Estate Planning Volume II
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Chapter 1 The Family Business

Introduction to Estate Planning

There is an old saying that "Nothing is certain but death and taxes". True enough, estate planning tries to take into consideration that it is very uncertain when the time of death will occur or how much will be owed in taxes. How much value will the assets in an individual's estate have at death? What will the rate of inflation be in the next few years? How long can I expect to live? No one knows for certain. We try to plan for the unexpected in that regard. After an estate plan is put in place, it needs to be reviewed periodically. Times change, laws change, and so do people.

There is no 'Best Way' to avoid strife among potential estate beneficiaries. Every situation will be unique. For this reason, it is important that people involved in the estate planning process be familiar with guidelines and concepts. There is no guarantee that beneficiaries will not go to war with each other. One sure fire way to generate conflict is to give similar beneficiaries unequal shares. The key word here is 'similar'. If a child is disabled, a parent may feel justified in looking out for the child financially. It will be pointed out numerous times that communication is involved here. The parent needs to let the other siblings know in advance why they intend to act in a certain way. This will hopefully avoid one person feeling they are more deserving than any other. It should help explain why the actions were taken. By telling beneficiaries about the chosen distribution before death it will help them understand the testator's thinking on the matter. The use of clear language in the estate documents will help to help avoid any misinterpretations that could be used as an excuse to challenge the testimonial.

Individuals plan their estates because they care about what will happen after they die. They have enough assets that an estate plan makes a difference. It goes against the wishes of the deceased to waste the assets of the estate fighting in court. Yet every day the papers have reports of a family's contesting a will or some aspect of an estate plan in court. Many are the lessons illustrated and exemplified in such reports. Many people today are, like Esau, bartering their familial rights for temporal gratification, or doing evil with the hope that good may come of it. It is a shame that the combatants in an estate dispute make more sorrow for themselves through the use of wrong means. You reap what you sow, as the saying goes. The mills of justice grind slowly, and in cases such as these the lawyers are the ones who end up with the grist.

The Family Business

An interest in a family business presents many challenges when it comes to estate planning time. There are many issues to deal with including taxes, heirs, and disposition of the business. Grooming a successor and tending to the financial needs of those family members outside the business become large questions. The entire issue is a minefield where actions are subject to misinterpretation by loved ones. More than usual, emotion becomes mixed with business. For this reason it is important for the business owner or entrepreneur to sit down and assess what will happen after he or she is gone from the scene. Once a plan is formulated, like any estate plan it needs to be reviewed from time to time to make allowances for the inevitable dynamics of the process of living and creating relationships, both formal and informal.

Anyone who owns a sole proprietorship or with interest in a partnership or closely-held corporation has a need for special planning. Consideration must be given to the value of the business at the time of death. There must be answers available to the questions of who will receive an interest in the business as well as who will run the business after the current owner is no longer alive.

Small businesses come in many shapes and forms. It could have been started by an immigrant who arrived from Saigon or Stuttgart last year or last century. The founder of the business may have never seen the current heirs or they may be personally grooming someone for succession. The entrepreneur could be running the business alone or there could be partners involved. The partners could actually be the driving force behind the success of the business or they could not care less that is at the helm as long as the money keeps coming.

The person in charge could wear a three piece suit or a bathing suit at work. The type of business could be anything from swimming pool construction/maintenance to providing components to the industrial sector of the economy. It has been said that the small business sector is the backbone of the U.S. economy. It is the garden from which new ideas grow and innovation flows. Every day a new batch of enterprising people sets out to create a market niche for themselves and contribute to the economy in creative ways never dreamed of before.

The business may be incorporated, a proprietorship or a partnership. Assets of the business could be equipment, inventory, raw materials or an individual's skill and talent. The person in charge may be the only employee or there could be a crowded shop floor. No matter what the configuration, estate planning issues will ultimately have to be addressed for a going concern.

At times a business may be so personal in nature that when the owner dies the business dies also. This can be especially true with service businesses. After the death of the owner, the assets are liquidated and the business is gone. If the business can continue, does it make good economic sense to keep it going? It may even be better to sell the business while the current owner is still alive. This is especially true if no family member is currently able or ready to take the helm of the business. At times an aspirant to head the enterprise may not yet have emerged from the family's ranks. There may be hopes for a member of the next generation to head the enterprise, but that person is still too young or inexperienced to take charge right away. In such a situation a replacement for the entrepreneur may have to be hired. Compensation for the temporary head of the business may amount to such a burden on the enterprise as to not make it worthwhile to continue operations. Again, this is a question that is best addressed while the health of the current chief is not an issue.

Even while the business is running smoothly under the guidance of the current, healthy leadership, succession will be a delicate affair. Stories abound concerning business owners who did not relinquish control at the appropriate time. It is justified because the owner still contributes significantly to the business. It may be felt that the successor needs more seasoning. Bringing in a successor and taking the time to properly train and coach them to run the business is critical, one of those once in a lifetime deals you only get to do once- so it better get done correctly. The older person will be offended while the younger person will feel stifled during the transition period. A balancing act must be effected that allows the implementation of new ideas and technologies while retaining the best of tried and true business methods. This will be difficult in the best of times, so it certainly should not be put off until death or disability makes it even worse.

Estate Tax Overview

<u>The tax is a political issue; it has and will continue to change on a regular basis.</u> As early as 1797, the Federal government experimented with a number of transfer taxes before settling on the estate tax system in 1916. This tax system, which has evolved into the Unified Transfer Tax, currently consists of three components: the estate tax, the gift tax, and the generations skipping transfer tax. This tax represents the only wealth tax levied by the Federal government. The estate tax, enacted in 1916, was chosen over an inheritance tax because it is relatively simpler to administer! At the time of its enactment, it applied to the wealth of decedents with estates in excess of $50,000, with a maximum tax rate of 10 percent. Over the years, the tax underwent numerous changes, notably in 1976, 1981, 1997, and 2001. If an asset is left to a spouse or a charity the tax usually does not apply. In addition, up to a certain amount varying year by year, amounting to $5,250,000 for estates of persons dying in 2013 and $5,340,000 for estates of persons dying in 2014 can be given by an individual, before and/or upon their death, without incurring federal gift or estate taxes.

The gift tax was first enacted in 1924, repealed in 1926, and re-enacted in 1932 in an attempt to reduce estate and income tax avoidance. In 1976, the gift tax was integrated with the estate tax under the Unified Transfer Tax, sharing a common tax rate schedule with a current maximum tax rate of 55 percent. As with the estate tax, cumulative gifts with a value below the taxable threshold are effectively exempt from taxation. Both estate and gift taxes are complemented with a generation skipping transfer tax (GSTT), first enacted in 1976.

OBJECTIVES OF THE TAX- The enactment of the estate and gift taxes, and their evolving structures over the years, serve several legislative objectives. **These are political objectives established by politicians in Congress.** First and foremost, the estate tax was enacted for its revenue yield. As revenues declined following the outbreak of World War I, the tax was enacted to help finance the looming deficit in fiscal year 1917 and the "war-readiness" campaign. In fiscal year 1918, its first full year of enactment, the estate tax yielded $45.5 million, which accounted for 1.3 percent of the receipts of the Federal government. The gift tax was re-enacted (Revenue Act of 1932) as government revenues shrank during the Great Depression. In fiscal year 1997, estate and gift taxes yielded about $20 billion and accounted for about 1.3 percent of Federal government receipts.

A second objective, which is very much related to the first, is that these taxes act as a backstop to the income tax and offset the erosion of its base. The gift tax was enacted in 1924 and re-enacted in 1932 to curb estate and income tax avoidance much of the capital income that escapes the income tax is subject to the estate tax. Under the personal income tax, accrued capital gains are taxed only when realized, and interest income from state and local bonds and the inside build-up on life insurance policies are tax-exempt. In contrast, most assets owned by decedents are included in their gross estates. As such, these taxes bolster the progressivity of the tax system.

A reduction in wealth concentration is a third objective. By taxing the wealth holdings of the wealthiest estates, estate and gift taxes are expected to reduce the size of bequests, which reduces the wealth accumulated over several generations. This is also accomplished by subjecting to estate taxation capital income that has escaped the personal income tax. When the estate tax was enacted, large concentrations of wealth were viewed as a danger to a democracy, and large inheritances were considered inconsistent with democratic ideals of equal opportunity.

Ensuring that the wealth of each generation is taxed is another objective. When the GSTT was enacted in 1976 and expanded in 1986, Congress was concerned that estate and gift taxes were avoided by the wealthy through generation skipping arrangements, such as gifts to grandchildren. Because of the emphasis on taxing each generation, an additional tax, the GSTT, is also levied on these transfers. The rationale for the GSTT is that a tax should be levied on wealth transfers to children, coupled with another tax when they, in turn, transfer wealth to their children. The GSTT applies as if transfers to grandchildren were transferred initially to the children, who in turn transfer them to their children. As such, the GSTT weakens the incentives to make tax-motivated transfers to grandchildren.

The states viewed estate taxation as their preserve, and, thus, to minimize objection by the states to the enactment of death taxes by the Federal government, the estate tax provides a tax credit for state death taxes, thereby keeping the state tax base intact (Revenue Acts of 1924, 1926). The credit was first set at 25 percent of the federal estate tax in effect in 1924 and later changed to 80 percent of the statutory tax rates that were in effect in 1926, equivalent to a maximum credit rate of 16 percent which is part of the tax code today. For the largest estates, the credit reduces Federal tax liability by about 29 percent. Effectively, the Federal estate tax minimizes the interstate competition for the wealthy, as the state death tax credit essentially offsets taxes levied by states on the wealthiest of estates.

DESCRIPTION OF THE TAX- Since their inception, estate and gift taxes have undergone a number of changes affecting the assets taxed, allowable deductions, exemptions, tax rate schedule, and credits.

