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PLANNING YOUR ESTATE

I

INTRODUCTION

Making plans now for the eventual distribution of your estate can be a confusing prospect. The purpose of this memorandum is to give you a brief overview of the various factors affecting your estate plan and some of the more common alternatives. While this memo will concentrate on disposition of property at death, additional information on lifetime estate planning is also available from this office.

Simply stated, estate planning means putting your property to the best possible use for your benefit during your lifetime and for the use of your "beneficiaries" after your death. Your beneficiaries are the people you want to receive your money and other possessions when you die. In many cases, sound estate planning can reduce the taxes and other costs that must be paid during your lifetime and when you pass on your property.

Basically, estate planning can be divided into four component parts, consisting of the following:

1. Designating your chosen beneficiaries.

2. Providing the proper "vehicle" to transfer your property.

3. Minimizing gift and estate taxes.

4. Avoiding conservatorship and probate proceedings.

Whether you have a will or not, your property will pass to someone on your death. If you do not have a will and die "intestate", then the California Probate Code will direct the disposition of your property. If you are married, community property will automatically pass to your surviving spouse. Separate property will be divided between your surviving spouse and your children. While the Probate Code does "designate" your beneficiaries, it does not provide for the proper "vehicle" nor minimize taxes. Also, because of the different results depending on the nature of the property (i.e., separate versus community), most people find it best to make a will and to leave the transfer of their property free of all doubt.

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If your desires are not the same as set forth in the Probate Code, then you must take steps to see that your property is transferred to your chosen beneficiaries. As will be discussed in greater detail later, the most common methods of transferring property is by way of a will, a trust, or by operation of law. Since a will is effective only on property which does not pass by some other means, it is important to review the title holdings of your various assets to determine whether they will be affected by a will or whether they will be transferred some other way.

The most common assets which transfer "outside" of your will include joint tenancy property, life insurance beneficiary designations and pension plan beneficiary designations. Joint tenancy, by its very nature, contains a feature by which the property transfers to the surviving joint tenant(s) by operation of law. Similarly, life insurance and pension plan beneficiary designations transfer property by their contractual nature and, too, are unaffected by the terms of your will unless you fail to make a beneficiary designation and the terms of those contracts provide that your will controls.

Since non-probate types of property can make up a very large portion of your estate, it is important to review the exact title holding on each of your assets in order to develop a coordinated estate plan. Now you can see that it is important for you to provide your attorney with a detailed list of the types of property and the nature of the title holdings in order for your desires to be carried out. Remember, the goal is to transfer your property to your desired beneficiaries, in a proper vehicle, while minimizing taxes and other costs. Once the estate planner has a good understanding as to the nature of your estate, then suggestions can be made as to the proper legal devices to carry out your intentions.

II

SIMPLE WILL

For the estate under $450,000 where death is not imminent, a simple will is probably all that is needed. The simple will can distribute property at death in a manner other than as provided by intestate succession. This is important for individuals who wish to make bequests of specific property or gifts to friends, relatives or charities.

A will is also used to nominate an executor of your estate. Since the executor is charged with collecting the assets of your estate, paying the debts and taxes and distributing properties to those named in the will, the ability to nominate an executor gives you the comfort that your intentions are carried out by someone you trust. Normally, the executor is required to obtain a bond unless the will waives this requirement. By waiving bond, you will save your estate money and leave more to pass to your beneficiaries.

A simple will can also be helpful in transferring property from one spouse to the other since it can provide that all property is to pass to the surviving spouse irrespective of the nature of the property. Thus, community property and separate property subject to the will can be transferred to the surviving spouse without any question as to origin. A simple will is also recommended where there are adult children of sufficient maturity to enable them to receive property from your estate without any additional arrangements.

III

WILL WITH MINOR'S TRUST

As mentioned above, a simple will is used to transfer property from your probate estate to your beneficiaries who will receive your property and be able to use it as they see fit. There are some situations in which it is undesirable that your beneficiaries receive property outright, such as the case of minor children or possibly an adult child with a physical or mental handicap.

A simple will or no will at all causes property passing to a minor to be transferred into a guardianship (or to a conservatorship for an adult child). Guardianship is a legal mechanism supervised by the court in order to hold title to property until such time as the recipient is of sufficient capacity to hold title to the property himself/herself. In California, the age of majority is eighteen, and as such, the guardianship will terminate at that point in time and whatever property is being held will be distributed to the beneficiary. Since most children at age eighteen still lack maturity, the termination of the guardianship at that point could have disastrous effects upon a child. Additionally, because the guardianship is supervised by the court, there are substantial reporting requirements to be met on an annual basis. Expenditures by the guardian must oftentimes be approved by the court.

