizen spouse.

Assets disposed of through a will are subject to probate

Probate is the court-supervised process of administering and proving a will. Probate can be expensive and time consuming, and probate records are available to the public. Several factors can affect the length of probate, including the size and complexity of the estate, challenges to the will or its provisions, creditor claims against the estate, state probate laws, the state court system, and tax issues. Owning property in more than one state can result in multiple probate proceedings. This is known as ancillary probate. Generally, real estate is probated in the state in which it is located, and personal property is probated in the state in which you are domiciled (i.e., reside) at the time of your death.

Will provisions can be challenged in court

Although it doesn't happen often, the validity of your will can be challenged, usually by an unhappy beneficiary or a disinherited heir. Some common claims include:

- You lacked testamentary capacity when you signed the will
- You were unduly influenced by another individual when you drew up the will
- The will was forged or was otherwise improperly executed
- The will was revoked

Facing the Possibility of Incapacity

Incapacity means that you are either mentally or physically unable to take care of yourself or your day-to-day affairs. Incapacity can result from serious physical injury, mental or physical illness, advancing age, and alcohol or drug abuse.

Incapacity can strike anyone at anytime

Even with today's medical miracles, it's a real possibility that you or your spouse could become incapable of handling your own medical or financial affairs. A serious illness or accident can happen suddenly at any age. Advancing age can bring senility, Alzheimer's disease, or other ailments that affect your ability to make sound decisions about your health, or to pay your bills, write checks, make deposits, sell assets, or otherwise conduct your affairs.

Planning ahead can ensure that your wishes are carried out

Designating one or more individuals to act on your behalf can help ensure that your wishes are carried out if you become incapacitated. Otherwise, a relative or friend must ask the court to appoint a guardian for you, a public procedure that can be emotionally draining, time consuming, and expensive. An attorney can help you prepare legal documents that will give individuals you trust the authority to manage your affairs.

Managing medical decisions with a living will, durable power of attorney for health care, or Do Not Resuscitate order

If you do not authorize someone to make medical decisions for you, medical care providers must prolong your life using artificial means, if necessary. With today's modern technology, physicians can sustain you for days and weeks (if not months or even years). If you wish to avoid this, you must have an advance medical directive. You may find that one, two, or all three types of advance medical directives are necessary to carry out all of your wishes for medical treatment (make sure all documents are consistent).

A living will allows you to approve or decline certain types of medical care, even if you will die as a result of the choice. However, in most states, living wills take effect only under certain circumstances, such as terminal injury or illness. Generally, one can be used only to decline medical treatment that "serves only to postpone the moment of death." Even in states that do not allow living wills, you might want to have one anyway to serve as evidence of your wishes.

A durable power of attorney for health care (known as a health-care proxy in some states) allows you to appoint a representative to make medical decisions for you. You decide how much power your representative will have.

A Do Not Resuscitate order (DNR) is a doctor's order that tells all other medical personnel not to perform CPR if you go into cardiac arrest. There are two types of DNRs. One is effective only while you are hospitalized. The other is used while you are outside the hospital.

Managing your property with a living trust, durable power of attorney, or joint ownership

Consider putting in place at least one of the following options to help protect your property in the event you become incapacitated.

You can transfer ownership of your property to a revocable living trust. You name yourself as trustee and retain complete control over your affairs as long as you retain capacity. If you become incapacitated, your successor trustee (the person you named to run the trust if you can't) automatically steps in and takes over the management of your property. A living trust can survive your death, but it can be expensive to maintain and administer.

A durable power of attorney (DPOA) allows you to authorize someone else to act on your behalf. There are two types of DPOAs: an immediate DPOA, which is effective immediately, and a springing DPOA, which is not effective until you have become incapacitated. A DPOA should be fairly simple and inexpensive to implement. It also ends at your death. A springing DPOA is not permitted in some states, so you'll want to check with an attorney.

Another option is to hold your property in concert with others. This arrangement may allow someone else to have immediate access to the property and to use it to meet your needs. Joint ownership is simple and inexpensive to implement. However, there are some disadvantages to the joint ownership arrangement. Some examples include (1) your co-owner has immediate access to your property, (2) you lack the ability to direct the co-owner to use the property for your benefit, (3) naming someone who is not your spouse as co-owner may trigger gift tax consequences, and (4) if you die before the other joint owner(s), your property interests will pass to the other owner(s) without regard to your own intentions, which may be different.

Adopt Advance Medical Directives for Health Care

What are advance medical directives?

At some point in your life, you may become incompetent; that is, lacking the mental capacity to make or communicate responsible health-care decisions for yourself. Without directions to the contrary, medical professionals are generally compelled to make every effort to save and sustain your life. Depending on your attitude toward various medical treatments and your views on the quality of life, you may wish to take steps now to control your future health-care decisions. The laws of your state may allow you to do so by adopting one or more advance medical directives. Advance medical directives allow you to manage your future medical care. There are three main types of advance medical directives: (1) a living will, (2) a durable power of attorney for health care (DPAHC) (also called a health-care proxy), and (3) a do not resuscitate (DNR) order. Each of these has unique characteristics, and each one is useful under specific circumstances. You may find that one, two, or all three advance medical directives are necessary to express all your wishes regarding medical treatment.

How do you decide whether to execute advance medical directives?

Your expectations regarding future medical care needs and your personal attitude will help determine whether you should execute one or more advance medical directives. Some of the questions you might wish to consider are:

- Do I have any strong feelings or wishes regarding my future medical treatment?
- What is my attitude toward life-sustaining treatments, such as artificial respiration and intravenous feeding? Are there circumstances under which I definitely would, or would not, want such treatment?
- Is there someone I trust to make medical decisions on my behalf?
- What are my wishes regarding day-to-day care or medication?
- Do I want cardiopulmonary resuscitation (CPR) to be performed if my heart or breathing stops?

By answering these questions, you should begin to get a feeling for whether you should execute advance medical directives and which one(s) might be appropriate for you.

What are your options?

- Living will — A living will allows you to approve or decline certain types of medical care, even if you will die as a result of the choice. However, in most states, living wills only take effect under certain circumstances, such as terminal injury or illness. Generally, one can be used only to decline medical treatment that "serves only to postpone the moment of death." You may have a living will that is not binding but serves only as an expression of your wishes.
- DPAHC — Using a DPAHC (called a health-care proxy in some states), you appoint a representative to make medical decisions on your behalf. This representative has the authority to consent to or decline medical treatments for you. You decide how much power your representative will have.
- DNR — A DNR is a doctor's order that tells all other medical personnel not to perform CPR if you go into cardiac arrest. There are two types of DNRs. One is effective only while you are hospitalized. The other is used by people outside the hospital.

What else should you know about advance medical directives?

- A living will generally cannot be used to express your wishes regarding day-to-day treatment. For example, a living will containing a request not to be placed in a nursing home would not be enforceable in most states.
- Some of the shortcomings of a living will can be corrected by using it in conjunction with a DPAHC, which allows your representative to make both major and minor decisions on your behalf.
- A DNR is the only advance medical directive specifically intended for use in an emergency.
- If you spend a significant amount of time in a state other than where you live, you may want to research that state's laws on advance medical directives. These laws vary considerably from state to state.
- Review your advance medical directives periodically to ensure they reflect your current wishes and attitude.

- If you have multiple advance medical directives, make sure your instructions are stated consistently throughout. In many states, the most recent document prevails in case of a conflict.

Example(s): *Martha, age 68, wants to maintain control of her future medical care decisions in case of incompetence. With a little research, Martha learns that living wills, DPAHC, and DNR orders are all permitted in her state. Martha decides to utilize all three advance medical directives to convey her wishes regarding medical care.*

Example(s): *Among other things, Martha states in her living will that she does not wish to be kept alive by artificial means, such as intravenous feeding or artificial respiration. Martha uses her DPAHC to appoint her son, Frank, as her representative. She gives Frank the power to act in her best interest if Martha becomes incompetent. Martha also has her doctor issue a DNR order. Martha provides her doctor with copies of these documents and periodically updates them to reflect technological advances and changes in her own attitude.*

Example(s): *Five years later, Martha develops Alzheimer's disease. Her condition deteriorates and eventually she is unable to make decisions for herself. As her representative, Martha's son, Frank, takes control of Martha's medical decisions and hospitalizes his mother. Frank approves the use of a newly developed experimental drug, which helps to slow Martha's rapid decline. Ultimately, even the drug no longer helps and Martha becomes weaker and weaker. Her breathing becomes extremely erratic and labored, but because of her living will, Martha is not placed on a respirator. One day, Martha's heart fails. In accordance with her DNR, CPR is not attempted.*

Durable Power of Attorney: Protecting Your Property against Incapacity

What is a durable power of attorney?

A durable power of attorney (DPOA) is a tool that allows someone to carry on your financial affairs and protect your property in a period of incapacity, almost always with no need to seek formal judicial approval. A DPOA is a legal document that gives another person the legal authority to act for you. The person to whom authority is given is referred to as an attorney-in-fact, but need not be an attorney.

You may want to execute a DPOA because in today's modern age of medical miracles, your life expectancy has increased and so have your chances of becoming physically or mentally incapable of managing your own financial affairs. A devastating illness or serious accident can happen suddenly at any age. Old age can bring senility, Alzheimer's disease, or other ailments that affect your ability to make sound decisions. You may not be able to pay your bills, write checks, make deposits, sell assets, or otherwise conduct your business. This can undermine your financial, tax, and estate planning strategies, exhaust your savings, or create debt.

Unless you have authorized someone to carry on your financial affairs, a relative or friend will have to ask the court to appoint a guardian. This public procedure can be embarrassing, emotionally draining, time-consuming, and expensive. By executing a DPOA, you select the person you trust and almost always keep the court out of it.

There are two types of DPOAs. A standby DPOA becomes effective as soon as you sign it while a springing DPOA does not become effective until you become incapacitated.

When can it be used?

You are the age of majority, as defined by your state (generally, 18), and competent when you sign your durable power of attorney (DPOA)

A minor cannot execute a DPOA. The age of majority in most states is 18.

Competency is a legal standard determined by state law. Competency generally means that you understand the meaning of your actions and have the capacity to enter into a contract.

The person you choose to be your attorney-in-fact is the age of majority, as defined by your state (generally, 18), when it comes time to make your financial decisions for you

The DPOA is allowed in your state

A springing DPOA is not permitted in some states. Check with an attorney to find out if a springing DPOA is allowed in your state.

Strengths

Can help avoid the need for guardianship

A durable power of attorney (DPOA) is preferable to a court appointment of a guardian because the latter procedure is time-consuming and expensive; it opens to public view your incapacity and financial affairs; it can be emotionally traumatic for your family; and the powers of a court-appointed guardian can be more restricted than those available to an attorney-in-fact.

Caution: *However, your DPOA does not preclude the court from appointing a guardian. In Connecticut, your DPOA terminates automatically once a guardian has been appointed. In all other states, your DPOA continues in operation after the appointment of the guardian, but the guardian has the same rights that you have and can terminate your DPOA.*

Tip: *Some states allow you to name a guardian in advance through your DPOA.*

Provides a flexible way to continue the management of your affairs and protection of your assets

Your attorney-in-fact steps in to make decisions for you as soon as you are unable to do so. It can prevent a lapse in the management of your financial affairs. Your attorney-in-fact has a legal duty to protect your best interest, keep accurate records, and keep your property separate from his or her own.

Allows you to choose who will act for you

You choose who you want and trust to manage your financial affairs while you are unable (e.g., your spouse, son, or daughter). If permitted in your state, you can name more than one person as your attorneys-in-fact, either as alternatives (Ken or Liz) or as partners (Ken and Liz). The latter may cause problems, however, if the attorneys-in-fact cannot agree on what is in your best interest.

Caution: *In some states, it may be necessary to name a state resident as your attorney-in-fact, or your attorney-in-fact may have to be a certain age. Check with an attorney regarding any restrictions your state may impose on who can be named.*

Allows you to plan according to your goals and concerns

You can make your attorney-in fact's powers as broad or as limited as you want, or terminate or change your DPOA as long as you have retained capacity, and even name the party or parties who determine whether you are incapacitated.

You can also give your attorney-in-fact the power to make gifts. This may be important because it allows your attorney-in-fact to continue your estate and tax planning (e.g., by taking advantage of the annual gift tax exclusion or Medicaid planning).

Caution: *The potential for abuse of the gift-giving power is great. Be sure to grant it wisely.*

Should be fairly simple and inexpensive to implement

A DPOA is usually only a two- or three-page document. You may be able to buy a fill-in-the-blank form at a stationery store. If not, your state may publish a form in its statute books that you can copy. An attorney's fee for drawing up a DPOA should be relatively inexpensive.

Tradeoffs

A standby durable power of attorney (DPOA) may be troublesome if you are unwilling to immediately share some degree of control over your financial affairs

A standby DPOA becomes effective as soon as you sign it. However, this type of DPOA means that your attorney-in-fact has immediate power over your affairs. You must be willing to take some risk if you choose to execute a standby DPOA.