The Tax Base- The current estate tax base has not changed much since the Act of 1954. The base includes the value of real estate, cash, stocks, bonds, businesses, pensions, and proceeds from life insurance policies owned by the decedent. Together, these assets form the gross estate. Cumulative taxable lifetime gifts are added back to the taxable estate in computing the estate tax, with a credit provided for previously paid gift taxes.

Although the gift tax was not enacted until 1924, from its enactment in 1916 the estate tax treated gifts made within two years of the date of death as transfers made in contemplation of death, and required such gifts to be included in the taxable estate. The Tax Reform Act of 1976 (TRA 76), which integrated the gift and estate taxes, required the inclusion in the taxable estate of all gifts made within three years of the date of death. Beginning in 1982, and following the Economic Recovery Tax Act (ERTA) of 1981, generally only transfers of ownership of life insurance policies and the gift tax on transfers made within three years of the date of death are included in the estate

The gift tax applies to lifetime transfers of assets just as transfers at death are taxed under the estate tax. Cumulative lifetime taxable gifts are added to the current year's taxable gifts in computing the gift tax, with a credit provided for previously paid gift taxes.13 One major distinction between the estate tax and the gift tax is that the latter applies on a tax exclusive basis. In other words, the gift tax is based on the amount received by the donee and not the total amount, including tax, transferred by the donor.

When transfers, either testamentary (at death) or inter-vivos (between living persons), skip a generation, as in the case of a grandchild, the underlying assets become subject to the GSTT, in addition to the estate and gift tax. Beginning with the Tax Reform Act of 1986 (TRA86), the GSTT applies regardless of whether the transfer is made directly to a grandchild, or through a trust as provided for in TRA76.

Valuation In determining the value of the gross estate, assets are generally valued at their market value (or appraised value in the absence of a publicly tradeable market) on the date of death. Because market values can fall between the date of death and the date the estate tax is due, the tax code provides an alternative valuation date. The alternative valuation date, first introduced in 1935, was one year from the date of death. Under current law, estates may elect to value their assets at six months after the date of death if the election would reduce both the value of the gross estate and the estate tax due.

The tax code also provides an alternative valuation method for real property used on farms or in businesses. Under this special use valuation method, the value of an asset is based on its value as used in an ongoing business when that is less than its market value. The excess of the market value over the special use value is excluded from the gross estate. This exclusion was first introduced in 1976, and limited to a maximum of $500,000. The maximum exclusion was increased to $750,000 in 1983, and is indexed for inflation beginning in 1999. The heir to such property is required to actively manage it. Failure to materially participate in its operations or disposal of the property within 10 years of its inheritance will subject the heirs to recapture taxes. In principle, assets are supposed to be valued at their fair market value. In certain circumstances, however, the reported value may be less than the market value. For example, if a decedent, or donor, owned a large block of publicly traded stock, the market value reported for estate or gift tax purposes would likely be discounted. The discounted value may reflect the reduction in the expected trading price of such stock if a large block were to be sold. This "blockage" rule is one of many valuation methods employed by estate planners.

Minority discounts are another valuation method commonly used to value inter-vivos gifts, especially transfers of closely-held businesses. This valuation discount is also extended to estates when a minority position is maintained at death. The value of the interest transferred may be less than the pro-rata share of the value of the corporation or entity transferred due to the lack of control or marketability by the new owner.

Life Insurance- Some life insurance proceeds are included in the gross estate, depending on the form of ownership of the policy: Life insurance proceeds first became taxable under the Act of 1918. Under the Act, proceeds from policies owned by the decedent, plus proceeds in excess of $40,000 from life insurance policies owned by others, were included in the gross estate. In the Act of 1942, all proceeds from policies where the decedent paid the premiums or had an incidence of ownership were also made taxable. The Act of 1954 dropped the "premium paid" test, and since then only proceeds from policies owned by the insured are taxable to the estate.

Family Owned Business- The Taxpayer Relief Act of 1997 (TRA97), as amended in the Internal Revenue Service Restructuring and Reform Act of 1998, introduced a new provision benefiting family-owned businesses. Beginning in 1998, estates may deduct a certain amount of the ownership in a family business in computing the taxable estate. For those who claim the maximum deduction, however, the maximum exemption avaable is limited to the current unified credit (applicable exclusion) amount. To qualify for this treatment, the value of the business must exceed 50 percent of the adjusted gross estate. Furthermore, the heirs are required to materially participate in running the business.

Tax Act of ’97 & ‘01

This act replaced the unified credit amount with an applicable credit amount effective for the estates of decedents dying, and gifts made, after December 31, 1997. The applicable credit amount will increase as shown in the table below. If one is a U.S. citizen or resident, they must use the unified credit to reduce any gift tax for which they may be liable. The amount of the credit depends on when the gift was made.

The 2001 Tax Act did not eliminate gift taxes. However, the Act allows larger gifts and lower tax rates. The exclusion was $13,000 (increasing over time) per year. No gift tax is due below this amount). These amounts were increased for gifts made, and for estates of decedents dying, after 2001. The unified credit and the applicable exclusion amount for the calendar year in which a gift is made or a decedent dies is indicated.

For Estate Tax Purposes

The 2001 tax act would have repealed the estate tax for one year (2010) and would then have readjusted it in 2011 to the year 2002 exemption level with a 2001 top rate. That is, had no further legislation been passed, the estate of a person who deceased in the year 2010 would have been entirely exempt from tax while that of a person who deceased in the year 2011 or later would have been taxed as heavily as in 2001. However, on December 17, 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. Section 301 of the 2010 Act reinstated the federal estate tax, setting the exemption at $5 million per person, and providing a top tax rate of 35 percent for the years 2011 and 2012. The American Taxpayer Relief Act of 2012 was passed which permanently establishes an exemption of $5 million (as 2011 basis with inflation adjustment) per person with a maximum tax rate of 40% for the year 2013 and beyond. Needless to say, the permanence of this regulation is not ensured.

Year	Exclusion Amount	Max/Top tax rate
2001	$675,000	55%
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	Repealed	
2011	$5 million	35%
2012	$5.12 million	35%
2013	$5.25 million[25]	40%

Qualified Family-owned Business

A qualified family-owned business is any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the U.S. if one family owns at least 50% of that trade or business, two families own at least 70%, or three families own 90%, as long as the decedent's family owns at least 30%. An interest in a trade or business doesn't qualify if the business's stock or securities were publicly traded within three years of the decedent's death. The value of a qualifying trade or business is reduced to the extent it holds passive assets or excess cash or marketable securities. Also, an interest generally doesn't qualify if more than 35% of the adjusted ordinary gross income of the business for the year of the decedent's death is personal holding company income.

Deferral of the estate tax
The IRC Section 6166 allows a personal representative to defer estate taxes if the interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate. For the estate to defer the payment of estate taxes, the following elements must be satisfied:

- The decedent must have been a U.S. citizen or resident at death.
- An interest in a closely held business must comprise more than 35 percent of the decedent's adjusted gross estate.
- The estate's personal representative must make the section 6166 election on a Form 706 Federal Estate Tax Return filed in a timely manner.

If the estate satisfies all three elements, the estate tax attributable to the closely held business may be deferred, with principal and interest on the deferred tax paid over a 14-year period. During the first four years following the due date of the return, only the interest on the deferred tax must be paid. The interest rate on the deferred tax is 2 percent on the tax attributable to the first $1,430,000 of the decedent's estate (From Rev. Proc. 2012-41.26). Beginning five years after the return is due, the deferred tax and interest are payable in equal annual installments over a 10-year period.

Meeting the 35 percent threshold
If an individual is considering using 6166 to defer estate taxes, the 35 percent of the decedent's adjusted gross estate is calculated by taking the gross estate and subtracting certain deductions such as debts, funeral expenses, administration costs, mortgages and liens. However, such deductions are taken into account prior to applying any available charitable and marital estate tax deductions.

Here are two scenarios of decedents who are US citizens and die in 2013, leaving a closely held business, investments and cash;

I Value of gross estate: $13 million Value of the decedent's closely held business: $3.6 million Cash needed (to be used for debts, funeral and administrative expenses): $400,000 Adjusted gross estate calculated after paying expenses, but before applying the marital deduction: $12.6 million Here, the $3.6 million closely held business interest represents 28.57 percent of the adjusted gross estate and does not meet the 35 percent threshold. As a result, estate tax deferral benefits would not be available.	**II** Value of gross estate: $15 million Value of the decedent's closely held business: $3.92 million Cash needed (to be used for debts, funeral and administrative expenses):$8,000,000 Adjusted gross estate calculated after paying expenses, but before applying the marital deduction: $7,000,000 In this example, the $3.92 million closely held business interest represents 56 percent of the adjusted gross estate. This exceeds the 35 percent threshold and estate tax deferral benefits would be available if the business meets the other two requirements above

Defining a closely held business
In order for section 6166 to be an available option, the closely held business must qualify as an active trade or business engaged in manufacturing, mercantile or service functions. If the business is comprised of or exists to manage passive investments, the value of all passive assets must be stripped out- those that are not used to carry out an active trade or business- in order to meet the 35 percent threshold. Moreover, passive assets cannot be considered when calculating the amount of tax that may be deferred. If the inheritance consists of various real estate holdings, any holdings managed as an active business may qualify, depending on certain factors:

- The amount of time the decedent devoted to the trade or business;
- Whether an office was maintained from which the activities of the decedent were conducted or coordinated and whether regular office hours were maintained for such purpose;
- The extent to which the decedent was actively involved in finding new tenants and negotiating and executing leases;
- The extent to which the decedent provided landscaping, grounds care or other services beyond the furnishing of leased premises;
- The extent to which the decedent personally made, arranged for, performed or supervised repairs and maintenance to the property; and
- The extent to which the decedent handled tenant repair requests and complaints.