In lieu of a guardianship, it is generally recommended that your will establish some other "vehicle" to hold property until the child is of sufficient age and maturity. The device most commonly used is that of a "testamentary trust". It is "testamentary" because the trust is created by your last will and "testament" and does not come into existence prior to the probate of your will. A "trust" is used since this is the legal relationship by which a person called a "trustor" provides certain instructions to the "trustee" to hold and administer property for the benefit of certain "beneficiaries". It is a separate legal entity much like a corporation or partnership, however, these mechanisms are more commonly used for business transactions while trusts are used for personal arrangements.

While the terms of the trust can be customized to carry out your personal desires, there are some general provisions which are commonly used. A trust generally provides for the health, support, maintenance and education of all the beneficiaries (your children) while they are growing up. Thus, the trust acts very similarly as parents would act in providing for their own children. After a child attains a specified age (usually age 25), the trust provides that the child is to receive the income from his/her proportionate share of the trust. The principal is generally held until the child attains sufficient maturity, and oftentimes is distributed in one or more phases, for example, one-third at twenty-five, one-third at thirty, and the balance at age thirty-five. As noted above, these provisions are subject to your own personal direction.

Your will also permits you to appoint a "guardian of the person" for each of your minor children. The "guardian of the person" is the individual or couple who take physical custody of your child or children during minority. There is no requirement that the guardian of the person and the trustee be the same individual, and, quite the contrary, many people find that the best person to administer money is not the best person to care for a child. Many times these two positions are filled with different individuals.

IV

TAX SAVINGS TRUST

While federal estate taxes have not been a significant issue in the above discussion, as your estate grows it will generally become subject to the prospect of substantial federal estate taxation. Federal estate taxes are imposed upon the property a person owns at the time of his/her death. Generally, what the decedent owns is determined under the laws of the state in which he/she resides at the time of his/her death. In community property states, only one-half of the community property is considered to be owned by the decedent prior to his/her death. The surviving spouse automatically receives a one-half interest in all community assets, consisting generally, of all assets acquired during marriage, except gifts and inheritances.

The U.S. Estate Tax rate is currently thirty five percent (35%) on all property includible in a decedent's estate. There are, however, three major deductions in calculating federal estate tax; namely, the credit exemption, the marital deduction, and the charitable deduction.

The law provides for a unified credit which directly offsets payment of federal estate tax. The amount of estate tax offset by the credit is commonly known as the "credit exemption" amount. For the persons dying in 2011 and 2012, the credit exemption equivalent amount is $5,000,000. The credit exemption amount was calculated to exclude approximately ninety-five percent of all estates from payment of federal estate tax.

The marital deduction provides the most powerful deferral of federal estate tax, since it is unlimited in amount. As long as property passes to the surviving spouse, the marital deduction can reduce U. S. estate tax in its entirety. Thus, even a $100,000,000 estate, if left to the surviving spouse, will avoid payment of federal estate tax on the death of the first spouse. Similarly, the charitable deduction reduces federal estate tax on an unlimited basis.

The goal in planning an estate is to take maximum advantage of these exemptions and deductions. For example, even though the unlimited marital deduction may avoid payment of federal estate tax on the death of the first spouse, the decedent's property will be included in the surviving spouse's estate. If he or she does not remarry and repeat the process, then all the property will be subjected to tax on the death of the surviving spouse with only the surviving spouse's exemption amount available to offset it.

Take for example a $8,000,000 estate which is entirely community property. On the death of husband, his $4,000,000 may pass to his wife without payment of tax pursuant to the unlimited marital deduction. However, on wife's later death, her estate would consist of $8,000,000 (assuming no increase or decrease in value) and would be subject to approximately $1,050,000 in tax if death occurred in 2011 or 2012. In order to minimize federal estate taxes, it is necessary for each spouse to take advantage of his or her credit exemption amounts.

Thus, if husband, instead of transferring the property outright to his surviving spouse, utilized a vehicle which would take advantage of his exemption amount, the following would result: husband would leave his $4,000,000 community property in trust for the benefit of his spouse in a manner which would use most of his credit exemption amount, his trust would be designed so as to avoid inclusion in the estate of his surviving spouse, and as such, wife would have an estate of only $4,000,000 (her one-half of their community property), which amount would be completely offset by the credit exemption amount.