Example(s): *Hal is worried that one day he'll get in an accident and end up in a coma. He executes a standby DPOA so that his wife, Jane, can pay the mortgage and buy the groceries in case his fears come true. Unfortunately, Jane is unhappy, and before Hal knows it, she has cleaned out his bank account and has moved to England.*

Tip: *A standby DPOA is good if you are facing a serious operation. You may become incapacitated for a time while you recuperate. Once you have recovered sufficiently, you can terminate the DPOA.*

Determining whether incapacity has occurred, causing a springing DPOA to become effective, can be difficult

A springing DPOA does not become effective until you have become incapacitated. This type of DPOA allows you to maintain control of your financial affairs for as long as possible. However, determining when you have become incapacitated is easier said than done. You can state in your DPOA that one or more physicians must certify that you are incapacitated. However, this arrangement may fail if your physician is hesitant to declare your incapacity, or if there is a dispute within your family. Your family may then become involved in the very court process you seek to avoid.

Third parties may challenge your attorney-in-fact's authority

Third parties who deal with your attorney-in-fact may be reluctant to honor your DPOA. They may be worried that your DPOA does not authorize your attorney-in-fact to perform certain acts, that you were incompetent at the time you executed your DPOA, or that you have terminated your DPOA. To help overcome these difficulties, you can do the following:

- Execute more than one original DPOA so that your attorney-in-fact can provide the third party with an original
- Provide the third party with a customized DPOA form
- Provide the third party with an updated copy of your DPOA if the third party establishes an arbitrary cutoff (some banks will not accept your DPOA six months or one year from the date of execution)
- Include a termination date in your DPOA and re-execute it when necessary
- Notify the third party that you have executed a DPOA

Other states may not recognize your attorney-in-fact's powers

Your attorney-in-fact may not be able to do business in a state other than the state in which your DPOA was executed.

Example(s): *Jane creates and executes a DPOA in Maine, where she currently lives and writes novels. She wants her attorney-in-fact to sell her condo in New York because she has had a falling out with her publisher and has decided to try acting in California. Whether her attorney-in-fact will be allowed to sell her condo depends on New York's recognition of Jane's DPOA.*

Tip: *You may want to execute a DPOA in each state where you own real estate or do business.*

How to do it

Choose an attorney-in-fact

You may be granting your attorney-in-fact significant power, so the person you choose should be someone trustworthy and capable. If permitted in your state, you can name more than one person as your attorneys-in-fact, either as alternatives (Ken or Liz) or as partners (Ken and Liz). Be sure to inform the person you choose that he or she will be under a legal duty to act in your best interest.

Caution: *Using multiple attorneys-in-fact is not without problems. They may disagree about the proper course of action and fights may ensue.*

Tip: *Choosing an alternate attorney-in-fact may be advisable in case your first choice cannot act.*

Set your goals

To create a durable power of attorney (DPOA) that is going to fit your goals, you need to think about and decide on your options, such as:

- Do you want your DPOA to become effective immediately (standby), or only if you become incapacitated (springing)?
- What powers will you want your attorney-in-fact to have?
- What powers will you want to keep from your attorney-in-fact?
- Do you want to specify who can declare your incapacity?

Create your DPOA

Although many states have their own fill-in-the-blank forms, a DPOA is a legal document. Careful drafting and a thorough understanding of your state's laws are needed to create a DPOA that will be effective. It may be advisable to consult an attorney when drawing up your DPOA. Remember, when it comes to a DPOA, there is no such thing as one size fits all.

Among other things, you should:

- Specifically provide in your DPOA that your attorney-in-fact's powers continue after you become incapacitated
- Specifically state gift-giving powers to satisfy the IRS
- Specifically enumerate each power, or certain powers, that you give your attorney-in-fact, if required by your state

Properly execute your DPOA

Requirements vary from state to state, which is another good reason to seek out the help of an attorney, but generally, you must sign your DPOA in front of a notary public. In some states, witnesses must be present to sign as well.

Prepare any DPOA forms required by third parties

Some banks and other financial institutions will not recognize your DPOA and will require you to execute their own forms. Be sure to contact any bank, insurance agent, or other broker with whom you do business and ask what you need to do.

Put a copy on file at the local land records office, if required

If you give your attorney-in-fact authority to deal in real estate, most states will require you to record your DPOA at the local land records office. This is an easy procedure for your attorney, or you can do it yourself. Simply give a copy to the clerk along with the filing fee (generally, a nominal amount).

Caution: *Once recorded, this information will no longer be private. Local land records are public records and available to anyone.*

Get court approval if it is required in your state

Most states do not, but some minority of states may require that your DPOA be approved by the court. You may need an attorney if this court process is required.

Tax considerations

Income Tax

If properly drafted, your durable power of attorney (DPOA) gives your attorney-in-fact the right to sign all your income tax returns.

Gift and Estate Tax

If properly drafted, your DPOA gives your attorney-in-fact the right to sign all your annual gift tax returns.

If properly drafted, your DPOA can give your attorney-in fact the power to make gifts on your behalf

Your attorney-in-fact's ability to give away your wealth (by taking advantage of the annual gift tax exclusion) before you die may help reduce any federal gift and estate tax that may be imposed on your estate.

Tip: *Include specific authorization to make gifts in your DPOA in order to ensure that any gifts made by your attorney-in-fact are valid.*

Gives your attorney-in-fact the right to elect to treat gifts made by your spouse as gifts made by you and your spouse

Your attorney-in-fact's ability to elect to split gifts between you and your spouse can produce estate and gift tax savings.

Questions& Answers

What does being competent to execute a durable power of attorney (DPOA) mean?

Competency is a standard determined by state law. Generally, it means that you understand what you are doing. This disqualifies those under guardianship, those whom the court has determined to be mentally incompetent or spendthrifts, and inebriated persons.

Once empowered, what can an attorney-in-fact do?

Your attorney-in-fact can do just about anything you could do. Your attorney-in-fact "stands in your shoes." Of course, you can limit this power by specifically stating what he or she can and can't do. And remember, some states require that particular powers be specifically enumerated. Some of the powers you can authorize are:

- Sign checks and tax returns
- Enter into contracts
- Deposit or withdraw funds
- Buy or sell securities
- Run your business
- Apply for and collect public benefits
- Use your assets to pay your everyday expenses
- Buy, sell, maintain, pay taxes on, and mortgage real estate
- Buy and sell insurance policies and annuities
- Invest your money in stocks, bonds, and mutual funds
- Represent you in court
- Manage your retirement accounts
- Make gifts

What happens to a DPOA when you die?

Your DPOA ends. You can't give your attorney-in-fact authority to handle your affairs after your death.

Minimizing Estate Shrinkage

What is estate shrinkage?

When you die, you will leave behind all your worldly goods. Presumably, you will want these goods, called your estate, to go to your loved ones for their support, or to charity or other specific people, collectively called your beneficiaries. However, not all of your estate will actually go to your beneficiaries. There will be many hands looking for something. Some of your estate will go to pay your final expenses. Some of it will go to pay attorney's fees and probate costs. A lot of it may go to pay estate taxes. All of these costs must be paid first, before your estate can be closed and what's left can be distributed to your beneficiaries. In other words, the size of your estate shrinks before it actually gets into the hands of the ones it is truly meant for. If your estate shrinks too much, your family may not receive what they need for their support or your beneficiaries may not get what you intend for them to have. Being aware of and minimizing estate shrinkage is what estate planning is all about.

What causes estate shrinkage?

The line that forms for your money after your death may be very long. What follows are the most obvious causes of estate shrinkage.

Last illness expenses

You may spend your final days in a hospital or other medical care facility. To the extent that they are not covered by insurance, expenses may be owed for room, board, inpatient care, medicine, and doctor's fees.

Medicaid recovery

The state may come looking for reimbursement for certain expenses it paid on your behalf under its Medicaid program.

Funeral and burial expenses

The cost of a funeral and burial these days can be thousands of dollars. These costs include fees paid to the funeral home and florist, for transportation, the burial plot, the monument, and eternal care.

Debts and liabilities

You will not only leave behind property when you die, you will probably also leave debts. Your creditors can make a claim against and are entitled to receive payment from your estate. Some of these debts may include mortgages, car loans, credit card accounts, and other loans or installment credit.

Tip: *Creditors have a limited amount of time to file a claim against your probate estate (typically, one year). Your personal representative is given time to investigate the validity of and settle these claims.*

Estate administration expenses

The total cost of administering your estate can be high (five percent of an average estate is not uncommon). This is especially true if assets need to be sold or your will is contested. Some common expenses include:

- Executor's or administrator's fees
- Cost of bonding your administrator, if required
- Attorney's fees
- Appraiser's fees
- Court costs
- Ancillary court costs, if you own property in more than one state
- Auctioneer's fees
- Brokerage fees

- Costs of insuring estate property while the estate is open
- Costs of maintaining estate property while the estate is open
- Accountant's fees

Taxes

As you may have guessed, taxes are the number one estate shrinkage factor. Here are the taxes for which you may need to plan:

- Unpaid property taxes
- Income tax on income earned during your last year of life (the tax should have been withheld)
- Tax on income earned by your estate
- Tax on income earned by any trusts included in your estate
- Federal gift and estate tax
- Federal generation-skipping transfer tax
- State death taxes , including generation-skipping transfer tax, and estate, inheritance, and credit estate taxes (sponge or "pickup" taxes)

Are there any hidden causes of estate shrinkage?

Beware of the hidden causes of estate shrinkage. What follows are the most common.

Incapacity

Should incapacity strike and you are not prepared, your estate could be devastated. Planning for incapacity is a vital component of your estate plan.

Lack of liquidity

If there are not enough liquid funds in your estate to pay expenses when they come due, your personal representative may be forced to borrow at a high interest rate or sell assets to raise the cash quickly. Such a fire sale may result in an economic loss to your estate because the assets may have to be sold at bargain prices. Therefore, planning for liquidity is an important part of any estate plan.

Defective estate plans

Outdated or improperly executed wills or trusts or poorly arranged life insurance can cause estate depletion. Be sure you review and update your estate plan on a regular basis.

Delay

The longer it takes to settle and close your estate, the higher the cost. Expenses that increase over time include:

- Executor's or administrator's and attorney's fees
- Costs of insuring estate property
- Costs of maintaining estate property

Also, inflation can erode the value of the assets in the estate. Assuring the smooth transition of your estate now can help you avoid this consequence after your death.

Bad timing

There is no good time to die, but if your death occurs when the economy is depressed or inflation is on the rise, the estate shrinkage problem will be increased. Unfortunately, there are no recommendations to help you avert this situation except one--stay healthy.

What can you do to prevent estate shrinkage?

Being aware of the estate shrinkage problem is a good first step in eliminating it. Then follow the next steps.

Minimize estate taxes

Because estate taxes may be the greatest estate shrinkage factor, you would be wise to make the most of the estate planning tools that can be used to minimize them. For example, you should understand and take advantage of allowable deductions and credits , implement estate freeze techniques, and plan for post-mortem elections.

Plan for incapacity

If incapacity strikes and you are not prepared, you may lose a large portion of your estate. There are many things you can do now to protect yourself against this event.

Provide for estate liquidity and wealth replacement

To keep your estate from having to sell assets in a forced sale or borrow at high rates of interest to meet estate expenses when they are due, you must plan now to ensure that the necessary liquidity will be present. Life insurance is probably the most common way to ensure sufficient liquidity and replace wealth lost to estate shrinkage factors.

Review your plans

Finally, review the plans you have made. Make sure that your estate planning tools--your will, trusts, forms of property ownership, life insurance, and so forth--will do the job.

Living Trust

What is it?

A living trust (also known as a revocable or inter vivos trust) is a separate legal entity that you create to own property, such as your home, boat, or investments. You transfer some or all of your property to the trust as soon as it is created. During your lifetime, you control the trust; you can change the trust terms, or terminate the trust and take the property back. At your death, the trust becomes irrevocable and may continue to exist for many years. The trustee administers and distributes the trust property according to the terms of the trust.

People create living trusts because they're able to retain control over their assets while achieving other important goals, such as:

- Controlling the manner and timing of asset distributions to heirs
- Efficiently transferring assets to heirs
- Enabling someone else to manage property
- Protecting property in case of incapacity
- Avoiding probate

Tip: *Though a living trust is a separate legal entity, it is not a separate taxpayer during your lifetime. You are considered the owner of the trust assets for income tax purposes; all income, deductions, credits, and losses flow through to you. Upon your death, the trust becomes a separate taxpayer and different tax rules will apply (see Tax Considerations below).*

Caution: *A living* trust *does not avoid estate taxes and does not protect assets from potential future creditors. To attain these objectives, the trust must be irrevocable. For more information, see Tradeoffs below.*

When can it be used?

Cannot be used for some types of property

Although a living trust can hold most types of property, it cannot hold:

- Qualified stock options or stock acquired under such a plan, at least until the holding period has passed
- An interest in a partnership, if prohibited by state law
- An interest in a cooperative or condominium, if prohibited by your contract with your co-owners
- An interest in a professional corporation (e.g., a law firm), because such an interest generally can only be owned by a professional (e.g., a lawyer)
- An IRA, although you can name your living trust as beneficiary of your IRA

Strengths

Lets you control your property until your death

A living trust is revocable until your death. That means you can use or withdraw trust property, change the trust terms, add or remove beneficiaries, replace the trustee, or even revoke the trust entirely up until your death. This gives you flexibility to meet unknown future contingencies and still meet other goals.