If the major asset of a closely held business is stock in other corporations, the business is classified as a holding company that "holds" stock in other corporations.
In such cases, the stock- classified as a passive asset- may prevent the business from meeting the 35 percent threshold. However, section 6166 contains two exceptions:
First, a holding company election is made if the company it owns stock in, or its subsidiaries, is an active trade or business. In order to take advantage of the exception the following requirements will need to be met:

- The active business must have 45 or fewer shareholders or the decedent owned 20 percent or more of the business' voting stock.
- The holding company's interest must exceed 35 percent of the decedent's adjusted gross estate.
- The personal representative must make the section 6166(b)(8) election.

If these requirements can be met, the holding company's stock is treated as stock in the active business for purposes of section 6166. However, neither the five-year deferral nor the favorable 2 percent interest rate on the deferred tax will be available.
The second exception enables a holding company that conducts an active trade or business to qualify for the deferral benefits and the favorable interest rate.
To do so, the active holding company must meet these criteria:

- The company must own 20 percent or more of the voting stock of the subsidiary, or the subsidiary must have 45 or fewer shareholders.
- 80 percent or more of the assets of the subsidiary must be used to carry on an active trade or business.

If these two elements are satisfied, then the corporations will be treated as one in the same.

Acceleration of the deferred tax
If it is planned to use section 6166, participants should be wary of certain actions that will accelerate the payment of all unpaid tax that has been deferred. If a distribution is made, sale, exchange, disposition or withdrawal of 50 percent or more of the decedent's interest in the closely held business after the date of death, the payment of all unpaid tax will be accelerated. If, on the other hand, the business redeems shares to pay for estate tax, funeral expenses and administrative expenses, the redemption will not face an acceleration of the unpaid tax. If it is decided to liquidate certain holdings in the course of conducting business and the assets continue to be used or owned by the business, acceleration of estate taxes will not occur. However, acceleration will occur if the business liquidates assets and distributes the proceeds to the shareholders in order to engage in separate businesses.

Prepare for the Inevitable

<u>All closely-held and family-run businesses should ask these questions:</u> Do you know of someone who is procrastinating when it comes to matters of succession? Are simple planning and decision making steps taken for granted? Are plans/choices in place in the event of an unforeseen tragedy? Does the business or family have competent mentors upon which they can rely?

Anyone owning an interest in a business needs to make certain that the questions are heeded. If not, the value of the business will be diminished at the time of death. If the ownership interest of the business is not complex, then transference of ownership will be straightforward. It may be transferred by will or through a living trust. If the surviving spouse is to receive the full interest, no estate taxes will be due, but problems can certainly develop down the road when that spouse dies. If only one child is to receive an interest, care must be taken so as to avoid potential family conflicts. Ideally, there will be ample resources to go around so that everyone feels treated fairly. Plans such as these are far from ideal and 'treated fairly' is a subjective evaluation. The business will often be the keystone asset in the estate and tending to everyone's needs, real or perceived, will be impossible. To prepare for this eventuality and these questions, when a business person nears the end of their time running an enterprise, some fundamental questions must be addressed concerning the disposition of the enterprise;

❶Should the business be sold off and the proceeds distributed to beneficiaries?

❷Can the business feasibly continue if the entrepreneur is not there?

❸Will the business continue and be run by one or more beneficiaries after the current owner's death?

❹Does the possibility exist for the business to continue in some other fashion?

The special estate planning problems for small business owners usually break down into three broad areas:

- operation of the business
- probate avoidance, and
- estate tax concerns

If there is more than one owner of a closely-held business, a buy-sell agreement will resolve many of the problems associated with the estate planning process. This agreement furnishes a method so that, upon the death of the entrepreneur, the business interest will be purchased. Buy-sell agreements have certain goals;

❖It provides a vehicle so the estate will receive cash or other liquid assets upon the owner's death rather than an illiquid interest in a closely-held enterprise. Discounts on ownership valuation of small businesses due to its non-marketability will be discussed later in this chapter. Many businesses do not pay any sort of dividend at all. This fact can be verified for even large companies by looking in the stock tables in the financial section of the daily newspaper. A business interest may be unmarketable and for practical purposes worthless. For estate tax purposes, it may have a substantial valuation if proper steps are not taken.

❖It is desirable to furnish a reliable, hassle-free perpetuation of the business after death of the owner. With the surviving owners purchasing the deceased owner's interest, the remaining owners do away with conflicts that may erupt with the estate or heirs.

❖The establishment of a valuation of the business for estate tax purposes.

Your estate will inevitably face difficult problems with valuation if a tool such as the buy-sell agreement is not employed.

Buy-Sell Agreements

The owner of a successful wholesale grocery business, Joe Jackson, tells you about the problems he had when he inherited the firm from his father. The cash needs for estate expenses and death costs were so heavy Joe was afraid the business was going to go under. Only a fortunate coup he scored by buying Mexican grapefruit cheap just before a freeze in Florida wiped out that state's grapefruit crop made enough money to tide him over.

Cross Purchase Buy-Sell Agreement

Joe does not want his son, who is still in college, to face the same problem if he decides to go into the family firm. A longtime business associate, Al, now owns 35 per cent of the firm and would like to buy the rest of it if he had the cash available at the time of Joe's death. Joe would also like to be able to buy Al's interest if he dies first.

With the business valued at $5,500,000, you and the firm's legal and financial advisors work out a plan for the orderly disposition of both interests in the business. A written agreement that Joe's interest is to be purchased by

Al if Joe dies first, and vice versa if Al dies first, is signed. Each one agrees to apply and pay for an insurance policy on the other's life, which will be owned by the buyer and of which he is the beneficiary. Each pays the premiums to the insurance company. If Joe dies first, the life insurance company will pay the death benefits to Al, who then will pay this cash to Joe's estate in return for Joe's interest in the company. The same provisions will work in reverse if Al dies first.

This arrangement allows for a smooth transition of ownership for the company by making cash available when it is needed to buy out the deceased owner's interest and keep the firm going. In case Joe's son eventually decides to enter the business and receives all or part of his father's interest, he can make the same kind of arrangement with Al for a further orderly transition of ownership.

There are in general three ways of disposing of a business when the owner dies. It may be retained by the family, liquidated, or sold intact to a willing buyer. Sometimes it is impractical to try to keep a business going after the owner's death if he has been the main figure in its operation and there is no one in the family willing or able to carry on. In such a case plans need to be made for orderly liquidation of the business at the owner's death. These will probably require life insurance on the owner equal to the difference between the actual value of the property to be liquidated and the liquidation value, which may be much less.

If there is a family member willing and able to take over the business, or if there is an outside buyer willing to purchase it, there should be insurance equal to the value of the interest to be transferred so the full dollar value of the business interest can be retained while the transfer is made. The buy-sell agreement makes it possible to sell a business as a going concern, maintaining its full value. It avoids disruption of the business through the owner's death and possible liquidation of business properties at a loss in order to pay death expenses and estate taxes. The two key factors in a buy-sell agreement are a contractual arrangement between the parties involved and life insurance to fund the purchase of the business at the necessary time.

Under current tax laws, the cross-purchase agreement is often preferred to an entity purchase agreement because the surviving owners under a cross--purchase have a higher cost basis for their shares. A higher basis is important under current capital gains tax provisions because it will mean fewer taxes on the gain if a survivor later sells his interest.

The Players

Applicant: The buyer(s).

Owner: The buyer(s).

Premium payor: The buyer(s).

Named insured: The owner(s).

Beneficiary: The buyer(s).

Taxability

Premiums paid by the buyer-partners or others in the buy-sell agreement are not tax deductible.

Death proceeds paid to the beneficiary or beneficiaries are not taxable.

Proceeds given to the estate for purchase of stock in the case of a corporation are not subject to capital gains tax if market is higher than book value.

Proceeds given to the estate in the buy-out are subject to estate tax.

Entity Purchase Buy-Sell Agreement

Another arrangement for orderly transition of business ownership is the entity purchase buy-sell agreement. When there are more than two or three principals in the business, the entity purchase agreement is usually considered the simpler arrangement. It requires only one policy for each principal. Under this plan it is the business entity that buys the deceased principal's interest, rather than the surviving principal or principals. The business entity applies for, pays for, owns, holds, and is the beneficiary of insurance on the life of each principal, under an agreement in writing signed by all.

The amount of insurance on each principal is equal to his share in the business. The business entity pays premiums to the life insurance company. On the death of a principal, the insurance company pays death benefits to the business entity holding the policy, which uses this cash to buy the deceased principal's interest in the business from his estate. Each surviving principal's percentage of ownership is then adjusted to reflect the proportionate increase in his share of the business.

Whether to use a cross-purchase agreement or an entity purchase agreement is up to the prospect. It is the insurance agent's job to see that whichever arrangement is used is properly funded by life insurance policies. To propose a concrete funding plan through insurance, the agent needs the owners' names, genders, dates of birth, and percentage of ownership, and the market value of the business. The owners' own estimate of the business worth may be used, or legal and financial advisors of the firm may cooperate with the insurance agency in a computer-generated valuation.

Either kind of buy-sell agreement, the cross-purchase or the entity purchase, can be used to cover disability of a principal as well as death, providing for orderly transfer of ownership in that eventuality. Either agreement helps the owners determine in advance the price at which the business will change hands and provides a buyer for it at that price, with funds to make the purchase possible.

<u>The Players</u>

Applicant: The business.

Owner of the policy: The business.

Premium payor: The business.

Named insured: The seller/owner.

Beneficiary: The business.

<u>Taxability</u>

The premiums paid by the company are not deductible.

The death proceeds received by the company/beneficiary are not taxable.