With both spouses taking advantage of the credit exemption amount, the $1,050,000 tax liability can be reduced to zero. In fact, with each spouse able to utilize up to an exemption amount of $5,000,000, a community property estate of $10,000,000 can be transferred free of any estate tax. However, in order to take advantage of this provision, you must act to create the proper vehicle to minimize the impact of this tax on the surviving spouse. The most commonly utilized device is known as a "tax exemption trust", sometimes referred to as a "bypass trust". This bypass trust is established by the decedent for the benefit of the surviving spouse with terms such that it will utilize the exemption amount and "bypass" taxation on the death of the surviving spouse. Terms of this trust normally provide that income is payable to the surviving spouse, and where necessary, principal can be utilized for his or her health, support and maintenance. Remember too, that the surviving spouse has his or her own one-half of the community property available for use without any restrictions.

Speaking of restrictions, oftentimes the predeceased spouse desires to control his or her one-half of the community property after death in order to see that it is eventually passed on to that spouse's beneficiaries (whether or not the same as the surviving spouse's beneficiaries). In this case, an outright transfer to the surviving spouse would not be appropriate since there would be no ability to control the ultimate disposition of the property. Instead, a "deferral trust" is utilized in order to maintain "strings" over the decedent's property during the lifetime of the surviving spouse so that the property will ultimately be transferred to the beneficiaries of the predeceased spouse.

This avoids the problems inherent in an outright disposition such as the possibility of incompetence of the surviving spouse. In order to protect the decedent's property against uncertainties after death, this type of trust is established which contains many of the same provisions as the above-described "exemption trust". However, this trust is not established for tax purposes in that it is merely a device to control ultimate disposition.

Though it is possible to defer payment of U. S. estate tax until the death of both spouses, depending on the nature and size of the estate, the ultimate payment of those taxes can be substantial and has been known to destroy many family businesses, require fire sales of property, and other actions with equally drastic results. If federal estate taxes are significant in your estate, please ask for additional guidance in this area. This office has considerable experience in planning for the substantial estate, especially one consisting of a closely held business or real estate holdings. This office has additional information on the minimization and payment of federal estate tax which is available upon request.

V

PROBATE AVOIDANCE TRUST

The concept of a trust controlling property until a minor child reaches sufficient age or maturity has been discussed above. While this type of trust is created only during probate, it is possible to establish a trust during your lifetime in order to avoid probate. These trusts are sometimes referred to as "living" or "inter vivos" trusts as compared to "testamentary" trusts.

As mentioned above, there are certain types of property automatically excluded from probate; namely, joint tenancy property, life insurance and pension plan beneficiary designations. A living trust acts much the same way after you transfer title from your own name (probate type title) to the name of the trust (probate-avoidance title).

The living trust consists of your spouse and you as trustors, your spouse and you as trustees// and you and your spouse as beneficiaries during your joint lifetime and the lifetime of the survivor, with your children or other relatives to act as beneficiaries upon the death of the surviving spouse. Much the same way as an executor administers a will, the trustee will administer the trust not only during your lifetime but at your death. In this way, probate is avoided. This saves both time and money.

Living trusts are generally "revocable" (undoable). Hence, as such, one may change or cancel the trust from time to time. As such, it is much like a will. In fact, it is sometimes easier to amend your trust than it is to modify your will.

The use of a living trust has other benefits in addition to probate avoidance. The most common benefit is the avoidance of a conservatorship proceeding as you grow older. Prior to reaching a point of incompetence, you could transfer management responsibility and this would avoid court intervention. It also is a convenient title holding entity to transfer management responsibility. For example, if you desire to take a year-long trip around the world, you could designate a bank or a trusted advisor as the trustee which would transfer the responsibility for the management of your trust assets to that trustee and free you up for your extended travel.

The revocable or living trust described herein can also be utilized to incorporate many of the other concepts we have discussed already. For example, your living trust can be drafted to establish the trusts for your minor children and the tax savings trusts for the surviving spouse. As such, the living trust works as an “umbrella” over your entire estate plan.

A living trust is oftentimes assisted by a “pour-over will”. Since the trust operates only over property which is transferred to it, should you forget to transfer a piece of property to the trust during your lifetime, the “pour-over will” will transfer the property to your trust after death. Although the pour-over will would require probate of the property in order to transfer it from your name to that of the trust, you would have a coordinated disposition of your assets. This is one reason why we recommend a review every two or three years of your trust and your title holdings in order to provide you with the assurance that your estate is properly organized to avoid probate and take maximum advantage of your living trust.

VI

CONCLUSION

In conclusion, it is the purpose of this memorandum to set forth some of the key issues and tools available for you in planning your estate. Estate planning for transfers effective at death is only one aspect of estate planning. However, it is generally viewed as the cornerstone, to be implemented prior to any of the more sophisticated techniques. Should you have any questions or comments regarding the contents of this memorandum, please contact me.

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