Allows distribution of your property to be customized

A will generally transfers specific amounts or percentages of your property to your beneficiaries. By placing your property in a living trust, you can direct the trustee to distribute property only in certain situations, for example "to pay tuition," or on certain occasions such as "on my son's 30th birthday," or at the trustee's discretion, perhaps "to my children, as necessary to fund their educational needs."

This may be beneficial if you're worried your heirs may be unable to manage outright gifts, or if you want to create "rewards" for

certain behaviors.

Caution: *Although a trust transfers property like a will, you should still have a will as well because the trust will be unable to accomplish certain things that only a will can, such as naming an executor or a guardian for minor children.*

Minimizes delays in the transfer of property

Probate takes time and your property generally won't be distributed until the process is completed. A small family allowance is sometimes paid, but it may be insufficient to provide for a family's ongoing needs. Transferring property through a living trust provides for a quicker, almost immediate transfer of property to those who need it.

Probate can also interfere with the management of property like a closely held business or stock portfolio. Although your executor is responsible for managing the property until probate is completed, he or she may not have the expertise or authority to make significant management decisions, and the property may lose value. Transferring the property with a living trust can result in a smoother transition in management.

Circumvents some limits on your power to transfer property

State law may limit your ability to leave property to charity. For example, some states invalidate any bequest to charity written within a month of your death. Other states won't let you leave more than a certain percentage of your property to charity. These laws often don't apply to living trusts.

State law may also force you to leave a certain percentage of your property to your spouse. In some states, these laws don't apply to living trusts.

Lets someone else manage your property for you

You may find that managing certain property is a burden, or that you do not possess the skills required to manage certain property competently. Or, you may be planning to be away from home for a period of time and unable to make financial decisions or transact certain business. Or, you may be entering public service and need to avoid the appearance of a conflict of interest. A living trust lets you name someone who can successfully handle your financial affairs for you in these situations.

Caution: *You will likely have to pay an annual fee if you hire a professional trustee.*

Gives someone the power to manage your property if you become incapacitated

If incapacity strikes, your trustee (or a co-trustee if you are the trustee) can take immediate control of your property to use it for your care and support, or in whatever way you have directed by the terms of the trust. This may help avoid the potential need for guardianship.

Avoids probate

Because property in a living trust is not included in the probate estate, some people may use them to avoid probate. Depending on your situation and your state's laws, the probate process can be simple, easy, and inexpensive or it can be relatively complex, resulting in delay and expense. This may be the case, for instance, if you own property in more than one state or in a foreign country, or have heirs that live overseas.

Avoiding probate may also be desirable if you are concerned about privacy. Probated documents (e.g., will, inventory) become a matter of public record. Generally, a trust document does not.

On the other hand, the probate process can serve many important functions, such as protecting the interests of beneficiaries and resolving disputes.

Determining whether avoiding probate would be advantageous, then, depends on many factors.

Tip: *There are other ways to avoid the probate process other than using a living trust, such as titling property jointly.*

Tradeoffs

You may incur attorney's fees to create

A living trust is a sophisticated legal document that should be drafted by a competent attorney who understands your state's laws as well as your personal situation and objectives. An attorney will help you coordinate your trust with other estate planning and financial goals, and will advise you regarding how to effectively execute and fund this device.

Caution: *Though there are "do-it-yourself" living trust kits available, you take many risks if you use one of these "one-size-fits-all" forms. It may end up costing you more if the trust is the wrong form, a form that is not valid in your state, is not appropriately customized to your situation, is not properly executed, or is not properly funded.*

Funding the trust can be burdensome and costly

In order to be effective, you must transfer title to property being transferred to the trust. This can be complicated and burdensome, though your attorney will offer advice to help you. Transferring some types of property can be especially difficult and costly:

- Real estate: Some states assess a transfer tax or reassess property taxes whenever real property changes hands, even if it is only being transferred to a living trust. In other states, homeowner tax deductions are not available if the land is owned by a living trust.
- Secured or insured property: If property secures a loan, that loan may prohibit any transfer of the property, even to a living trust. Title or property insurance may also prohibit transfer of the property to the trust.

Should not be used to transfer some types of property

Although a living trust can hold most types of property, it is generally inappropriate for the following types of property:

- Stock acquired at less than market value under a restricted stock option or stock purchase plan, because income tax will be assessed on the gain
- Certificate of deposit, because of the penalty that will result if the bank considers the transfer an early withdrawal
- Real estate generating loss, since you probably cannot take losses on actively managed rental property owned by a living trust
- Personal property, such as furniture or clothing

Does not help achieve Medicaid eligibility

Assets in a revocable living trust are countable resources for the purposes of Medicaid eligibility. The assets are treated just as if you (the grantor) owned the them outright. Thus, your eligibility for Medicaid is reduced to reflect any gifts you make from your living trust during the preceding 60 months.

Caution: *Questions regarding Medicaid eligibility are extremely complex. You should seek specific assistance with these issues.*

Does not avoid estate taxes

Unlike an irrevocable trust, a living trust does not inherently reduce estate taxes . Because you retained control over the trust during your lifetime, property in the living trust at your death will be included in your gross estate for estate tax purposes, even though they won't be considered part of your estate for probate purposes.

Tip: *Spouses can use a special living trust (i.e., a bypass or credit shelter trust) to help minimize estate taxes on their combined estates. With such a trust, both spouses can more fully utilize their applicable exclusion amounts. However, you do not need a living trust to accomplish this; you can create the bypass trust at your death by including a provision in a* pourover will *.*

Does not protect property from creditors

The probate process requires that all claims against your estate be presented within months of your death, preventing delayed claims against your estate and beneficiaries. A creditor may be able to bring a claim against property that passed through your living trust for years after your death.

Tax considerations

Income Tax

During your life

While you are living, the IRS will ignore the trust entity. All income, gains, losses, deductions, and credits flow through directly to you. Generally, you do not need to obtain a taxpayer identification number (TIN) for the trust, though you may choose to do so. You may furnish your own name and Social Security number to banks, brokers, and others paying income to the trust. You report all income on your own Form 1040 in the year it is earned, regardless of whether it was distributed to you. You do not need to file Form 1041. If you are not the trustee, however, the trustee must send you a statement with all pertinent information you will need to prepare your Form 1040.

You may choose to furnish banks, brokers, and others paying income to the trust with a TIN. In this case, the trustee must file Form 1099 and Form 1041. And, if you are not the trustee, the trustee must also send you a statement with all pertinent information you will need to prepare your Form 1040.

If you create a living trust jointly with your spouse, and you and your spouse file separate returns, you must use the second method described above.

After your death

If your living trust doesn't distribute all of the property it owns at your death, it becomes an irrevocable trust and is subject to income tax as a separate taxpayer. The tax rules become very complicated and are much less advantageous. Among other things, the trust

- Cannot take a charitable deduction for income set aside for charity
- Must use a calendar tax year
- Cannot file a joint return with your surviving spouse in the year of your death
- Is allowed a smaller income tax exemption than for individuals
- Is subject to more compressed tax rates
- Cannot deduct losses on distributions of assets to beneficiaries
- Is assessed income tax on the gain if it takes ownership of stock acquired at less than market value under a restricted stock option or stock purchase plan
- Cannot take rental real estate losses

May be unable to continue to hold S corporation stock after your death

A living trust can hold S corporation stock during your life without jeopardizing the corporation's S corporation status, as long as certain conditions are met. However, after you die, the trust is permitted to continue as a shareholder only for the two-year period beginning on the date of your death.

Caution: *This is an extremely complex area. You should consult an experienced tax professional.*

Must file gift tax returns when property is transferred to the trust

Although transferring property to a living trust does not result in any gift tax liability (because transfers to a revocable trust are not "complete"), you are required to disclose the living trust on a gift tax return.

Does not avoid estate taxes

Because you retained control over the property during your lifetime, all property in your living trust at your death will be included in your estate for estate tax purposes, even though it is not included in your estate for probate purposes.

Bypass Trust (also called B Trust or Credit Shelter Trust)

What is it?

A bypass trust is used to minimize federal estate tax on the combined estates of a married couple

A bypass trust (also called a B trust or a credit shelter trust) is a trust that can be used by married couples in conjunction with a marital trust to minimize federal estate tax that will be due on their combined estates. Assets will be transferred from the estate of the first spouse to die into the bypass trust such that his or her federal applicable exclusion amount (the amount that can be sheltered from gift and estate tax by the unified credit) is fully used. The remainder of the assets of the first spouse to die will then be transferred into the marital trust.

To prevent inclusion of the bypass trust in the estate of the surviving spouse, he or she can be given only certain rights and limited control over the assets in the bypass trust. He or she may receive income from the trust or may be given the right to invade the trust principal for his or her health, education, maintenance, or support. The surviving spouse may also be given a limited power of appointment over the assets in the bypass trust. A limited power of appointment permits the power holder to direct that the assets in the trust ultimately pass to a limited class of beneficiaries that does not include himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate.

Caution: *This may not be the proper strategy for some married couples. A tax law passed in 2001 replaced the state death credit with a deduction starting in 2005. As a result, many of the states that imposed a death tax equal to the credit, decoupled their tax systems, imposing a stand-alone death tax. Many of these states allow an exemption that is less than the federal exclusion. This may leave some couples vulnerable to higher state death taxation. See your financial professional for more information.*

Tip: *In 2011 and later years, the unused basic exclusion amount of a deceased spouse is portable and can be used by the surviving spouse. Portability of the exclusion may provide some protection against wasting of the exclusion of the first spouse to die and reduce the need for a credit shelter or bypass trust.*

A bypass trust typically is used by a married couple with assets in excess of the applicable exclusion amount

Typically, both a bypass trust and a marital trust will be used by married couples who expect to have assets in excess of the applicable exclusion amount at the death of the first spouse. A married couple will set up both a bypass trust and a marital trust so that the applicable exclusion amount of the first spouse to die can be used to exempt the bypass trust from estate tax while the surviving spouse's applicable exclusion amount can be applied to exempt some or all of the assets in the marital trust from estate tax. The assets in the bypass trust will not be included in the taxable estate of the surviving spouse. By using the two trusts, a married couple could protect up to $25,840,000 (in 2023) from estate taxes.

Ownership of marital assets should be divided between the husband and the wife

A married couple who wish to set up a bypass and marital trust should first divide up ownership of their assets. After the division, each spouse should own in his or her own name an equal share of the couple's total assets. If one spouse owns all the assets alone or all their assets are owned jointly, the couple may not be able to fully use the applicable exclusion amount of each spouse. If one spouse owns all the assets alone, and the other spouse dies first, the applicable exclusion amount of the first spouse to die will be wasted as there will be no assets in the estate to which it can be applied. Correspondingly, the estate of the surviving spouse may be overqualified (i.e., have more than the applicable exclusion amount in the estate). Similarly, if both spouses own all assets jointly, when one spouse dies, the other spouse automatically owns all of the assets. When the surviving spouse then dies, his or her estate may be overqualified. If ownership of their assets is split up between the married couple, each individual will have assets to which his or her applicable exclusion amount can be applied.

Assets not transferred into the bypass trust will fund a marital trust

The assets that are not transferred into the bypass trust will fund the marital trust. In many cases, the marital trust will be set up as a qualified terminable interest property (QTIP) trust. With a QTIP trust, the surviving spouse must receive all income (at least annually) for life from the trust, but the grantor (creator) of the trust can designate where the assets pass when the surviving spouse dies. The assets in the marital trust will be included in the estate of the surviving spouse. However, that spouse can use his or her applicable exclusion amount to shelter some or all of the assets from estate tax. Because of the unlimited marital deduction, the assets transferred to the marital trust will not be taxed at the death of the first spouse. Therefore, the estate tax will be postponed until the second spouse dies.

When can it be used?

A married couple should expect to have assets in excess of the applicable exclusion amount at the death of the first spouse before setting up a bypass trust

Generally, only couples who expect to have assets in excess of the applicable exclusion amount should incur the expense and trouble to set up both a bypass and a marital trust. Many married couples who have assets below the applicable exclusion amount will have joint wills, in which all of their assets are left to one another outright, or they may own all assets jointly with right of survivorship. Either way, the surviving spouse will receive all of the assets after the death of the first spouse tax free due to application of the unlimited marital deduction. Since the total amount of the assets owned by the surviving spouse will be below the applicable exclusion amount upon his or her death, the surviving spouse's estate will not incur estate taxes.

Example(s): *Say you and your spouse have net assets of over $25,840,000 in 2023. Both you and your spouse would like to minimize the estate taxes due on your combined estates. Your estate planning attorney suggests setting up bypass and marital trusts. When the first spouse dies, sufficient assets will be transferred to the bypass trust to fully use his or her applicable exclusion amount. The remaining assets will go to the marital trust. Because of the unlimited marital deduction, the assets in the marital trust (if it is properly structured) will not be taxed in the estate of the first spouse to die. The assets in the marital trust will, however, be included in the taxable estate of the surviving spouse. The surviving spouse can use his or her applicable exclusion amount to shelter assets in the marital trust for his or her benefit from estate tax that would otherwise be incurred as a result of his or her death. By using the two trusts, all or almost all of your assets should be able to pass to your heirs free from estate tax.*

Tip: *In 2011 and later years, the unused basic exclusion amount of a deceased spouse is portable and can be used by the surviving spouse. Portability of the exclusion may provide some protection against wasting of the exclusion of the first spouse to die and reduce the need for a credit shelter or bypass trust.*

The assets of a husband and wife should be equalized before setting up bypass and marital trusts

If a married couple expect that their combined estates will be above the applicable exclusion amount when the first spouse dies, they should divide up ownership of their assets so that each spouse owns approximately one-half of the assets. You do not want one of the spouses to own all the assets, and you do not want the spouses to own all of the assets jointly. If one spouse owns all of the assets and the other spouse dies first, the applicable exclusion amount of the first spouse to die will be wasted as there will be no assets in his or her estate to which it can be applied. The surviving spouse's estate may also be overqualified (i.e., have assets in excess of the applicable exclusion amount). Similarly, if the spouses hold all of the assets jointly, when one spouse dies, the other spouse will automatically own all of the assets, which will pass to him or her free from estate tax due to application of the unlimited marital deduction. Again, the applicable exclusion amount of the first spouse to die will be wasted because there will be no assets in his or her estate to which the exclusion can apply.