The proceeds used to purchase stock from the estate, assuming a corporation, are subject to capital gains tax.

The proceeds by the estate are taxable

Valuation Alternatives

Several alternative valuation methods exist for closely-held businesses to use for setting the price for succession, including a buy-sell agreement;

1.) The parties can agree on a predetermined price, possibly reviewed on a periodic basis.

2.) a price might be decided through appraisal or arbitration

3.) Determine the book value of the business interest. This is the total value of all tangible assets of the business, less the business liabilities, and is normally calculated each year as part of preparing a financial statement.

4.) Use the "capitalization" of net earnings formula. This method is useful in some types of businesses where there are generally net earnings, and the numerical multiplier used to calculate the value of the business has been generally defined and accepted in the trade. This method basically involves a method of multiplying annual net earnings (or net earnings averaged over however many years you pick) by a "multiplier," to determine the value of the business. To come up with a reasonable multiplier, you need to investigate carefully what is the norm for your type of business. You will also usually need to consult with an experienced business attorney.

5.) Give the surviving owner the right to match any outside bona fide purchase price, sometimes called "the right of first refusal." For this method to work, there must be an outside offer. Since this can rarely be assured beforehand, it's sensible to have a backup method for determining the worth of a deceased owner's interest also included in the partnership agreement, corporate bylaws or shareholders' agreement.

Each method has pros and cons which should be examined in concert with business partners, family members and all other parties concerned. More times than not, buy-sell agreements are beneficial. Disadvantages that may arise in any particular situation should be given careful consideration.
After a valuation method is chosen a means of paying the deceased's beneficiaries for their interest must be agreed upon by the owners. The purchase of life insurance, such as the buy-sell agreement, is one way, or the surviving business owners can be allowed to pay the deceased partner's beneficiaries over time. The most important thing is that all participants agree, and the agreement is in writing.
Buy-out agreements for corporations can become complex. Example; the business buys the deceased's stock from the estate. Is the purchase price taxed to the deceased's estate as a dividend, meaning more taxes will be owed? It does under certain circumstances. This is further reason that estate planning should be reviewed with someone who has expertise in the particular area being considered.

Any agreement should define the method of payment upon the death of one of the owners. Funding the payment with life insurance is quick, efficient and should always be considered first. With this method, when an owner dies, the estate will receive payment immediately and the purchaser will not have to raise capital. Of course, this is based on the owners being insurable. Different types of funding alternatives create different gift, estate, and income tax results. The insurance program should be carefully planned.

It may also be feasible for the estate to receive the business interest and the value of the insurance. Rather than get into a buy-sell agreement funded with life insurance, the business owners could secure the necessary amount of life insurance on their own life, then select a beneficiary or place the policy in an irrevocable life insurance trust. This way, the owner's family will have both the business interests and a greater amount of insurance proceeds when the owner dies. There is give and take involved with choosing either alternative. The business owner's rights in the business are restricted. The target price in the buy-sell agreement may become unrealistic. At the death of the business owner, it may be desirable to liquidate the business. It may be desirable to continue the business interest in the family rather than to have it sold.

Addressing the needs of the business partner

Buy-sell agreements address the case of an entrepreneur with a substantial partner, be it a partnership, corporation, or joint venture. This does not have to mean equal shares in the business. The other player simply has to have a 'substantial' stake in the enterprise and refuses to be party to any succession plan whereby he or she ends up being in a business with the late partner's family. The solution here is a buyout of the interest of the partner who dies first. That may turn out to be the person for whom the estate planner is working, in which case everything will have to go back to square one. Conversely, the other partner(s) may die off first and the person for whom the planning is being done will have to increase their interest in the business. These issues seem to always remain open. Planning for succession is a dynamic, with parameters shifting frequently. The plan must be reviewed on a regular basis. Again, the two questions that predominate above all others;

<u>How do we arrive at a buyout price?</u> The issue is not being sold now. Nobody can see clearly into the future and know precisely when the sale will occur and the business itself may expand, fold or keep on keeping on its current track. The business interest will be worth somewhere between 10¢ and $10 million when the current owner dies. An equitable method of price determination must be agreed upon and placed on the business when the time comes. Frequently the partners will set a price and then periodically adjust it. The advantage is that this allows the partners to come to terms concerning this vital matter.

Unfortunately, once the price is set, time passes (in big chunks) before any type of adjustment is made and the price becomes unrealistic. In such a situation, any agreement should call out an alternate valuation method. The alternate could call for an inflation adjustment factor to be used or specify an appraisal if no valuation review had occurred within the past few years.

<u>How will the price be paid?</u> It must be a fair and fast method of payment for both the heirs and surviving partner. Heirs will need cash to pay taxes and other final expenses. The business needs reasonable terms so as not to be excessively burdened by debt or payments in such a critical period. Frequently a substantial amount is paid at once with the balance paid out over time. The down payment is often paid out with proceeds from life insurance with the other payments secured by the business itself as collateral. To prevent a breakdown in future payments, restrictions can be put on what the surviving

business partner can extract from the business in the form of salary and dividends, so that the security of the collateral (the business) retains its integrity.

Valuation for tax purposes

Determining a value for a business for estate tax purposes is a primary concern for estate planning purposes. The value may or may not be the same as that attached to the business for purposes of buy-sell or other liquidation purposes. If shares of the business are doled out during the entrepreneur’s lifetime, values for gift tax purposes must be established. The government has the advantage in this matter. The taxpayer is required to make the first move by declaring a value on a tax return. The government, upon receipt of the return, can then ask the question, “How was the value arrived at?” The question of tax matters is addressed in another chapter of this book. It is enough to say here that the government can be a tough adversary. Upholding a low value and presenting evidence to justify same can be a major challenge, especially for a prosperous business. There is only one taxpayer and a few advisers arrayed against the government, who is in the business of just saying ‘no’ in such situations. It also rankles to know that the taxpayer is funding the government in its efforts.

Split-Dollar Insurance

A prospect, Jim Jones, tells you that he knows he needs life insurance but simply does not have the money to pay premiums. In talking with him you find out that he and his wife, who have two children, both work in order to make payments on their home. Their two salaries barely cover house payments and living expenses. Jim works for his uncle, a bachelor, who owns a printing plant and has taught Jim the business. It is a secure position but the plant is not large, and Jim currently is making only $20,000 a year.

It occurs to you that the uncle might be interested in a split-dollar insurance arrangement, both to keep Jim working in his plant and to help safeguard the future of Jim's family, who are his nearest relatives. Jim sets up an interview for you with his uncle and the result is a sizable sale with benefits for all concerned.

By using a split-dollar policy, the employer (the uncle) and the key employee (Jim) split the cost of the premiums paid to the insurance company for the policy on Jim's life. The part of the premiums paid by the business constitutes a "current economic benefit" for Jim and he must pay income tax on it at the government's P.S. 58 rates for term insurance.

If Jim should die, the insurance company would pay the cash value of the policy to the uncle's business. The remainder of the death benefit would go to Jim's beneficiary, with the result that the family would have cash to take care of income needs and the business would recover approximately what it paid into the contract. The arrangement has made Jim able to buy insurance at far less than permanent rates, and has cost the business only the loss of the use of the money going for payment of premiums.

Split-dollar insurance is a solution often overlooked in business and personal insurance needs. To put it into practice the basic necessity is to find an individual who needs insurance and someone who is willing to help him pay for it. You might know of an employee who needs insurance and find that his employer is willing to help share the cost or you might find an employer who wants a way to keep a key employee in the firm. Split-dollar insurance would benefit both parties in either case. The employer's contribution to the plan generally equals the annual rise in the policy's cash value and the employee's payments decline annually, sometimes to the point where he no longer has to pay for his life insurance protection. On the employee's death, the employer receives at least the cash value portion of the policy or enough to cover the premium payments, and the employee's beneficiary receives the balance. Split-dollar is a nonqualified plan because the employer chooses which employees he wants covered, making it useful as a fringe benefit for key individuals. It can also be used to fund the buy-out of a sole proprietor on his death by making the employer the insured and giving the employee the cash necessary to buy the employer's interest when he dies.

Variations of the plan can fund cross-purchase buy-sell agreements to help the business itself share in the cost of funding buy-outs. Split-dollar insurance also can be set up for family situations. Split-dollar is a solution worth thinking about whenever someone says he needs insurance but cannot afford it.

Information needed to produce a specific split-dollar proposal includes the names, genders, and dates of birth of the proposed insureds, their tax brackets, and the amounts of coverage desired.

The split-dollar arrangement can be worked out from this information to benefit everyone involved.

The Players

Applicant: The employee.

Owner: The employer.

Premium payor: Employee/employer split premium payments.

Named insured: The employee.

Primary beneficiary: The employer up to the greater of cash value or employer premium cost.

Secondary beneficiary: The employee's choice receives the death benefit less the greater of cash value or employer's premium cost.

Taxability

Premiums paid by the employer are not tax deductible as this is a discriminatory plan.

Premiums paid by the employer are taxable to the employee as a current benefit. Premiums paid by the employee are not deductible.

Death benefits paid to the employer and to the second beneficiary are not taxable.

Additional opportunities for effective use of the split-dollar plan can be found among small (or large, for that matter) closely-held companies. Split-dollar is seen by some as the only remaining form of interest-free loan available. The premiums are paid by the insured's company. At the insured's death, the company recovers the aggregate amount it paid in premiums. As explained above, the death benefit passes to the insured's estate or to an irrevocable insurance trust. Ordinarily, the insured is an executive or owner of the company. The insured has taxable income for a portion of the premium paid, the P.S. 58 cost. Note also that the P.S. 58 amount is the same amount as that of the gift the insured makes if the policy is held by an insurance trust.

Discounted Value Transfers

A useful method for disposing of closely-held business interests involves family members and transfer of shares on a 'discounted' basis. Correct employment of this method will accomplish two things; 1.) Appreciation of the post-transfer assets will be eliminated from the donor's estate. 2.) The possibility exists to configure the transfer so that even the present value is not subject to either gift or estate taxation. Recent court decisions allow minority interest and nonmarketability discounts to be taken in valuing shares of stock in family-owned corporations for gift and estate tax purposes. These decisions are a bonanza for the owners of businesses. Over time, sufficient minority interest gifts may be made to family members so that at death, the owner's remaining interest may also be valued as a minority interest. Each of the gifts may be valued as after applying the minority interest discount. Combine the two, and it is possible that the entire business may be transferred without being taxed at full value.

Example; Ron Martinez has built up his laundry business, One Hour Martinez Dry Cleaning, over the last 17 years. The business has a value of $1,600,000. Mr. Martinez transfers 20% of the stock to each of his three children. Thus, he retains 40% of the business. It is determined (from a third party expert in such matters) that a minority interest discount of 25% is suitable. This way, 60% of the business will be gifted at a value of $720,000 rather than $960,000. When Martinez dies his 40% interest will be valued applying the minority discount. Assuming the business is still worth $1,600,000, the estate value of the business interest will be $480,000 ([$1,600,000 × 40%] × 75%). Taking the minority ownership discount results in the business being transferred at a value of $1,200,000 rather than $1,600,000, a substantial savings.

In a 1993 revenue ruling (93-12) the Internal Revenue Service dropped its previous views and allowed a substantial discount on a gift of a minority interest in a family partnership even though all interests in the partnership were controlled by members of the same family. Prior to this, it was IRS policy that if family members owned all of an enterprise no discount was allowable. This ruling allowed brought forth a wave of family partnerships, often linked with a variety of other estate planning techniques.

Typically, a corporation owned by generation A has a 1% general partnership interest and the parents share the 99% limited partnership interest. The general partner retains control over all aspects of the business. This includes strategic business planning, the acquisition of assets, and income distributions. Limited partners cannot demand the distribution or return of their capital account during the term of the partnership. The partnership can be funded with a family business, real estate, or perhaps marketable securities. Most experts believe an investment portfolio, or some portion of it, makes a suitable and IRS admissible asset for a family 'discount' partnership. It is not clear if the stock of only one publicly traded company can be used as the sole asset of a family partnership, with pieces of the stock *corpus* handed out and the discount taken.

One or both of the parents make gifts of minority limited partnership interests to the children after the partnership interest is in place. The standard test applies in valuing the donated interest. What would an unrelated pay for the interest in an arm's-length transaction? Normally, much less will be paid than the value of the underlying property represented by the interest. The reasoning is that there is not much one can do with a limited partnership interest. It cannot be sold. Apart from the family there is no market for it. It cannot be liquidated to get at the asset, because the general partner must consent to the liquidation. It may not generate income, because the general partner calls the shots with respect to partnership distributions.

The gifted interest may be discounted for gift tax purposes. The appropriate discount rate is available for each of these restrictions. Depending on the nature of the partnership's assets, discounts ranging from 25% to over 50% may be available to reflect the share's lack of liquidity and lack of control due to its minority position. With the increase in popularity of this partnership vehicle, tax advisers are becoming more aggressive when it comes to the size of the discounts. Discounts in the 20-35% range are the norm, with some valuations going from 50-60%. In 1993 a case was decided involving Samuel LeFrak, a New York City developer. He was allowed 30% discounts on gifts if interest in 20 New York City buildings, despite the fact that the IRS had argued successfully that these were not gifts of partnership interest, but instead were undivided interest in the buildings themselves.

Personal and Business Combinations/Agreements to Help in Estate Planning

<u>Family partnerships</u> are an effective way to allow children to share in the parents' investments. At the same time, it allows the parents to maintain control over the investments. As mentioned above, such combinations are becoming a popular method of intergenerational wealth transfers because of the discount in value involved. The

discounts result from the limited marketability of the limited partnership share. Limited partnerships, corporations, and limited liability companies should be a part of estate planning when a business, significant investments, or a farm are involved. These planning tools efficiently transfer interests, reduce taxes and protect assets. Each combination will have its own particular legal and tax implications that must be addressed. Another objective of family business combinations is the protection of family assets from litigation. An expansion of the concept of liability has caught many people in the civil liability maze that previously would not have been considered accountable. This observation, according to the Insurance Institute of New York, has caused litigants to look for deep pockets in the form of a business, savings or homes.

Judges have the ability to void financial manipulations used to protect assets from litigants, reversing any such creative action as a ‘fraudulent conveyance’. The justice system is not so quick to act on conveyances of assets for legitimate estate planning purposes initiated before any liability problems arise. Asset protection in these cases involve trade-offs that must be given thorough consideration. If you later have a change of heart as to who should receive the assets, you may have no recourse. Some of the planning tools available include;

Family limited partnership- The husband and wife are general partners. The husband, wife, and children are the limited partners. Gifts of partnership interest are made by the parents as a means of reducing estate value and to distribute income. The minority and unmarketability discounts reduce the value of the gifts

The partnership agreement should include a provision stating that distributions from the partnership are too made only at the general partners’ option. The general partner should be allowed to resign under terms of the agreement and become a limited partner but general partners are only removable by a supermajority vote, such as 90-100%. Historically a creditor cannot attach a partnership’s assets and can only obtain a charging order to receive distributions if and when the partnership decides to do so. If such an order occurs, the creditor may then be taxed on the income, even if not distributed. Several partnership entities may be created as vehicles for various types of investments; one for stocks and bonds, one for real estate, etc

<u>Family Corporations</u>— This vehicle has been in use a long while and has proved generally unassailable in the courts. A corporation is ideal when there is a substantial liability risk or an operating business with employees is included among the family’s assets. Intergenerational stock gifting, buy-sell agreements, and transfer restrictions help control ownership. Management of the enterprise is controlled by majority voting stockholders. Election of the S corporation eliminates the risk of income tax at the corporate level.

<u>Foreign Trusts</u>— In the media and in real life, offshore banks and accounts of every stripe are linked with drug lords, crooked politicians and tax cheats. It doesn’t take a rocket scientist to determine that the trusts set up in such exotic places as the Cayman Islands, Bermuda, or the Bahamas raise a red flag with the IRS as well as anyone else.

Expatriation of assets inevitably results in loss of control, negative tax consequences and unfriendly decisions from U.S. courts with regard to defrauding creditors.

Family Limited Liability Companies (LLC)— A new concept in asset protection and prolongation for families. It is a cross between a partnership and a corporation that requires more monitoring than the other two. More than one owner is required. The people in charge of affairs for the LLC are called managers while the owners of shares are known as members. The risk management advantages of a corporation and tax advantage of a partnership are features of this style of ownership.

Here is an example of how a limited partnership agreement can be set up and operated. Mrs. X inherits a building in Chicago that has a current value of $10 million and a yearly cash flow of 10%, or $1,000,000. Mrs. X wants to begin the process of moving interest in the building to her children for the purposes of estate planning. The building is put into a limited partnership. A separate corporate entity owns the 1% general partnership interest, the mom (Mrs. X) owns 89% of the limited partnership interest, and her husband, Mr. X owns the last 10% of limited partnership interest.

It would be simplest to make distributions of minority limited partnership interests to the children with a discounted value of 30% for gift tax purposes. For our example, the mother is concerned about decreasing her cash flow, and ultimately her income, over the short term. With this concern in mind, rather than making an outright gift the limited partnership interest is transferred to a 10 year Grantor Retained Annuity Trust (GRAT) that pays her a 9% annuity. This is a trust in which the grantor substitutes retention of a right to payment of a fixed income for a fixed period of time. The annuity is established as a fixed dollar amount equal to 9% of the value of the initial property placed in the GRAT.

The mother-donor would like to shift 10% of the limited partnership interest to the children. That translates to an undercounted value of $1,000,000. Since a limited partnership interest is what is being transferred, not some portion of actual title to the building, we are taking a 30% discount for our example. For purposes of determining the annuity as well as for gift tax purposes, the value of the partnership interest is $700,000. The annuity amount is $63,000 (9% of the $700,000). Under the applicable IRS actuarial tables, a ten-year GRAT with a $63,000 annuity will result in a taxable gift of 40% of the trust property, $400,000 (.4 x $1,000,000). As a result, mom has accomplished the transfer of $1,000,000 in assets by making a gift of $400,000. Since the entire gift is covered by her unified credit (applicable credit amount), there is no federal gift tax paid Over time the building may increase in value. After the end of the GRAT, ten years later, all appreciation ascribed to the gifted interest will pass to the children transfer-tax free.

We have seen from the discussion that advantages accrue to the family unit adroit enough to employ the business combination tools as a means of maximizing wealth preservation. These are relatively inexpensive methods that work in many different asset allocation situations. Best of all, it does not need to be a family on a par with the

Rockefellers for such an instrument to work. Below, we will summarize the high points of the concept of personal/business combinations:

➲ Combination of family assets can lead to efficiencies from legal, administrative and cost perspectives. Costs of probate are also reduced.

➲ The elders in the family, the ones who generated or shepherded the wealth, control distributions (income and principal) from the partnership/corporation.

➲ The annual distribution of varied types of assets (stocks, bonds, artwork, business interest, etc.) in the form of gifts is made simple.

➲ Another bulwark is created between creditors and family assets. Family partnerships may also provide asset protection against claims of nonfamily members. In a subsequent section of this chapter we will look at the issue of in-laws who become ‘outlaws’ through divorce.

➲ Adaptability is enhanced. Family partnerships are easier to amend and terminate than a trust.

➲ Discounts on gifts of the limited partnership interests to younger family members and the potential for lower valuations for estate tax purposes.