Example(s): *Say you expect that you and your spouse will have assets in excess of $25,840,000 if one spouse were to die in 2023. You and your spouse currently own all of your assets jointly. Your estate planning attorney recommends that you divide up the ownership of the assets so that you and your spouse each own approximately one-half of the assets. If the assets are split evenly ($12,920,000 to each spouse), then at the death of the first spouse, an amount equal to the applicable exclusion amount of that spouse can be transferred to the bypass trust, and the remaining assets can be transferred to the marital trust. The assets in the marital trust will be included in the surviving spouse's taxable estate. However, the surviving spouse can use his or her applicable exclusion amount to avoid the federal estate tax due (partially or fully) on these assets at his or her death. By splitting up your assets and using a bypass trust and a marital trust, you may each be able to fully use your applicable exclusion amounts, maximizing the amount that you can leave to your heirs free from estate tax.*

A marital trust is not necessary to minimize federal estate taxes

It is not necessary to use a marital trust in conjunction with a bypass trust to minimize the federal estate taxes of both spouses. Rather than using a marital trust, assets from the estate of the first spouse to die could be transferred to a bypass trust such that his or her applicable exclusion amount was fully used. The remainder of the assets could be left outright to his or her surviving spouse. The surviving spouse could then use his or her applicable exclusion amount to shelter the assets from estate tax at his or her death. A married couple may want to use a marital trust (usually a qualified terminable interest property (QTIP) trust) if they have children and are concerned that the surviving spouse will remarry or where there is a second marriage and one or both spouses are concerned about the surviving spouse "cutting out" children from a first marriage in favor of their own family members or children. With a QTIP marital trust, the surviving spouse must receive all income from the trust for life. However, you can designate in the QTIP trust who will receive the assets at the death of the surviving spouse.

Example(s): *Say you and your spouse have been married for 10 years and have three children. You have net assets in excess of your combined applicable exclusion amounts, and both you and your spouse would like all of your assets to eventually go to your three children. You should first divide ownership of the assets and then set up both a bypass trust and a QTIP marital trust. At the death of the first spouse, sufficient assets could be transferred to the bypass trust to fully use that spouse's applicable exclusion amount. The remaining assets could then be transferred to the QTIP marital trust, and the surviving spouse would receive all of the income from that trust for his or her lifetime. When the surviving spouse dies, all of the assets from both trusts could then pass to the children. If you and your spouse did not have children, or you were not concerned about the assets passing to the children, you might not want to incur the expense to set up the QTIP marital trust. Any assets remaining after funding the bypass trust could simply be left to the surviving spouse.*

Strengths

Use of both bypass and marital trusts allows married couple to have full benefit of wealth while minimizing estate taxes

The main reason for using both bypass and marital trusts is to allow the surviving spouse to benefit from family wealth during his or her lifetime while minimizing the federal estate tax that may be incurred on the couple's combined estates. The use of these two trusts in conjunction is an especially effective estate planning strategy when the married couple would like some or all of their assets to pass to their children or others when the surviving spouse dies. Although the surviving spouse must receive all income from a qualified terminable interest property (QTIP) marital trust, the grantor of the trust may designate to whom the assets in the trust pass upon the surviving spouse's death. You can thus prevent your assets from eventually ending up in the hands of the new spouse if your spouse remarries, or you can ensure that your assets pass to your children from a previous marriage rather than to your second spouse's relatives. The use of the bypass and the marital trusts can also minimize the federal estate tax incurred in each spouse's estate by allowing each spouse to fully use his or her applicable exclusion amount.

Example(s): *Say you and your spouse expect to have a taxable estate in excess of your combined applicable exclusion amounts at the death of the first spouse. You have three minor children, and you would like your children to inherit all of your assets when the surviving spouse dies. On the advice of your estate planning attorney, you have equally divided the ownership of your assets between you and your spouse (to prevent wasting of the applicable exclusion amount of the first spouse to die and possibly overloading the surviving spouse's estate). Your attorney has drafted both a bypass trust and a QTIP marital trust. At the death of the first spouse, sufficient assets are transferred to the bypass trust to fully use that spouse's applicable exclusion amount. The remainder of the assets is transferred to the QTIP trust. The surviving spouse receives all income from the QTIP trust for life, and your children are named as the remainderpersons of the trust. At the death of the surviving spouse, all of the assets in the QTIP trust will pass to your children. Although the assets in the QTIP trust will be included in the surviving spouse's taxable estate, the surviving spouse can use his or her applicable exclusion amount to protect some or all of these assets from federal estate tax. By using the bypass trust and the marital trust, you have permitted the surviving spouse to benefit from family wealth (through lifetime income), minimized the federal estate taxes incurred at the deaths of both you and your spouse, and ensured that your children will inherit the bulk of your assets upon the death of the survivor of you and your spouse.*

Tip: *In 2011 and later years, the unused basic exclusion amount of a deceased spouse is portable and can be used by the surviving spouse. Portability of the exclusion may provide some protection against wasting of the exclusion of the first spouse to die and reduce the need for a credit shelter or bypass trust.*

Use of a bypass trust can provide professional management of assets to surviving spouse and beneficiaries

Another advantage of using a bypass trust is that you can name a professional trustee to manage the assets in the trust. If you are concerned that your spouse lacks the sophistication and experience to wisely manage your assets, you can appoint a bank trust department or professional fiduciary to be the trustee of the bypass trust. Once the trust is funded (either during your lifetime or at your death), the professional trustee can then manage the assets for the benefit of the beneficiary. You may even designate that the professional management of the trust continue past the death of the surviving spouse if you think that your children may be too young or too irresponsible at that time to handle the assets themselves.

Use of a bypass trust will allow assets to avoid probate

If you fund a bypass trust while you are alive, those assets will avoid probate at your death. Assets held in a trust do not have to be probated. There are two main disadvantages to probating an estate.

The first disadvantage to probating an estate is the time delay between the death of the decedent and the distribution of the assets. In almost all states, the heirs may have to wait six months to two years before they receive their assets. With a trust, the assets can be distributed immediately upon the death of the grantor.

A second disadvantage is that the probate process is public. Anyone can go down to the probate court and obtain a copy of your will to see what assets you owned and how those assets will be distributed. A trust is a private instrument that allows your assets and the distribution of those assets to remain private.

Both the bypass and the marital trust may be used to maximize use of each spouse's exemption from the generation-skipping transfer tax exemption of both spouses

In recent years, many estate planning attorneys have designed both the bypass and the marital trust to maximize use of each spouse's exemption from the generation-skipping transfer (GST) tax). The GST tax applies to a transfer from one individual to another individual (called a skip person) who is two generations or more below the transferor. The GST tax rate is 40 percent (in 2023). This tax is in addition to any other gift or estate tax that may be assessed on the transfer. Each individual has a lifetime exemption from the GST tax of $12,920,000 (in 2023, $12,060,000 in 2022). The exemption may be allocated between the bypass trust and the marital trust. The surviving spouse's GST tax exemption can also be allocated to the marital trust, making it more likely that both the husband and wife can fully use their respective GST tax exemptions. By using this method, spouses can leave an amount equal to their combined maximum available exemptions to skip persons without incurring the GST tax.

Caution: *Unlike the gift and estate tax basic exclusion amount in 2011 and later years, the GST tax exemption is not portable for spouses.*

Tradeoffs

Attorney should be hired to draft the bypass trust

You should hire a competent and experienced estate planning attorney to draft the bypass trust. Your attorney should also advise you on the estate and tax implications of setting up a bypass trust. As noted before, a bypass trust is typically used in conjunction with some type of marital trust. Because this strategy involves fairly sophisticated estate planning, you should have your estate planning attorney review your entire estate plan. Furthermore, in many cases, the ownership of assets will have to be split up, and the trusts may even be funded during your lifetime. You will need an attorney to retitle assets and to transfer assets into the various trusts. This level of estate planning can be quite expensive, with legal fees running possibly into the thousands of dollars.

Trustee will be needed for the bypass trust

You will need to appoint a trustee for the bypass trust. Depending on the size of the trust, you may want to hire a professional trustee for the trust. Many people hire a bank trust department or a private trust company, or even an individual who is a professional fiduciary, to be the trustee of the bypass trust. A professional trustee will have to be compensated for his or her services. Typically, he or she receives a percentage (usually 1 percent or more) of the assets under management.

Surviving spouse will not have full control over the assets in the bypass trust

Another tradeoff to using a bypass trust is that the surviving spouse will not have complete control over the assets in the bypass trust. If the spouse does have complete control over the assets, then the assets in the trust would be included in his or her taxable estate when he or she dies and might therefore be subject to estate tax. This outcome would completely defeat the purpose of using a bypass trust, which is to use the applicable exclusion amount (the amount that can be sheltered from gift and estate tax by the unified credit) of the first spouse to die to allow the assets in the bypass trust to pass to the remainder beneficiaries tax free.

Unfortunately, your spouse may not relish the idea of having no control over assets that you may have spent your lifetimes accumulating. Of course, the surviving spouse can be given some limited rights in the bypass trust. He or she can receive all of the trust's income for life, or he or she can be given trust principal to pay for health, education, maintenance, and support. An independent trustee can give unlimited amounts of trust principal to the surviving spouse at the trustee's discretion. The surviving spouse can have a limited power of appointment over trust assets to make lifetime or testamentary gifts to children or grandchildren, or anyone except himself or herself, his or her estate, and his or her creditors. Finally, the surviving spouse can be given the noncumulative right to withdraw each year the greater of $5,000 or 5 percent of the value of trust assets.

How to do it

Hire competent and experienced estate planning attorney to draft the bypass trust

Setting up a bypass trust (usually in conjunction with a marital trust) is a fairly complex estate planning strategy. You should seek the advice of a capable estate planning attorney to determine if setting up a bypass trust would be beneficial in your situation. If you decide to set up a bypass trust, a competent and experienced estate planning attorney should be hired to draft the trust. Furthermore, if you fund the trust during your lifetime, you may also need your attorney to transfer assets into the trust.

Choose an individual or institution to be the trustee of the bypass trust

If your estate is large, you should consider hiring a professional trustee, either a corporate trustee (such as a bank trust department or a private trust company) or an individual who is a professional fiduciary. Your estate planning attorney should be able to recommend several qualified trustees to you. The trustee has two primary responsibilities. First, the trustee must manage and invest the trust assets to generate income for the beneficiaries. Second, the trustee must attempt to preserve the corpus of the trust assets for the remainderpersons — the individuals who will ultimately inherit the trust assets (usually your children). If you have substantial assets, you should hire an individual or institution that has experience in managing these types of trusts.

You must choose beneficiaries and remainderpersons for the bypass trust

You must choose the beneficiaries and remainderpersons for the bypass trust. In almost all cases, the beneficiary will be the surviving spouse. Typically, the surviving spouse will be given at least all income from the trust. He or she may also be given access to the trust principal (for health, education, maintenance, or support). The individuals who will ultimately inherit the assets in the trust when the income beneficiary dies may be anyone you choose.

In community property state, one-half of property accumulated by married couple automatically belongs to surviving spouse

In a community property state, one-half of the property accumulated by a married couple during the marriage automatically belongs to the surviving spouse. This property is not subject to the provisions of the will of the first spouse to die. This fact can cause complications for estate planning purposes. The first spouse to die can specify that he or she wants all of the community property to be subject to the provisions of his or her will, but the surviving spouse must affirmatively acquiesce to this instruction before it will be effective as to the surviving spouse's share of such property. If you live in a community property state or own

property in a community property state, you should hire an experienced attorney in that state to assist you with your estate planning.

Marital deduction rules apply to community property states

The marital deduction rules apply to community property states. By taking advantage of the unlimited marital deduction, a married couple in a community property state can defer payment of federal estate taxes until the death of the surviving spouse. Some or all of the assets of the first spouse to die can be transferred into a bypass trust that may be shielded from federal estate tax by the applicable exclusion amount. The remainder of the assets of the first spouse to die can then be left to the surviving spouse, either outright or in a marital trust that will qualify for the unlimited marital deduction.

Tax considerations

Income Tax

Income from assets transferred to a revocable living trust will be taxed to the grantor of trust

If you transfer assets into a revocable bypass trust while you are alive, you will still be subject to income tax on any income generated by those assets. Since the transfers of assets are not irrevocable transfers into the trust, you are still considered the owner of the assets for income tax purposes. After your death, the income from the trust will be taxed to either the beneficiary (usually the surviving spouse) or the trust, depending on whether the income is paid out to the beneficiary or retained by the trust.

Example(s): *Say you set up a revocable bypass trust during your lifetime and transfer $500,000 to the trust. The trust generates $20,000 per year of income. You must include this amount in your taxable income each year. After you die, the beneficiary of the trust (usually your spouse) will then be taxed on this income if it is distributed to him or her. If the trust retains the income, it will be taxed on the income.*

Gift and Estate Tax

No gift tax due for transfers into a revocable living trust

Since you retain the right to terminate a revocable living trust, no gift tax is due at the time of the transfer into the trust. Those assets, however, will be included in your gross taxable estate when you die.

Gift tax may be due on transfers into an irrevocable trust

A gift tax may be due if you make transfers into an irrevocable trust during your lifetime. Any gift tax due may be offset by your available applicable exclusion amount of $12,920,000 (in 2023, $12,060,000 in 2022).

Caution: *Any portion of your applicable exclusion amount you use during your lifetime effectively reduces the amount that will be available at your death.*

Tip: *Lifetime gifts may qualify for the annual gift tax exclusion if trust beneficiaries are given Crummey withdrawal powers. These gifts are not taxable and do not use up your applicable exclusion amount.*

Assets transferred into a testamentary bypass trust are included in the taxable estate of the grantor

Any assets that are transferred into the bypass trust at your death will be included in your taxable estate. However, you can use your applicable exclusion amount to shelter these assets from the federal estate tax.

Most people using the bypass trust authorize their executor to transfer just enough assets into the bypass trust to fully use their applicable exclusion amounts then available. The remaining assets will then either be left directly to the surviving spouse or transferred into a marital trust. These assets will qualify for the unlimited marital deduction, and no estate tax will be due at the death of the first spouse.

In some rare instances, however, you may want to give your executor the discretion to overfund the bypass trust so your estate has to pay some estate tax at your death. Since the estate tax is graduated, it may make sense to incur estate tax at a lower rate at your death rather than overload the surviving spouse's estate, where the marginal estate tax rate may be much higher.

Tip: *In 2013 and later years, a federal gift and estate tax rate of 40 percent generally applies to taxable amounts in excess of the applicable exclusion amount. In those years, there may be no advantage to equalizing estates in order to avoid graduated tax rates.*

Generation-skipping transfer tax will apply to transfers to beneficiaries two generations or more below grantor

The generation-skipping transfer (GST) tax may apply to distributions from a trust in which there are beneficiaries (known as skip persons) who are two or more generations below the grantor. See the discussion above.

Caution: *The GST tax is a very complicated and onerous tax. If you think that you have any beneficiaries that may be skip persons, you should consult a competent and experienced estate planning attorney about the best ways to avoid the GST tax.*

Questions & Answers

What size estate should a married couple have before they consider using a bypass trust?

Most married couples will not need to set up a bypass trust if their combined assets are below the applicable exclusion amount. Couples with larger combined estates can use a bypass trust in conjunction with a qualified terminable interest property trust to take maximum advantage of the applicable exclusion amounts of both spouses.

Most couples who have assets below the applicable exclusion amount can either hold all of the assets in joint name or have simple wills in which each spouse leaves all of his or her assets to the other spouse. If assets are held jointly, then upon the death of one joint owner, the other owner automatically owns all of the assets. If the value of the assets in the surviving spouse's estate (including any assets transferred to the surviving spouse as a result of the death of the first spouse to die) is below his or her available applicable exclusion amount, no federal estate taxes will be due upon his or her death. A similar result would ensue if both spouses simply left all of their assets to each other.

A trust may be desirable if one or both spouses would like his or her assets to pass to specific individuals upon the surviving spouse's death. If so, it may make sense to set up a trust whereby the surviving spouse receives the income from the trust for life with the principal to pass to these specific individuals (possibly the couple's children) at the death of the surviving spouse.

Should a married couple with assets in excess of the applicable exclusion amount hold their assets jointly?

No. In general, a married couple who expect to have assets in excess of the applicable exclusion amount should not hold their assets in joint name. If the assets are held jointly, then upon the death of the first spouse, the other spouse would automatically own all of the assets that would pass to that spouse tax free due to application of the unlimited marital deduction. The applicable exclusion amount of the first spouse to die would then be wasted, as there would be no assets taxable in his or her estate to which the exclusion can be applied. The surviving spouse's estate may then be overqualified (i.e., have assets in excess of the applicable exclusion amount) due to inclusion of the joint assets. The married couple should divide up the ownership of the assets so that each one owns approximately an equal amount.

Can life insurance be used in conjunction with a bypass trust?

Yes. Many people use a revocable trust to hold life insurance in conjunction with a bypass trust (and sometimes a marital trust). One way to use a life insurance trust in conjunction with a bypass trust is to take out a life insurance policy on your life and then name the trustee of the revocable life insurance trust to be the beneficiary of the policy. Upon your death, the proceeds from the life insurance policy flow directly into the trust. The residue from your estate (i.e., what is left over after specific bequests, taxes, debts, and expenses) will also flow into the trust. The trust document will then authorize the trustee to divide the assets in the trust into both the bypass trust and the marital trusts. The trustee can decide at the time of your death how to best divide the assets to minimize taxes and to provide for your family.

Does it ever make sense for a married couple to pay estate taxes at the death of the first spouse?

Yes. There may be situations in which a couple with substantial assets will actually be better off paying some estate taxes at the death of the first spouse. If the estate of the first spouse to die would be taxed at a lower marginal rate, it may make sense to cause some assets to be included in his or her estate thereby incurring federal estate taxes at the lower marginal rate applicable to that estate. These assets will then not be included in the surviving spouse's taxable estate, where the marginal estate tax rates may be much higher.

Tip: *In 2013 and later years, a federal gift and estate tax rate of 40 percent generally applies to taxable amounts in excess of the applicable exclusion amount. In those years, there may be no advantage to equalizing estates in order to avoid graduated tax rates.*

Can a bypass trust be set up in your will?

Yes. The bypass trust would then be known as a testamentary trust. At your death, the assets in from your estate will fund the trust. One tradeoff to setting up a testamentary trust is that the trust cannot be funded until your estate has been probated. The probate of an estate can take from six months to two years. In contrast, an inter vivos trust may be funded during your lifetime. A testamentary trust may also be subject to supervision by the court making it more expensive to administer than an inter vivos trust.

Why might it be useful to use the full applicable exclusion amount (or a portion of it) at the first spouse's death?

Even with the current portability of the basic exclusion amount, it might be useful to use the full applicable exclusion amount (or a portion of it) at the first spouse's death if:

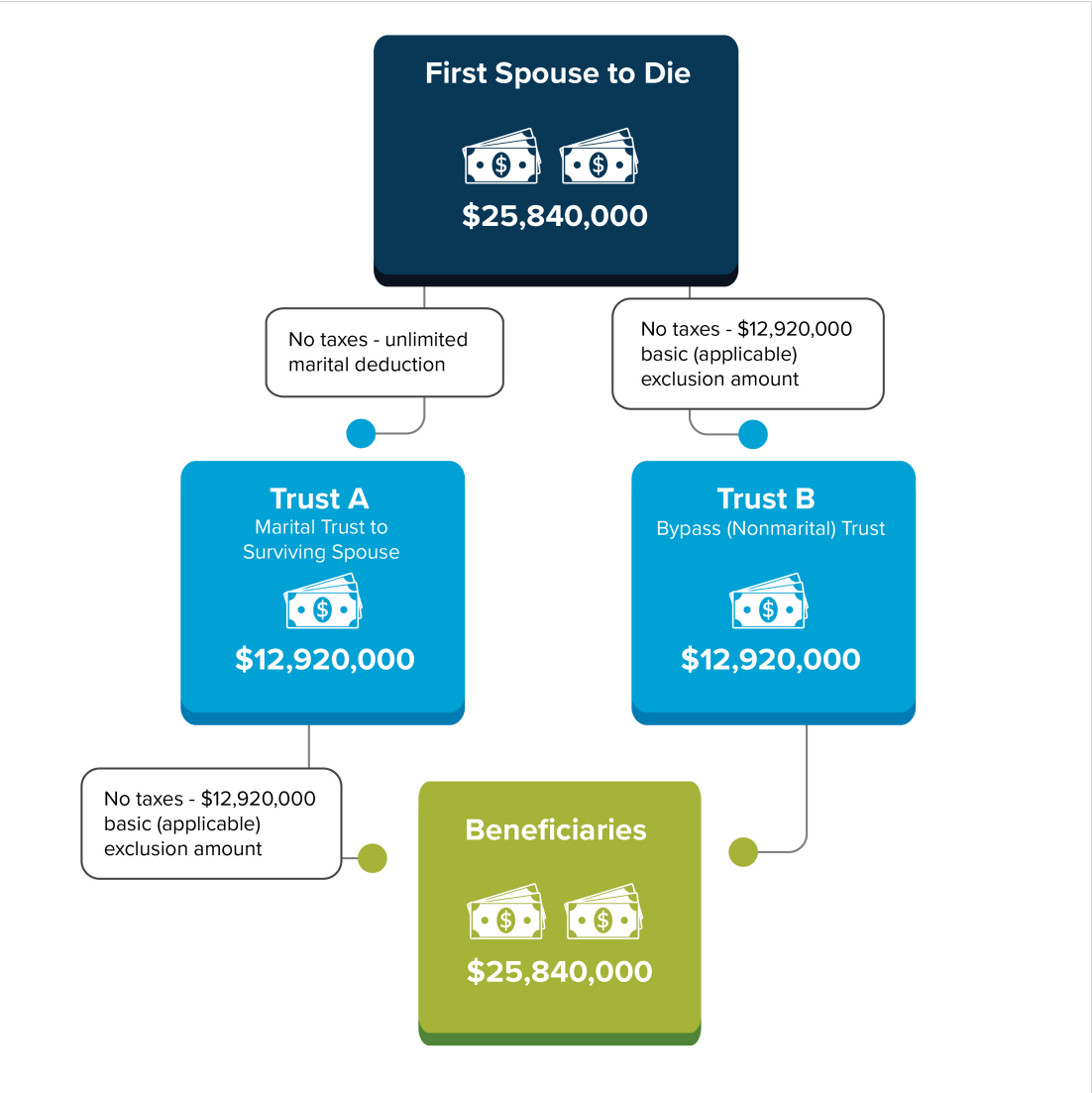
- There are persons other than your spouse that you would like to benefit prior to the death of your spouse.
- There are concerns whether the exclusion will be portable between spouses in the future (and the unused exclusion of the first spouse to die could be lost).
- There are concerns that the applicable (or basic) exclusion amount will be lower in the future (and the total amount sheltered by both spouses could be reduced).
- There are concerns that tax rates may be higher in the future (including the possibility that the failure to equalize estates may

result in higher graduated tax rates on the surviving spouse's estate).

- The property is expected to appreciate in value after the first spouse's death (and could outgrow any unused exclusion, which is not indexed for inflation).
- The spouses would like to benefit multiple generations and use both of their GST tax exemptions (the GST tax exemption is not portable).
- State death taxes can be saved (state exclusion amounts may be different and may not be portable between spouses).

Tip: *Property included in the gross estate for estate tax purposes generally receives a step-up in basis to fair market value for income tax purposes. Property that bypasses the surviving spouse's estate will not receive a step-up in basis at the surviving spouse's death. This could result in greater income tax, for example, when property is sold. Planning should attempt to balance estate tax and income tax considerations.*

A/B Trust Diagram: $25,840,000 Estate



The Tax Cuts and Jobs Act, signed into law in December 2017, doubled the gift and estate tax basic exclusion amount to $11,180,000 in 2018. It is $12,920,000 in 2023. After 2025, the exclusion is scheduled to revert to its pre-2018 level and be cut by about one-half.

Prior to 2011, each taxpayer was entitled to use only the exclusion allotted to him or her, and any unused exclusion amount would be lost. A married couple could ensure they fully used their respective exclusion amounts by implementing an estate plan that split a spouse's estate into a marital portion (Trust A) and credit shelter portion (Trust B), as illustrated.

In 2011 and later years, portability of the applicable exclusion amount between spouses may reduce the need for A/B trust planning, because it allows the executor of the first deceased spouse's estate to transfer any unused exclusion amount to the surviving spouse (along with the surviving spouse's own exclusion). This "portability" allows the second spouse to die to dispose of $25,840,000 worth of assets, estate tax free, without the need of planning. However, even with portability, there may be other tax and nontax reasons to implement an A/B trust, including:

- Sheltering the difference between the inflation and appreciation from estate tax
- Spendthrift and creditor protection
- Ability of the first spouse to die to control assets after death

Trust as Beneficiary of Traditional IRA or Retirement Plan

What is it?

A trust is a legal entity that you can set up and use to hold property for the benefit of one or more individuals (the trust beneficiaries). Every trust has one or more trustees charged with the responsibility of (1) managing the trust property, and (2) distributing trust income and/or principal to the trust beneficiaries according to the terms of the trust agreement. (A trustee can be an individual or an institution, such as a bank.) Many different types of trusts can be used to achieve a variety of objectives.

You may be able to designate a trust as beneficiary of your IRA or employer-sponsored retirement plan, if the IRA custodian or plan administrator allows such a designation. If the trust meets certain requirements, the beneficiaries of the trust can be treated as the designated beneficiaries of the IRA or retirement plan for purposes of calculating the distributions that must be taken following your death (required post-death distributions).