➲ With partnerships, family elders retain control without bringing transferred interests back into the estate as can be the case with family-controlled corporations.

➲ Language can be written into the partnership agreement requiring family disputes to be arbitrated rather than resolved in court.

Deferred Compensation and Estate Planning

For years, station KXYZ's local television newscasts have led the ratings in Middleburg. Anchor persons and sportscasters have come and gone, network news ratings have seesawed, but the KXYZ 6 and 10 o'clock news has stayed on top. Station executives finally have concluded that this success is due chiefly to their weather man, Ted Wright. He has a way of making forecasts understandable, entertaining, and even usually correct, and the citizens of Middleburg and the surrounding area look forward to them every day as something upon which to depend. The only trouble is that the management of station KZYX, a competitor, has reached the same conclusion and wants to hire Ted Wright away.

In talking to the KXYZ manager you find that he is willing to match the competitor's salary offer for Ted, but he would like some way to tie him even more closely to the station.

You suggest a deferred compensation plan that would guarantee Ted future payments beginning on a specified date, provided he remains with KXYZ until that time. If he leaves KXYZ, he will give up the rights to this future compensation. The plan to pay Ted $15,000 a year for ten years beginning when he is 65 results in a sale by you of a $150,000 insurance policy.

Known in the insurance industry as executive compensation, this plan pleases Ted because it will give him more retirement income. It pleases the management of KXYZ because it will keep Ted as a key employee and over the years will cost them little if anything.

The employer, KXYZ, purchases, owns, and is the beneficiary of a $150,000 life insurance policy on the life of Ted Wright. KXYZ pays the premiums on the policy to the insurance company. As the beneficiary of the policy, it will receive tax-free the death benefits of the policy in case of Ted's death. The deferred compensation agreement between KXYZ and Ted is separate from the insurance policy which funds it. Under the agreement, KXYZ must make tax-deductible payments to Ted when he retires. KXYZ can fund these payments either by cashing in the policy, by borrowing on it, or by using cash set aside for this specific purpose. If Ted dies before receiving his deferred compensation, KXYZ can use the $150,000 in death benefits to make tax-deductible payments to Ted's beneficiary.

Ted or his beneficiary must pay income tax on the money they receive. These benefit payments are deductible to KXYZ. The premiums KXYZ has been paying on the policy, however, were not tax deductible, so the plan is classified as "nonqualified" and can be put in effect for any key employee the management wishes. No government approval is required.

The plan provides an incentive for the key employee, giving him compensation for services currently rendered to be paid at some future, pre-determined date. This compensation will not be taxed to the employee until it is received. It cannot be deducted by the employer during his current contributions to the plan, but the benefits to be paid out in the future will be deductible.

Such a plan generally is attractive to an individual who has enough income for current needs but wants to provide additional financial security for the future. Both employer and employee must be in good financial shape and expect to remain so for this plan to be successful. To achieve tax benefits the plan must rely on the employer's unsecured promise to pay benefits in the future. Therefore the plan and the insurance policy used to fund it must be separate.

There is no guarantee that funds will be on hand to pay retirement or death benefits unless the employer holds an insurance policy on the life of the key employee. The employer owns the policy, pays premiums on it, and is the beneficiary. If the employee lives to the date he is to receive deferred compensation benefits, the cash value of the policy should be available to pay all or part of the benefits due. If the employee dies before receiving the deferred benefits, the death benefits will come tax-free to the employer and under the terms of the agreement may be paid out to the employee's beneficiary.

Another advantage of using life insurance as funding for deferred compensation is that waiver-of-premium benefits can be used if the agreement calls for disability payments in case the employee becomes unable to work before retirement age. Premiums waived on the policy would free cash to go toward the payment of disability benefits. Cash benefits building up on the life insurance policy are free of current income tax, which is not the case with any other type of uninsured sinking fund.

The employer has flexibility in the way he will pay retirement benefits when the funding is done by life insurance. They may be paid out of cash values of the policy, out of other current assets, or in any other combination the employer wishes. If the policy is to be kept intact, benefits will go to the employer on the employee's death, tax-free, and any death benefits payable to the employee's beneficiary can be made out of those tax-free proceeds. Prospects for deferred compensation funding policies may be found either among key employees or employers. The employee may request deferred benefits for his retirement, or the employer may want them to tie employees to the firm during their working lives. Both prospects need to be in sound current financial condition. Unless the employer has the funds to pay the insurance premiums and the employee has enough current income to motivate him to defer additional benefits for his retirement, the agreement between them would be worthless.

Information needed on prospects includes names, genders, and dates of birth of covered employees, the amounts of coverage desired or the amount of the company's contribution, and the company's and employee's tax brackets.

The plan is attractive to many small business owners because it can be discriminatory--the government has no say in which employees may receive it. It is also attractive because eventually it will cost the employer little if anything. The insurance agent is selling cash for employee retirement, cash to hold key employees in the firm, or cash for the employee's beneficiary on his death, in the cheapest way cash can be purchased--through life insurance.

The Players

Applicant: The business.

Owner of the policy: The business.

Premium payor: The business.

Named insured: The key person.

Beneficiary of the plan's death benefit: The business.

Beneficiary of the optional premature death benefit: The employee's choice.

Taxability

Premiums paid by the employer are not deductible to the employer or to the employee.

Death benefits under the plan are not taxable to the employer.

They are taxable to the employee's beneficiary when funded by the plan.

Deferred benefits are deductible to the employer when paid to the employee. They are taxable to the employee at that time.

Deferred Compensation Characteristics

From the examples above, we see that deferred compensation is basically postponing receipt of current income until some future date or occurrence, like death, disability, or retirement. The highly compensated person elects to put off receipt of the income for various reasons, including avoidance of current taxes. A typical employee-employer plan is called a private plan while certain government and non-profit employees use Section 457 plans. It is named for the section in the internal revenue code where the tax rules for such codes are found.

Deferred compensation may be setup two ways.

1.) A **Qualified Plan**:

- Required to be submitted and approved by the IRS
- Furnishes current tax-deductible contributions and tax deferred investment growth
- It is in writing and must be communicated to the plan participants
- Is for the benefit of employees and their dependents
- Has to comply with current participation, funding and vesting provisions
- Cannot discriminate in terms of employee participation

2.) A **Non-Qualified Plan** is seen frequently. This type of deferred compensation is written with the following characteristics;

- Does not require filing with the IRS

- Participation and eligibility can be selective or discriminatory

- Must be in writing and communicated to the plan participants

- Current tax deductions or income deferments are not permitted

Deferred compensation is a written agreement between an employer and an employee where a specific amount of current income for current services is deferred until a later date or occurrence. Non-qualified plans are not for all employees, it is discriminatory. The plan is not IRS approved. The only tax advantage is the postponement of taxes until the deferred compensation is actually received.

Deferred compensation can be established through one of the following methods;

A.) **Salary Continuation Approach;** The deferred compensation is really an additional benefit in addition to the employee's salary. Also known as a Selective Executive Retirement Plan-SERP. This plan is non-qualified as it is discriminatory. The employer promises to pay a deferred benefit upon retirement while the employee does not forego any current pay. The SERP is a benefit in addition to the current level of compensation.

B.) **Salary Reduction Type;** Most deferred compensation plans are this type. They would be classed as non-qualified private deferred compensation plans. In it, the employee postpones receipt of current income per the terms of the written agreement.

Funding

Plans are sub-classified according to how money is appropriated for compensation under the terms of the plan.

Funded Plans-The employer will set aside an amount of money or pledge other assets in an account or trust as the security for the promise to pay the deferred benefit at a later date. The employee will normally be named as the beneficiary of this trust or account. This setup results in a current economic benefit for the employee according to IRS regulations. Thus, the employee will be taxed on the money as current income even though the money is not actually received.

To avoid taxation, the rights to the assets must be subject to forfeiture. A clause concerning forfeiture will be found in the written agreement. The employee forfeits the money if he goes to work for a competitor or does not remain with the employer for other reasons. Funded plans bind the employee to the company. In addition to the forfeiture clause, the employee may not have any beneficial interest in the plan's funding to avoid current taxation. That means the assets used to fund the plan are wholly owned by the employer and subject to attachment by creditors. As a result, this type of plan is not as common as the next.

Unfunded Plan- It consists of the employer's unsecured promise to pay future benefits. No money is set aside and you cannot eat promises, so no tax liability is incurred (lack of constructive receipt). This applies to the SERP as well. The written agreement must still specify the conditions pursuant to forfeiture. Obviously, the employee has no guarantee of future payment. If payments are not made as promised, the employee or the estate will be a creditor of the business.

Informal Funding- As a means of countering the uncertainty that future payments will be made, the IRS permits informal funding of unfunded deferred compensation plans. Life insurance, annuities or trusts can be used without threatening the tax status of the unfunded plan. Any of these methods can be used so long as there is no present economic value or benefit to the employee provided that the employer is the owner, premium payor, and beneficiary of the policy or annuity, according to IRS rulings.

Funding with life insurance-Several advantages accrue to funding a deferred compensation plan with life insurance:

♦ It allows the employer's obligation to deliver deferred benefits to be funded by a precise amount of money deliverable right when it is required; at the death of the employee.

♦ Living benefits are provided through the policy's cash values. Premium payments result in a forced savings to facilitate future delivery of the deferred benefits

♦ Presence of a life insurance policy affords a degree of security to the employee. There can be seen that a plan is set up to provide future benefits.

♦ The employer pays the deferred benefits and keeps the insurance policy in its name. Eventually, when the employee dies, the proceeds from the insurance allows the company to recover some, all, or possibly more than the costs of retirement benefits paid

♦ Flexibility is found in the different types of settlement options found in a life insurance contract.

♦ Life insurance proceeds and cash values grow tax free.

Life insurance contracts are not investment vehicles. If the employer has an investment objective then some other product could be employed in place of or in addition to the life policy. One must keep in mind that risk accompanies any form of investment. With insurance, the employee gains the peace of mind in knowing that the funds will be there when needed most.

Rabbi Trust- Another method that can be used to provide assurance of payment. It stems from an IRS ruling in which plans were placed in an irrevocable trust as future payment for a rabbi. The assets were of no current economic benefit to the rabbi and they remained subject to the claims of creditors. With this type plan, the assets can be placed in escrow for the benefit of the employee, thus providing a degree of assurance of future delivery. The trust can be funded by almost any form of tangible asset.

Secular Trust- Here, the employer contributes assets to the trust and the employee is fully vested in the trust assets. This way the employee has confidence that the deferred benefits will be available. Booth contributions and earnings are currently taxable to the employee and deductible for the employer.

It would seem to make little sense for the employee to defer the income and still pay taxes on it currently. However, if the employee is also the business owner it may be a good idea. The same holds true from the businesses' point of view if the employee is not an owner. The company can use the secular trust and receive a current tax deduction. To assuage the employee, the company might pay a bonus equal to the employee's tax.

Gift/Estate taxation and Deferred Compensation

With a salary continuation plan there are gift tax implications while the employee is alive if the beneficiary designation is revocable. Recipients can argue that the employer's payment was a gift if such payments were made on a voluntary, one-time basis. Thus, no income tax liability would fall on the recipient. The employer would also lose the income tax deduction. The "gift" reasoning cannot hold up when there is an express or implied contract or past custom of employer payments to employees. Potential gift tax issues can arise upon the death of an employee who is a participant in a survivor income benefit plan (death benefit only plan). Participation in such plans is mandatory and the employer reserves the right to modify the plan at any time. Employees have no say over the amount, payment form or timing of the payments. Termination of the plan is effected by employment termination.

Even with such absolute control by the employer, the IRS asserted in Revenue Ruling 81-31 (1981) that the present value of the survivor income benefit was a gift that became complete upon the employee's death. It became includable in the estate as an adjusted taxable gift even though the employee in this ruling had no control over the plan. Such logic seems convoluted because it directly contradicts gift tax regulations that define a gift as a lifetime transfer. In 1986, this taxable gift concept was by the Tax Court in *Estate of DiMarco v. Commissioner.*

With estate tax, the present value of future nonqualified deferred compensation payments are generally includable in the gross estate of the decedent/participant. The value of annuity or other payments receivable by a surviving beneficiary under any form of contract or agreement is also includable in the gross estate of the decedent. A properly structured death benefit only plan should not be includable in the gross estate. This would be a plan where the employee has no power to change the plan or the beneficiaries. There is no retained interest by the employee in such a plan. For small businesses, the proceeds from a properly arranged death benefit only plan can be excludable from the gross estate of the insured if the benefits are payable to or for the benefit of the corporation and the insured is not the sole or controlling shareholder. Corporate control utilized by a majority shareholder can equate to control of the plan and subsequent tax-inclusion. Problems can also arise when the controlling shareholder is given the contractual right to purchase the policy before the employer corporation can surrender it. The IRS may consider such right to purchase a corporate-owned policy by an employee as a characteristic of ownership.

Deferred compensation may be includible in a deceased employee’s gross estate and be subject to tax. Life insurance proceeds are generally received free of income tax but are includable in the decedent’s gross estate for federal estate tax purposes. The same is true for deferred compensation. If a deceased employee had an enforceable right to lifetime benefits through a deferred compensation plan, the present value of benefits payable to a surviving beneficiary are included in the gross estate. The deceased employee is considered to have an enforceable right to future benefits if they have conformed to the conditions spelled out in the deferred compensation agreement at the time of death.

DBO- Death Benefit Only plans refer to deferred compensation arrangements providing for survivor benefits only with no rights or benefits after employment. It may not be includible in the gross estate of the deceased employee. A DBO is also referred to as a widow’s benefit plan. The chief function of the DBO is to provide survivor benefits and a life insurance policy will normally be used to fund such a plan. The employer agrees to pay a specified sum of money, possibly in installments, to the beneficiary. The DBO, as the name implies, must provide only survivor benefits. If a separate agreement is made to include retirement and disability benefits the IRS will treat them together as one agreement and the present value of these benefits would be included in the deceased’s gross estate. Such a scenario can be avoided by extinguishing the DBO upon the retirement of the employee and at that point commencing a deferred compensation agreement.

Like all other schema involving income, treatment of DBO plans is subject to review by the taxing authorities. At this time the IRS says these plans are considered a completed gift of present interest as of the date of death. When the value of this gift of present interest exceeds the annual gift tax exclusion of $13,000 (for 2009, increasing over time), gift tax may be due. Summary information for taxation is shown here;

-The first $5,000 of the death benefit may be excluded from the death benefit by the survivor.

-The employer receives a tax deduction for the payments made to the survivor providing they meet the test of being reasonable compensation as a necessary business expense.

-No amount is includible in the employee’s current income for tax purposes during the employee’s lifetime.

-None of the DBO benefits are includible in the employee’s gross estate when the agreement is properly structured.

Normally the DBO provides benefits for the employee’s family rather than for the employee. Below are examples of situations where a DBO may be desirable to an employee;

-An employee who has a good size retirement nest-egg already but is in need of a pre-retirement death benefit. Other retirement benefits may be forthcoming through military retirement, investment programs, etc.

-An employee with a large estate in the form of real assets and little need for added retirement benefits. The DBO will provide liquidity to pay final expenses and taxes.

Estate Issues Concerning the Family Farm

These days the term ‘agribusiness’ conjures up images of huge, Soviet-era mega collective farms (but run on a for-profit basis). For those of us old enough to remember “forty acres and a mule” stories or lifestyles, agriculture and the family farm are seen as ways of life worth preserving. The family as a most efficient economic unit for the operator of a farm or ranch business has yet to be disproved. Inheritance will be the most common way for the next generation of farmers and ranchers to come into the business. A degree in agriculture from UC Davis or A&M will not guarantee succession. Knowledge and implementation of an estate plan will be necessary.

In the tax laws, Congress has allowed for ‘special use valuation’ for farm, ranchland, and other real estate used in family businesses as well. It allows this real estate to be valued at the agricultural value instead of at its ‘potential’ value if used for other purposes. This has an impact on the land’s federal estate tax valuation.

Special Use Valuation Requirements The special federal estate tax rules apply for closely-held businesses. As with all estate plans, a tax expert should be consulted before any plan is put into action. A summary of special use rules is shown below;

-The family business or farm must comprise at least 50% of the value of the overall estate.

-The real property used in the business must make up at least 25% of the overall estate.

-At death, the family business must go to a member of the deceased’s family

-The decedent or a family member must have used the real estate in question in five of the eight years before death

-Restrictions are placed on the sale and use of the property after disposition of the estate for at least a 10 year period, sometimes 15 years. IRS must be notified if there is a change in the status of the real estate.

-There are material income tax savings for the proceeds of corporate stock redeemed to pay estate taxes due on a family farm or other business.

Land handled in such a manner for estate tax purposes is subject to a federal tax lien. Federal tax liens pass with title to property. A federal tax lien seriously affects the ability to get a mortgage on a piece of property. Care should be taken in any effort to take advantage of the special use valuation. If all the property passes to a surviving spouse, the unlimited marital deduction makes special use valuation unnecessary. It should be employed upon the death of the second spouse.

The estate taxes due on the value of the closely-held business can be deferred for five years. Payments can then be made over a ten year period, making the final payment due 15 years after death of the testator. This applies to small business that meets the test of comprising 35% of total estate or 50% of taxable estate.

The real estate included in the estate can have its value reduced by up to a maximum of $750,000 from its ‘highest and best use’. That represents a substantial savings from its present use as farmland and its potential to be, perhaps, a shopping mall. Several other tests must be met for this rule to apply. Again, a tax expert should be consulted concerning matters such as this.

Probate Avoidance for Small Businesses

It cannot be stressed enough that for small business person's estate planning on a personal and business level are inextricable. Finding the best method of transferring a legacy will require attention to both. Besides seeing that the business, or proceeds from liquidation, goes to your beneficiaries, entrepreneurs will want to do their best to avoid probate. This will save by avoiding probate fees as well as aid in the prompt transfer of ownership rights.

Probate costs money. More importantly, it keeps the business under court control for a year or possibly longer. Seeking the probate court’s approval for all decisions but the minutiae is time consuming and not at all efficient. Steps can be taken to avoid probate by considering either a joint tenancy or a living trust. There are compelling tax and ownership reasons to give consideration to these methods. A discussion of both occurs elsewhere in the book.

Chapter 2 Trusts, Insurance & the Estate

The type of trust this chapter deals with concern those of a fiduciary nature. A trust is an entity that holds assets (the **res** or *corpus*) for the benefit of certain other persons or entities. The person holding legal title or interest, who has responsibility for the assets and distribution of the assets or distribution of the income generated by such assets, is the trustee. Any time a relationship is created where one party acts as guardian or fiduciary in relation to another person's property, a trust is created.

The structure of a trust is simple. The trustee is the owner. This person also manages the affairs of the trust. The trustee has control of the assets of the trust. Buying or selling of assets and the transfer of ownership is handled by the trustee. Powers to perform these functions derive from two sources; 1.) The law vests in the trustee the authority to bargain on behalf of the trust. 2.) The instrument creating the trust can add to or take away from the trustee's power.