Caution: *This discussion applies to qualified employer-sponsored retirement plans and traditional IRAs, not to Roth IRAs. Special considerations apply to beneficiary designations for Roth IRAs.*

Caution: *Employer-sponsored qualified plans may require that you designate your spouse as beneficiary, unless your spouse signs a waiver allowing you to name a different beneficiary.*

Naming a trust as beneficiary usually will not affect required minimum distributions during your life

Under federal law, you must begin taking annual required minimum distributions (RMDs) from your traditional IRA and most employer-sponsored retirement plans [including 401(k)s, 403(b)s, 457(b)s, SEPs, and SIMPLE plans] by your "required beginning date" — April 1 of the calendar year following the calendar year in which you reach age 73 (age 75 if reach age 73 after 2032). If you reached age 72 in 2022, your general RMD age is 72.

With employer-sponsored retirement plans, you can delay your first distribution from your current employer's plan until April 1 of the calendar year following the calendar year in which you retire if (1) you retire after age 73 (age 75 if reach age 73 after 2032), (2) you are still participating in the employer's plan, and (3) you own 5 percent or less of the employer.

Your choice of beneficiary generally will not affect the calculation of your RMDs during your lifetime. An important exception exists, though, if your spouse is your sole designated beneficiary for the entire distribution year, and he or she is more than 10 years younger than you. The same exception may also apply if you name a trust as your sole beneficiary, and the sole beneficiary of the trust is your spouse who is more than 10 years younger than you.

If you name a trust as your beneficiary, the beneficiaries of the trust may be treated as the IRA or plan beneficiaries for purposes of required post-death distributions. See below for additional information.

Caution: *If a trust is a designated beneficiary, all beneficiaries of the trust are considered in determining the oldest beneficiary. The only exception is an individual whose benefit is contingent on another beneficiary dying prior to the payout of the entire IRA or plan balance. For beneficiaries inheriting from a decedent dying after 2019, the life expectancy method can only be used for eligible designated beneficiaries (see below). It is unclear if a trust (other than certain trusts for disabled or chronically ill beneficiaries) can use the life expectancy method if the trust has beneficiaries other than one eligible designated beneficiary.*

Caution: *The calculation of RMDs is complex, as are the related tax and estate planning issues. For more information, consult a tax professional or estate planning attorney.*

What rules must be followed for a trust beneficiary to qualify as a designated beneficiary?

Caution: *The SECURE Act ushered in a new set of rules establishing what's known as an eligible designated beneficiary (EBD). Although the Act did not change the definition of a designated beneficiary (DB), the IRS has not yet clarified how the new rules will specifically apply to beneficiaries of trusts. The distinction between an EBD and a DB matters significantly in determining the rules surrounding distributions. See note below under "A trust beneficiary can be treated as the IRA or retirement plan beneficiary." An EDB is a beneficiary who meets at least one of the following criteria: the account owner's surviving spouse; the account owner's child who is under the age of majority (21 — once the child reaches the age of majority, he/she is no longer considered an eligible designated beneficiary); a disabled or chronically ill individual, as defined by the IRS; someone not more than ten years younger than the account owner. For more information, consult a tax professional or an estate planning attorney.*

Certain special requirements must be met in order for an underlying beneficiary of a trust to qualify as a designated beneficiary of an IRA or retirement plan. The beneficiaries of a trust can be designated beneficiaries under the new IRS distribution rules only if the following four trust requirements are met in a timely manner:

- The trust beneficiaries must be individuals clearly identifiable (from the trust document) as designated beneficiaries as of

September 30 following the year of your death.

Caution: *Final IRS regulations state that trust beneficiaries may not use the "separate account" rules that might otherwise allow each beneficiary to use his or her life expectancy when calculating required post-death distributions. You may need to establish separate trusts for each beneficiary to accomplish this goal. Consult an estate planning attorney.*

- The trust must be valid under state law. A trust that would be valid under state law, except for the fact that the trust lacks a trust "corpus" or principal, will qualify.
- The trust must be irrevocable, or (by its terms) become irrevocable upon the death of the IRA owner or plan participant.
- The trust document, all amendments, and the list of trust beneficiaries (including contingent and remainder beneficiaries) must be provided to the IRA custodian or plan administrator by the October 31 following the year of your death.

Caution: *There is an exception to the above deadline in cases where the sole beneficiary of the trust is your spouse who is more than 10 years younger than you, and you want to base lifetime RMDs on joint and survivor life expectancy. In this case, trust documentation should be provided before lifetime RMDs begin.*

In addition to these requirements, a surviving spouse will not be considered the sole beneficiary of a trust if any of the IRA or plan funds in the trust can be accumulated during the surviving spouse's lifetime for the benefit of remainder beneficiaries.

Caution: *You should consult an estate planning attorney regarding the above requirements, as a mistake may prove costly.*

Advantages of naming a trust as beneficiary

A trust beneficiary can be treated as the IRA or retirement plan beneficiary

As mentioned, if you name a trust as beneficiary of your IRA or plan and meet certain requirements, the individuals named as beneficiaries of the trust can be treated as the designated beneficiaries of the IRA or plan. This is significant because it typically allows you to provide the individual trust beneficiaries with the same post-death options they would have if you named them directly as the IRA or plan beneficiaries. These individuals will generally have the opportunity to calculate post-death distributions using the life expectancy method (provided that the IRA custodian or plan administrator permits this method, and that the beneficiaries are eligible designated beneficiaries), potentially stretching distributions over many years. A longer post-death payout period will spread out the beneficiaries' income tax liability on the funds and prolong tax-deferred growth in the IRA or plan.

One situation in which naming a trust as the IRA or plan beneficiary will limit post-death distribution options is when you want to provide for your surviving spouse. In this case, naming your spouse directly as IRA or plan beneficiary is generally a better strategy for income tax planning purposes (but maybe not death tax planning purposes) than naming a trust that has your spouse as beneficiary.

Caution: *If the life expectancy method is used, post-death distributions must begin no later than the December 31 following the year of your death, and must be based on the single life expectancy of the oldest beneficiary of the trust (i.e., the one with the shortest life expectancy).*

Caution: *If the trust you have designated as IRA or plan beneficiary is not properly designed, you may be treated as if you died without a designated beneficiary. That would likely limit the payout period for post-death distributions, in many cases considerably.*

Note: *For decedents dying after 2019, the life expectancy method can only be used if the designated beneficiary is an eligible designated beneficiary. An eligible designated beneficiary is a designated beneficiary who is the spouse or a minor child of the IRA owner or plan participant, a disabled or chronically ill individual, or other individual who is not more than ten years younger than the IRA owner or plan participant (such as a close-in-age sibling). Special rules apply in the case of certain trusts for disabled or chronically ill beneficiaries. In any other case, it is unclear if a trust can use the life expectancy method if the trust has beneficiaries other than one eligible designated beneficiary.*

Naming a trust can allow you to retain control after your death

When you designate one or more individuals directly as beneficiaries of your IRA or retirement plan, after your death, those individuals are generally free to do with the inherited funds as they please. This could mean, among other things, withdrawing all of the funds in one lump sum and incurring a large income tax bill. However, you can retain some control over the funds after your death by setting up a trust for the benefit of your intended beneficiaries, and then naming that trust directly as beneficiary of your IRA or plan. Your intended beneficiaries will still receive the IRA or plan funds after you die, but generally according to your wishes as spelled out in the trust document, provided IRS rules are followed. This often gives you the ability to control the timing and amounts of distributions, preventing your children or other trust beneficiaries from squandering the funds.

Caution: *In some cases, the tradeoff for receiving tax benefits may involve following IRS rules on distributions instead of completely designing your own distribution provisions for your trust. Also, income that is retained in a trust and not paid out to beneficiaries may be heavily taxed for income tax purposes.*

Assets held in a trust may be protected from creditors

IRA or retirement plan funds left to a properly drafted trust for the benefit of your intended beneficiaries may enjoy considerable protection against their creditors, at least as long as those funds remain in the trust. In fact, leaving retirement assets to your beneficiaries via a trust will often provide greater creditor protection than if you left those assets directly to your beneficiaries. This can be a major advantage if one or more of your beneficiaries has substantial unsecured debts. Consult an estate planning attorney for further details, and to find out what type of trust will provide the most creditor protection.

A QTIP trust for your spouse may be beneficial

A qualified terminable interest property (QTIP) trust is a type of marital trust that allows you to provide for your surviving spouse during his or her lifetime, defer estate tax at your death, and control who the ultimate beneficiaries will be. If you name this type of trust as the beneficiary of some or all of your retirement assets, your spouse will receive distributions during his or her lifetime and, to the extent the entire account is not consumed, the balance may be left to your children and/or other beneficiaries. Retirement plan assets left to this type of trust are not subject to estate tax at your death, but the remaining assets will be included in your spouse's taxable estate at his or her death. Consult an estate planning attorney for further details.

Caution: *To use a QTIP, your spouse must be a U.S. citizen. If your spouse is not a U.S. citizen, a special type of trust known as a qualified domestic trust (QDOT) may be appropriate. With a QDOT, as with a QTIP, all trust income is paid to your surviving spouse during his or her lifetime. However, unlike a QTIP where remaining trust assets are included in the surviving spouse's estate at his or her death for estate tax purposes, the assets will be taxed in the first spouse's estate at the surviving spouse's death or upon the earlier withdrawal of principal. Consult an estate planning attorney for further details.*

A credit shelter trust may be beneficial

In some cases, you may want to name a certain kind of estate-tax-saving trust as the beneficiary of some or all of your IRA or retirement plan assets. This type of trust goes under many names, including "credit shelter trust," "B trust," "bypass trust," and "exemption trust." The size of the trust is usually tied to the size of the federal applicable exclusion amount.

The purpose of this type of trust generally is to allow your spouse (or other trust beneficiaries) to benefit from the assets placed in the trust, but to exclude those assets from estate tax, not only at your death, but also at your surviving spouse's death. Consult an estate planning attorney for further details.

Caution: *If too much or all of your estate goes into this type of trust under the increasing applicable exclusion amount, then your surviving spouse may not be adequately provided for, unless you have specific provisions added to the trust document.*

Caution: *Since this type of trust may be forever exempt from estate tax, you may not want to diminish its value by funding it with retirement assets that are subject to income tax. If possible, other assets might be more appropriate sources of funding for the trust.*

Caution: *This may not be the proper strategy for some married couples. A tax law passed in 2001 replaced the state death credit with a deduction starting in 2005. As a result, many of the states that imposed a death tax equal to the credit decoupled their tax systems, imposing a stand-alone death tax. Many of these states allow an exemption that is less than the federal exemption. This may leave some couples vulnerable to higher state death taxation. See your financial professional for more information.*

Tip: *In 2011 and later years, the unused basic exclusion amount of a deceased spouse is portable and can be used by the surviving spouse. Portability of the exclusion may provide some protection against wasting of the exclusion of the first spouse to die and reduce the need for a credit shelter or bypass trust.*

Disadvantages of naming a trust as beneficiary

Naming a trust for the benefit of your spouse may limit post-death options

If you want to provide for your spouse after your death, you can set up a trust for the benefit of your spouse, and then name that trust directly as beneficiary of your IRA or retirement plan. Your spouse, as beneficiary of the trust, could then be considered an eligible designated beneficiary of the IRA or plan (as long as all of the above requirements are met). However, think carefully and seek professional advice before making this beneficiary choice. The use of a trust may limit or rule out certain post-death options that would otherwise be available to your spouse if he or she were named directly as beneficiary of the IRA or plan.

For example, under the minimum required distribution rules, your spouse would lose the right to treat an inherited IRA as his or her own account (even if your spouse were the sole beneficiary of the trust). If you want your spouse to ultimately receive your IRA or plan assets, the best way to achieve this goal is typically to directly name your spouse as beneficiary of those assets (unless there are specific reasons for using a trust instead). Naming your spouse as primary beneficiary provides greater options and maximum flexibility in terms of post-death distribution planning.

Caution: *Nonspouse beneficiaries cannot roll over inherited funds to their own IRA or plan. However, a nonspouse beneficiary can make a direct rollover of certain death benefits from an employer-sponsored retirement plan to an inherited IRA (traditional or Roth).*

Trusts can be complicated and costly to set up

Setting up a trust can be expensive, and maintaining it from year to year can be burdensome and complicated. So, the cost of establishing the trust and the effort involved in properly administering the trust should be weighed against the perceived advantages of using a trust as an IRA or retirement plan beneficiary. In addition, remember that if the trust is not properly drafted, you may be treated as if you died without a designated beneficiary for your IRA or plan. That would likely shorten the payout period for required post-death distributions. Provisions of your trust need to take into account laws regarding the payout of trust income in connection with estate tax planning issues. Also, funding a trust that is exempt from death tax (e.g., credit shelter trust) with assets that have a built-in income tax liability reduces the net amount really in this trust.

Also, depending on the purpose of the trust and other factors, a trust may not be worthwhile. Depending on the size of your estate and the amount of the estate tax exemption in the year of your death, using a trust for estate tax purposes may or may not make sense. Consult an estate planning attorney for further guidance.

Irrevocable Life Insurance Trust

What is it?

An irrevocable life insurance trust (ILIT), sometimes referred to as a wealth replacement trust, is a trust that is funded, at least in part, by life insurance policies or proceeds. If properly implemented, an ILIT can help minimize estate taxes and provide a source of liquid funds to your estate for the payment of taxes, debts, and expenses.

Generally, assets you own at death are subject to federal estate tax. This includes life insurance policies and proceeds. Estates in excess of the applicable exclusion amount (in 2023, $12,920,000 plus any deceased spousal unused exclusion amount) may have to pay estate tax at rates as high as 40 percent. If you're an insured individual whose estate will have to pay estate tax, your family may receive less money from your life insurance than you originally planned for.

An ILIT can solve this problem, and may be especially appropriate if your estate would not have to pay estate taxes were it not for the inclusion of the policy proceeds.

Tip: *Although this discussion concerns federal estate taxes only, an ILIT can also help minimize state death taxes.*

How does it work?

Because an ILIT is an irrevocable trust, policies and proceeds (and any other assets) held by the trust are considered owned by the trust entity and not owned by you. Since you won't own the policy at your death, the proceeds will not be included in your estate. They will be received by the ILIT and ultimately pass to your family members undiminished by estate taxes. Your family members can use the proceeds to pay estate expenses. This may save your family members from having to sell assets at fire sale prices, and allow them to keep assets that may generate needed income or are valued family keepsakes. One key to this strategy is that you must relinquish all power over and benefits from the property in the trust.

In a typical scenario, an insurable person (the grantor) first creates an ILIT, names an independent trustee (e.g., a bank trust department), and names the beneficiaries of the trust (usually his or her spouse and/or children). The trustee then applies for life insurance on the grantor's life and designates the ILIT as the sole beneficiary. The trustee also opens a checking account for the ILIT. The grantor gives the trustee funds for the initial premium, which the trustee deposits into the ILIT checking account. The trustee writes a check from the ILIT checking account, pays the premium to the insurance company, and coverage becomes effective. As premiums come due, the grantor and trustee repeat the same procedure. Whenever the ILIT receives funds from the grantor, the trustee provides a special notice (a Crummey notice) to each of the beneficiaries. This Crummey notice lets the beneficiaries know that they have a right to withdraw the recently deposited funds, but only within a certain limited time frame (e.g., 30 to 60 days). The trustee waits until this time frame passes before remitting the funds to the insurance company. This notice procedure serves to qualify the gift for the annual gift tax exclusion (see the section on Crummey withdrawal rights). At the grantor's death, the ILIT trustee collects the total proceeds and distributes them to the beneficiaries according to the terms of the trust.

Tip: *An ILIT can hold almost any type of life insurance policy, including a second-to-die (survivorship) policy. A second-to-die policy covers the lives of yourself and your spouse, and pays off at the death of the survivor. If your ILIT will hold this type of policy, extra care must be taken when drafting and funding the trust.*

Why use an ILIT?

There are many reasons to use a trust rather than have an individual own your life insurance policy. For example, having your spouse own the policy may defeat the purpose of the ILIT, as the proceeds will be subject to estate taxes in his or her estate. Having an adult child or any other individual own the policy may expose the policy or proceeds to that individual's creditors, or may create disharmony among family members. An ILIT can accomplish some or all of the following:

- Avoid inclusion of the proceeds in your (and your spouse's) estate
- Make the cash liquidity provided by the total proceeds available to the estate of the insured
- Insulate the proceeds from estate taxes over multiple generations
- Provide professional management of the proceeds
- Protect the policy and proceeds from future creditors and potential ex-spouses
- Provide incentives to beneficiaries

Creating the ILIT

Trust must be irrevocable

To enjoy its benefits, a life insurance trust must be irrevocable. That means you (the grantor) can't change the terms of the trust or the beneficiaries, end the trust, or retain any power over or interest in the trust. Further, any property transfers made to the trust must be complete and permanent. This also applies to your spouse if the ILIT is funded with a second-to-die policy.

Tip: *Because it will be difficult, or even impossible, for you to make changes to the trust without adverse tax consequences, it's important to build flexibility into the trust document. Be sure to consult an attorney experienced with ILITs.*

Naming a trustee

Your choice of trustee, the person who will administer the trust, is an important decision. For the ILIT to be effective, you cannot serve as trustee, and you shouldn't even retain the power to name yourself as trustee. The IRS has clearly stated that proceeds will be included in an insured's estate if the insured serves as trustee. If the ILIT holds a second-to-die policy, your spouse cannot serve as trustee for the same reason.

Tip: *The trust document should expressly prohibit the insured(s) from serving as trustee. Further, the trust document should contain language that limits your power to change the trustee. You can change the trustee so long as the successor trustee is not related or subordinate. The term "related or subordinate" includes spouses, parents, descendants, siblings, and employees, but not nieces, nephews, in-laws, or partners.*

A noninsured spouse can serve as trustee, but it is not recommended. Remember, one key to an ILIT is relinquishing all control over and interest in the trust property. If your spouse is administering the trust, you may be regarded as retaining some control, albeit indirectly. If you choose this course, however, your spouse must not make any gifts to the trust. If your spouse is also a beneficiary, a co-trustee is recommended to handle distributions to your spouse, or a successor trustee should assume all duties at your death.

Other beneficiaries can serve without adverse tax consequences, but this is generally not a good idea because there may be conflicts of interest.

Other non-beneficiary family members or friends can serve as long as you trust them to perform their duties competently. A professional trustee may be the best choice because a professional will have the experience to properly administer your ILIT, and you can be fairly assured of competent asset management and impartiality.

The key duties of an ILIT trustee include:

- Opening and maintaining a trust checking account
- Obtaining a taxpayer identification number for the trust entity, if necessary
- Applying for and purchasing life insurance policies
- Accepting funds from the grantor
- Sending Crummey withdrawal notices (see the section on Crummey withdrawal rights)
- Paying premiums to the insurance company
- Making cash value investment decisions
- Claiming insurance proceeds at your death
- Distributing trust assets according to the terms of the trust
- Filing tax returns, if necessary

Naming the beneficiaries

To keep the proceeds out of your estate, do not name your executor, your estate, your creditors, or the creditors of your estate as beneficiaries of the trust. The proceeds will be considered payable to your estate if your ILIT requires the trustee to use the proceeds to pay your estate's debts, taxes, or other obligations. If the ILIT merely gives the trustee the authority to pay such expenses, however, the proceeds will not be included in your estate unless the trustee actually uses them to satisfy such obligations. To make the proceeds available to your estate, the ILIT should include language that permits the trustee to buy property from your estate or make loans to the estate. If the trustee does either, the transaction must be completed in a reasonable, arm's-length manner.

If you want to name your spouse as a beneficiary and also keep the proceeds out of your spouse's estate, the ILIT must be drafted so that access by your spouse to the proceeds is limited. Your spouse can receive some or all of the annual income from the ILIT, but access to trust principal must be limited to ascertainable standards (i.e., for support, health, or education only). Further, your spouse can hold a right of withdrawal not to exceed the greater of five percent of the trust balance or $5,000 each year. Your spouse can also be given a limited (or special) power of appointment, but not a general power of appointment. In other words, your spouse can name subsequent beneficiaries, but cannot name himself/herself, his/her creditors, or the creditors of his/her estate.

Funding the ILIT

You can create an ILIT and leave it unfunded during your lifetime. An unfunded ILIT is one that holds a life insurance policy only, and does not hold any other assets. With an unfunded ILIT, you will need to gift money to the trust so the trustee can pay policy premiums. If the trust holds a permanent life insurance policy and the policy allows it, premiums can be paid with accumulated cash values or dividends, and you may not need to gift additional funds.

Alternatively, you can fund an ILIT during your lifetime with assets in addition to your life insurance policy. Funding an ILIT with income-producing assets can provide the trustee with the money needed to pay the policy premiums. An additional benefit of funding your ILIT is that any future appreciation in the assets will be sheltered from estate taxes, again because the trust is irrevocable. Funding your ILIT also allows you to coordinate the asset's final disposition with the insurance proceeds.

After you die, the ILIT (unfunded or funded) will receive the policy proceeds and the trustee will administer them according to the terms of the trust. The trust can receive other assets at your death along with the insurance proceeds, such as assets poured over from your will, or death benefits paid by your employer or employer benefit plan. The trust terms can direct that the proceeds be distributed to the beneficiaries immediately, or the trust terms can direct that the proceeds remain in the trust and under the trustee's management for a period of time before being distributed. The latter option may be desirable if you anticipate that your heirs might mismanage the funds or if your heirs are minor children.

Caution: *Funding an ILIT with assets in addition to your life insurance policy may trigger gift tax and income tax consequences (see the section on Tax Considerations).*

Caution: *If you live in a community property state and your spouse is a beneficiary, do not fund the trust with community property. If you do, half of the insurance proceeds will be included in your spouse's estate. To avoid this situation, be sure to initially fund the trust and make any subsequent contributions with separate property only.*

The three-year rule

You may have existing life insurance policies you want to transfer to an ILIT. While this is possible (merely execute an absolute assignment of ownership form provided by the issuing insurer), it is not advisable because transferring existing policies triggers the three-year rule. This rule states that, if you transfer a life insurance policy to an ILIT within the three years preceding your death, all the proceeds will be brought back into your estate for estate tax purposes. Because of the three-year rule, it is not advisable to transfer policies unless you're no longer insurable or can't afford the cost of replacement policies.

Caution: *Funding an ILIT with policies that have accumulated cash values may trigger gift tax consequences (see the section on Tax considerations).*

You can avoid the three-year rule by allowing the trustee, on behalf of the trust, to apply for and purchase a new policy. If the trust owns the policy from the outset, the three-year rule will not apply. Because the purchase must be purely discretionary, be sure the trustee is not obligated to buy the policy, but is permitted to do so.

The ownership problem

To keep the proceeds out of your estate and your spouse's estate, you and your spouse must not retain any incidents of ownership in the policies held by the trust. Though the IRS doesn't specifically define incidents of ownership, the phrase generally refers to any rights you retain that might benefit you economically. Those rights include:

- The right to transfer, or to revoke the transfer, of ownership rights
- The right to change certain policy provisions
- The right to surrender or cancel the policy
- The right to pledge the policy for a loan or to borrow against its cash value
- The right to name and to change a beneficiary
- The right to determine how beneficiaries will receive the death proceeds

You must not retain any of these rights. Further, the trust document should expressly state that the trust is irrevocable and that the insured is retaining no rights to the policies held by the trust.

Tip: *You can, however, retain the power to change the trustee so long as the successor trustee is not related or subordinate.*

Crummey withdrawal rights

Transfers of cash (or any other property, including cash values accumulated in existing policies) to your ILIT may be subject to gift tax. However, you can minimize or eliminate your actual gift tax liability by structuring the transfer so that it qualifies for the annual gift tax exclusion ($17,000 per beneficiary in 2023).

Generally, a gift must be a present interest gift in order to qualify for the annual gift tax exclusion, which allows you to gift $17,000 (in 2023) per beneficiary gift-tax free. A present interest gift means that the recipient is able to immediately use, possess, or enjoy

the gift. Gifts made to a trust are usually considered gifts of future interests and do not qualify for the annual gift tax exclusion unless they fall within an exception. One such exception is when the beneficiaries are given the right to demand, for a limited period of time, any amounts transferred to the trust. This is referred to as Crummey withdrawal rights or powers.

The beneficiaries (or their parents/guardians) must also be given notice of their rights to withdraw whenever you transfer funds to the ILIT, and they must be given reasonable time to exercise their rights. The basic requirement is that actual written notice must be made in a timely manner. It is best to give written notice at least 30 to 60 days before the expiration of the withdrawal period. It is the duty of the trustee to provide notice to each beneficiary.

Of course, so as not to defeat the purpose of the trust, your beneficiaries should not actually exercise their Crummey withdrawal rights, but should let their rights lapse. Lapsed withdrawal rights, however, are considered gifts to the other trust beneficiaries, and are generally includable in a beneficiary's estate. To address this problem, the Internal Revenue Code provides an exception, referred to as the five or five power. The Code states that the lapse of rights to withdraw will not be treated as a gift, and will not be included in the beneficiary's estate, to the extent it does not exceed the greater of five percent of the trust balance or $5,000 each year.

Because the beneficiaries' withdrawal powers are limited to five percent or $5,000 of the trust's assets each year, your annual gift tax exclusion is also limited to the five or five amount. If you need to contribute more than this to cover the policy premium, the excess will be subject to gift tax. You may be able to avoid this result with the use of hanging powers. The hanging power throws the excess into future years, until all of it is used.

Tax considerations

Income Tax

Trust's income generally attributed to the grantor

If you fund your ILIT with income-producing assets and the trust is a grantor trust, income from the trust will be taxed to you, and you can use any gains, losses, deductions, and credits realized by the trust (most ILITs are grantor trusts). If the trust is not a grantor trust, the income tax rules are generally as follows:

- Income used to pay premiums is taxed to you (the grantor)
- Income paid to the beneficiaries is taxed to them
- Income retained by the trust is taxed to the trust

If the trust is not a grantor trust, the trustee must obtain a taxpayer identification number (TIN), which can be obtained online, over the phone, or by mail. If the trust is a grantor trust, a TIN is not required while you are alive, but the trust will need one upon your death. That being the case, it may make sense to obtain a TIN at the outset.

Gift Tax

Transfers to an ILIT are taxable gifts

Transfers to an ILIT are taxable gifts. Crummey rights of withdrawal held by the beneficiaries, however, allow the transfers to qualify for the annual gift tax exclusion. Transfers that do not qualify for the annual gift tax exclusion are exempt from gift tax to the extent of your lifetime gift and estate tax applicable exclusion amount ($12,920,000 in 2023, $12,060,000 in 2022), which is automatically applied.

If existing life insurance policies are transferred to your ILIT, they will be valued at the interpolated terminal reserve value (which is approximately the same as the cash surrender value of the policy). Upon request, your insurance company can give you the exact terminal reserve value. Depending on the size of the policy, your health, and the length of time that the policy has been in place, this terminal reserve value may be quite large.

Tip: *One possible strategy to reduce the size of the gift is to take out a loan against the cash value of the policy prior to the gift. Such a loan will reduce the interpolated terminal reserve value.*

Community property considerations

If you live in a community property state, special attention should be paid to the drafting and funding of your ILIT. For example, you should create a separate property agreement and fund the trust with separate property.

Beneficiaries may incur gift tax or estate tax due to withdrawal right lapses

When a beneficiary allows his or her right to withdraw money gifted to the trust to lapse, he or she is considered to have made a taxable gift to the remaining beneficiaries of the trust and the funds are includable in the beneficiary's estate. Five percent of the trust balance or $5,000, whichever is greater, is exempted. Gift tax consequences on lapses in excess of this so-called five or five power can be avoided using hanging powers, or by giving the beneficiaries the right to appoint the unwithdrawn amounts in their wills (those amounts will still be includable in their estates, however).

Caution: *This is an extremely technical area. You will need to consult your accountant or tax attorney.*

Estate Tax

Proceeds from life insurance policy not included in grantor's estate

If the ILIT is drafted, funded, and administered properly, the proceeds from insurance policies held by the trust will not be included in your estate. This is one of the main benefits of setting up this type of trust.

Caution: *If an existing insurance policy is transferred to the trust and you die within three years of the transfer, however, the proceeds will be included in your estate.*

Generation-Skipping Transfer Tax

Transfers to trust with beneficiaries two or more generations below grantor are subject to generation-skipping transfer tax

An ILIT can be an excellent vehicle for generation-skipping transfer (GST) tax planning for life insurance proceeds. If your ILIT has beneficiaries that are two or more generations below you (your grandchildren, for example), gifts to the trust may be subject to both gift tax and GST tax. The GST tax rate is a flat rate at the highest estate tax rate in effect. Fortunately, there is an annual gift tax exclusion ($17,000 per skip beneficiary in 2023) similar to the annual gift tax exclusion, and a lifetime GST tax exemption ($12,920,000 in 2023).

Your ILIT can be designed as a dynasty trust meant to last for several generations, leveraging your GST tax exemption, and avoiding successive generations of taxes. This is a complicated strategy, however, requiring careful planning.

Caution: *Unlike the gift tax applicable exclusion amount, which is allocated automatically, you may have to explicitly allocate your GST tax exemption on Form 709.*

How do you implement an ILIT?

Contact your insurance professional

Your insurance professional will help you decide what kind of policy is best for you. Do not purchase the policy, however.

Hire an attorney

For an ILIT to work according to your intentions, careful drafting of the trust document is essential. One error can negate all your planning. In addition, there are many complex legal issues that can arise when you set up a trust. You should hire an experienced attorney to draft the trust document and advise you on the complex legal issues.

Fund the trust

You must transfer cash to the ILIT trustee so the trustee can purchase the policy (and additional amounts as premiums come due). As noted before, the trustee should buy the policy in order to avoid the three-year rule. In addition, you may want to transfer other assets to the trust. Your attorney should assist you in properly transferring ownership.

Serve Crummey notice to the beneficiaries

The ILIT trustee must fulfill the Crummey notice requirements to keep the ILIT effective. This means that when the trust is initially funded, and whenever you make any subsequent contributions, the trustee must give actual written notice to each beneficiary at least 30 to 60 days prior to the expiration of the withdrawal period.

Tip: *The trustee should consider sending the notices so that the recipient's signature is required, and should keep the signatures on file.*

File federal gift tax return (Form 709), if necessary

If the transfers you make to the trust exceed the annual gift tax exclusion and you have used up your applicable exclusion amount, you may have to file a federal gift tax return (Form 709) and pay gift tax. If you want to allocate a portion of your generation-skipping transfer tax exemption, you will also need to file Form 709. You may want to consult your accountant or tax attorney prior to making any gifts.

Caution: *If your state imposes gift tax, you may also need to file a state gift tax return.*

Include trust income on your personal annual income tax return, if required

Income earned by the trust that is taxable to you (the grantor) must be included on your personal income tax return for the year in which it is earned.

Property Ownership Issues that Concern Married Couples

What is it?

The way that you as a married couple structure the ownership of your real or personal property is an important step in the financial planning of your future together. Whether you own a piece of real estate or a checking/savings account, the method of property ownership you choose can affect future sales of that property, divorce proceedings, or the distributions of an estate upon your death. If you live in a state that follows the traditional system of property ownership, you and your spouse can choose to either own property jointly or retain sole ownership of the property. If you and your spouse live in a community property state, both you and your spouse share equally any income earned and property that is acquired during marriage.

Caution: *If you are a same-sex married couple, property ownership issues may be more complicated if you live in a state in which your marriage is legally recognized, but own property in a state that does not recognize same-sex marriage. Consult an experienced attorney or financial professional for more information.*

Joint ownership

Joint tenancy

A joint tenancy is the ownership of property by two or more persons and where each owner enjoys the same rights in the property. Title to the property is held by the group as a whole and not by the individuals who make up the group. A joint tenancy may come with the right of survivorship, meaning that if one of the joint owners/tenants dies, all rights pass equally to the remaining joint tenants. A joint tenant can sell his or her interest, but the purchaser becomes a tenant-in-common while the other owners remain joint tenants.

Tip: *Right of survivorship is not automatic. Sometimes the right of survivorship must be explicitly stated. If you want a joint tenancy with right of survivorship, check whether it is automatic under your state's property ownership laws or whether you must explicitly state it.*

Caution: *A disadvantage of a joint tenancy is that it could result in an unintentional elimination of ownership.*

Example(s): *Jane and Hal decide to give the family summer home on Cape Cod, Massachusetts to their children Bob and Ken as joint tenants so that the home can stay in the family. Both Bob and Ken are married and have children. Ken later dies, and the property passes to Bob, the remaining joint tenant. Unfortunately, Ken's widow Sue and their child Fred end up with nothing.*

Tenancy in common

A tenancy in common is the ownership of property by two or more persons who have an undivided separate interest in the property with a common right of possession. No tenant in common owns a specific part of the property. Instead, all of the tenants in common have an interest in the entire property. Unlike a joint tenancy, there is no right of survivorship with a tenancy in common. In other words, a tenant in common can transfer his/her interest in the property to anyone upon death.

Example(s): *Jane and Hal decide to give the family summer home on Cape Cod, Massachusetts to their children Bob and Ken as tenants in common. As tenants in common, Bob and Ken have an undivided separate interest in the property with a right to possess the whole. Two years later, Ken decides to transfer his interest in the property to his son Fred. Now Bob and Fred own the summer home as tenants in common. One year later, Bob dies. In his will, Bob devises his interest in the summer home to his son Mark. Now Fred and Mark own the summer home as tenants in common.*

Tenancy by the entirety

A tenancy by the entirety is one type of the ownership of property by a husband and wife. It is similar to a joint tenancy in that both the husband and wife share the right of survivorship. However, a part interest cannot be transferred to another individual without the consent of both spouses. Like a joint tenancy, the tenancy by the entirety can result in the unintentional elimination of ownership. If one spouse dies, the property will go to the surviving spouse, regardless of the terms of the will.

Example(s): *Jane and Hal own a home as a tenancy by the entirety. Hal has a child from a former marriage, Ron. Hal indicates in his will that he wishes to leave his interest in the home he owns with Jane to Ron. When Hal dies, his interest in the home will go to Jane under the right of survivorship, not Ron, despite the terms of his will.*

Tip: *Tenancy by the entirety is not available in all states. Certain states will give the wife a life estate in any real property held at death by the husband, regardless of whether or not the husband and wife held property as tenants by the entirety.*

Sole ownership

Sole ownership is when one individual has both the legal and beneficial ownership of property. One of the major advantages of sole ownership is the ease of property transfer during one's lifetime or upon one's death.

Example(s): *Hal has sole ownership of a piece of property on Cape Cod, Massachusetts. Hal's wife Jane does not have any ownership interest in the Cape Cod property. In most states, Hal can transfer his entire interest in the property at any time during his lifetime or upon his death to his son from a prior marriage, Ron.*

Community property

While most states follow common law rules as to the ownership of property, nine states are community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin (in addition, Alaska has an elective community property system). If you and your spouse reside in a community property state, property that either you or your spouse acquire during the marriage is considered the property of both of you, with each of you owning an undivided one-half interest in the property. No matter which of you acquires the property, title to half the acquisition passes to the other spouse by operation of law. Any property that either of you brings into the marriage, inherits during the marriage, receives as a gift during the marriage, or together agree is separate property is considered separate property of the owner-spouse.

Example(s): *Hal and Jane live in California, a state that follows community property laws. During Hal and Jane's marriage, Hal purchases a house and receives his favorite uncle's gold coin collection as an inheritance. Although Hal purchases the house on his own, Jane receives title to half of the house by operation of law. Hal and Jane own the house together, each having an undivided one-half interest. As for the gold coin collection, Hal is the sole owner, since it was acquired as a result of an inheritance.*

Tip: *Another form of ownership for married couples is through a trust or QTIP trust.*

Conducting a Periodic Review of Your Estate Plan

What is conducting a periodic review of your estate plan?

With your estate plan successfully implemented, one final but critical step remains: carrying out a periodic review and update.

Imagine this: since you implemented your estate plan five years ago, you got divorced and remarried, sold your house and bought a boat to live on, sold your legal practice and invested the money that provides you with enough income so you no longer have to work, and reconciled with your estranged daughter. This scenario may look more like fantasy than reality, but imagine how these major changes over a five-year period may affect your estate. And that's without considering changes in tax laws, the stock market, the economic climate, or other external factors. After all, if the only constant is change, it isn't unreasonable to speculate that your wishes have changed, the advantages you sought have eroded or vanished, or even that new opportunities now exist that could offer a better value for your estate. A periodic review can give you peace of mind.

When should you conduct a review of your estate plan?

Every year for large estates

Those of you with large estates (over the applicable exclusion amount) should review your plan annually or at certain life events that are suggested in the following paragraphs. Not a year goes by without significant changes in the tax laws. You need to stay on top of these to get the best results.

Every five years for small estates

Those of you with smaller estates (under the applicable exclusion amount) need only review every five years or following changes in your life events. Your estate will not be as affected by economic factors and changes in the tax laws as a larger estate might be. However, your personal situation is bound to change, and reviewing every five years will bring your plan up to date with your current situation.

Upon changes in estate valuation

If the value of your estate has changed more than 20 percent over the last two years, you may need to update your estate plan.

Upon economic changes

You need to review your estate plan if there has been a change in the value of your assets or your income level or requirements, or if you are retiring.

Upon changes in occupation or employment

If you or your spouse changed jobs, you may need to make revisions in your estate plan.

Upon changes in family situations

You need to update your plan if: (1) your (or your children's or grandchildren's) marital status has changed, (2) a child (or grandchild) has been born or adopted, (3) your spouse, child, or grandchild has died, (4) you or a close family member has become ill or incapacitated, or (5) other individuals (e.g., your parents) have become dependent on you. For example, many states have a law revoking all or part of your will if you divorce or remarry.

Upon changes in your closely held business interest

A review is in order if you have: (1) formed, purchased, or sold a closely held business, (2) reorganized or liquidated a closely held business, (3) instituted a pension plan, (4) executed a buy-sell agreement, (5) deferred compensation, or (6) changed employee benefits.

Upon changes in the estate plan

Of course, if you make a change in part of your estate plan (e.g., create a trust, execute a codicil, etc.), you should review the estate plan as a whole to ensure that it remains cohesive and effective.

Upon major transactions

Be sure to check your plan if you have: (1) received a sizable inheritance, bequest, or similar disposition, (2) made or received substantial gifts, (3) borrowed or lent substantial amounts of money, (4) purchased, leased, or sold material assets or investments, (5) changed residences, (6) changed significant property ownership, or (7) become involved in a lawsuit.

Upon changes in insurance coverage

Making changes in your insurance coverage may change your estate planning needs or may make changes necessary. Therefore, inform your estate planning advisor if you make any change to life insurance, health insurance, disability insurance, medical insurance, liability insurance, or beneficiary designations.

Upon death of trustee/executor/guardian

If a designated trustee, executor, or guardian dies or changes his or her mind about serving, you need to revise the parts of your estate plan affected (e.g., the trust agreement and your will) to replace that individual.

Upon other important changes

None of us has a crystal ball. We can't think of all the conditions that should prompt us to review and revise our estate plans. Use your common sense. Have your feelings about charity changed? Has your son finally become financially responsible? Has your spouse's health been declining? Are your children through college now? All you need to do is give it a little thought from time to time.

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