Restrictions on the trustee's ability to invest the assets of the trust can be very narrowly worded or very broad in scope. Rapidly changing economic condition and the possibility to adapt to unforeseen future events mean the trustee should be given leeway in investment opportunities. It is best to select a trustee who is smart and conscientious. It is not wise to try to spell out trust operation to the last detail. Authority can be granted to the trustee beyond the power to invest. The trustee can retain counsel on the trusts behalf. If needed, real estate or investment experts can be consulted. In many states, as long as the trustee picks the adviser with care, the trustee can seek outside help with management skill.

Creation of a Trust

Each trust has three components
- The creator or "settlor"
- A trustee
- A beneficiary

Smith can convey property in trust to Jones for the benefit of Johnson or Smith may declare himself trustee for the benefit of Johnson or Smith may convey in trust to Jones property for the benefit of himself, Smith.

There are many varieties of trusts. All trusts may be divided into two major groups, express and implied. Implied trusts are imposed upon property by courts and are known as either <u>constructive</u> or <u>resulting</u> trusts. The express trust is a trust established by voluntary action and is represented by a written document. An oral statement may be sufficient in some situations. Overwhelmingly, legal jurisdictions require an express trust of real property to be in writing to meet the requirements of the Statute of Frauds. No particular words or phraseology is necessary to create a trust, providing that the intent of the settlor is to establish a trust is unmistakable. Trusts are often employed in wills as a means of conserving property for the benefit of widows and children. This is known as a **testamentary trust.** Trusts are frequently established by individuals during their lifetime. These are known as ***inter vivos*** trusts. Frequently living trusts have been employed as a tax avoidance method but tax reform legislation continues to chip away at such shelters.

Any person legally capable of making a contract can also create a trust. Unlike a contract, consideration is not an essential element to an enforceable trust. A trust is more like a conveyance than a contract. As a result it is not always clear if a person has, through their actions, created a trust or merely promised to create a trust in the future. Also differing from a contract is the fact that the subject matter of a trust must be definite. A trust cannot be created of property not yet in existence or to be acquired at a later date.

If Mr. X executes a trust instrument declaring he holds all future dividends of his corporation in trust for his children, the subsequent dividends do not necessarily have to be set aside as trust property. Prior declarations do not oblige the holding of future unrealized profits in trust. If Mr. X tells Ms. Y that he has left Ms. Y 200,000 in his will, a declaration of trust by Ms. Y during Mr. X's lifetime covering this expectancy does not effectively bind Ms. Y upon the death of Mr. X. We do meet the need of a definite and certain subject matter when Mrs. R provides in her will that she leaves to Mr. S, as the trustee, enough money to pay $800 per month to Mr. T. I pity the fool that can't follow this example.

The definite subject matter test is what frequently distinguishes a trustee-beneficiary relationship from that of a debtor-creditor. This distinction has many important consequences in business affairs, especially when an obligor becomes insolvent. When Mr. A owes Mr. B $10,000 and Mr. A becomes insolvent, Mr. B will be on equal footing with the rest of Mr. A's creditors. Instead, suppose Mr. A opens a bank account styled as "A, Trustee for B". Mr. A deposits $10,000 into this account and later becomes insolvent. Mr. B will be able to collect the full amount due under the trust. Whenever money is paid over to one person for the use of another, as with rents paid to an agent for the landlord, the designation of the proceeds as a separate credit by the agent general establishes him as a trustee, not a debtor.

Duties of the Trustee- Anyone legally capable of dealing with property can be a trustee. Corporations can act as trustees within the limits of their authorized powers. So can public institutions. Banks carry on substantial trust business on behalf of their customers. Trustees can decline to serve. Before the property vests in the trustee it is necessary for the trustee to accept the trust. Acceptance is often inferred from acts of the trustee that indicate the intent to exercise dominion over the trust estate. A common statutory requirement is that a court appointed trustee must post a bond for the honest administration of prescribed duties. The three primary duties of the trustee are;

⌘ To carry out the purposes of the trust. This is obvious. The trustee is charged with following the direction of the settlor as to the manner of administration of the estate and the distribution of property to the beneficiaries.

⌘ To act with prudence and care in the administration of the trust. This duty is more difficult to define. No special skill is required from the trustee under ordinary circumstances. Saying what is-or was-prudent is not easily defined from case to case. Hindsight is always 20-20. What turned out to be a poor investment may have been, at a previous time, a pretty good risk. Generally, a trustee ensures a safe course by making the conservation of capital the main goal and income realization an objective to the extent that it is consistent with the security of capital.

⌘ To demonstrate a high degree of loyalty toward the beneficiary. This duty of the trustee arises out of the fiduciary character of the relationship between the trustee and the beneficiary. The trustee must in all dealings act in the exclusive interest of the beneficiary. In order to protect against accusations of misfeasance, the trustee must scrupulously avoid any hint of personal advantage arising from the trust. Lack of loyalty can arise from evident self-dealing or it may be entirely innocent. Either way, the trustee can be accused of a lack of loyalty. Common instances of violation of this fiduciary duty include the sale of the trustee's property to a trust or the purchase of trust property at a sale conducted by the trustee. Similarly, the advance of funds from the trust to the trustee or a trustee's business would constitute a breach of duty. It is commonplace for a court to set aside such transactions. The fact that no harm was done to the trust does not excuse the transaction. This is a rule designed to be preventative in nature in order to discourage the temptation regardless of the outcome of any particular transaction. A beneficiary can require that the disloyal trustee restore the status quo. A beneficiary who is legally competent may, on the other hand, ratify the disloyal act and be prevented from later charging the trustee with disloyalty. In such a case, the beneficiary would be estopped, however, only if full disclosure of the entire transaction had been made by the trustee.

Powers of the trustee- The trustee's powers are determined by two things. One is the rules of law in the jurisdiction in which the trust is established. The other is the scope of authority granted the trustee by the settlor in the instrument creating the trust. Investment of trust funds is the chief area of concern for state law. Most of the states define types of securities that qualify for trust investment. The roster can be mandatory or permissive. If mandatory, the investments must be of the listed type. If permissive, investment can be made in unlisted types of securities as long as the trustee can demonstrate that this was a prudent action. Investments of the approved type usually include U.S. government obligations, State and municipal bonds, mortgage debt instruments and top-rated corporate debt (utility companies). Unapproved or improper investments for a trustee might include speculative ventures, unsecured loans, any type of subordinate lien on real property, and stock investing. Note that the list of proscribed investments read very much like that of insurance companies with regard to the investments of policyholder's surplus.

Unlike insurance carriers, it is within the power of the settlor to give the trustee great leeway concerning the risk associated with investments. When instructed by the settlor, the trustee is not bound to adherence to the list considered advisable under state law. If the state statute does not include stock on its listing a trustee may still invest in same if given the authority by the settlor. Often, a trust gives the authority to retain the stock in a family business. The trustee can keep the stock in this situation. Otherwise, under state statute the trust would be required to dispose of the stock. Such wide discretion in the trust document does not relieve the trustee from the general duty of diligence and care. The trustee has the power and duty to dispose of securities when specific instruction is wanting. Without specific authority, there are incidents of ownership exercised by the average person that a prudent trustee would be unwise to accept. This is why trust instruments often grant blanket powers to the trustee.

The Beneficiary- Very few limitations are placed on who or what may be the beneficiary of a trust. Other humans, animals, charities, and institutions have been beneficiaries. If defrauding creditors is not the object, the settlor can make himself the beneficiary of the trust. If no restrictions are found in the trust document, the beneficiary’s interest can be attached by creditors. The beneficiary’s interest in the trust may also be sold. If more than a life estate in the trust is held, the interest in the estate can pass to the beneficiary’s heirs or assigns by will or trust.

Termination of the Trust- The general rule is that a trust, once created, is irrevocable unless such power is reserved by the settlor. The power of revocation is often kept by the settlor. One example is a parent creating a living trust for a child while reserving the power of revocation. Under current tax law the income from such a trust arrangement is taxable to the settlor if the power of revocation is reserved directly or indirectly. A trust will commonly state a termination date at which time the trust will end without formality or fanfare. Termination may occur after a period of years or after the lifetime of the beneficiary. If the trust is set up to run a span of years, death of the trustee or beneficiary does not mean the trust will terminate. Conversely, the reason for creation of the trust may end before the specified termination date. Either way, a court will at times decree the termination of a trust. Most courts will not order the termination of a trust just because a beneficiary petitions the court to do so. The findings of the court will be controlled by the purpose contemplated by the settlor, not the wishes of the beneficiaries.

Trust Types

Trusts take on many different forms, each with different characteristics. Some characteristics may overlap, some are unique.

>Implied Trusts- When there is an absence of any expressed trust intent; courts will occasionally presume the existence of a trust. That is because the acts of the parties involved seem to call for such a construction. Such trusts are divided into two classes.

Constructive trust- It covers those instances where a court will impose a trust upon property to rectify a fraud or to block unjust enrichment. A constructive trust exists where a confidential relation, and the subsequent abuse of the confidence reposed are sufficient to establish such trust, or where actual fraud is considered as equitable ground for raising the trust. While, as a general rule, a donee by deed who has received real property, under an oral promise to hold it for the donor or another may rely on the Statute of Frauds; an exception prevails where a confidential relation exists between grantor and grantee. The existence of such a relationship prohibits the one trusted from seeking any selfish benefit during the course of the relationship. This affords the basis for fastening a constructive trust upon the property in hand. Generally speaking, a fiduciary relationship exists where trust and confidence are placed by one person in another who, as a result of the relationship, gains influence and superiority in the relationship over the first person. This can be found in relationship of kinship, business or social association, differences of age, physical or mental condition. The grantee occupies an intimate position with regard to the grantor and the latter reposes a high degree of trust and confidence in the former.

Business and personal affairs give many examples of constructive trusts. Whenever a person obtains money or property by fraud or duress, equity may treat him as a trustee. A director of a corporation who makes an undisclosed profit in a deal with a corporation will be treated as a trustee for the corporation to the extent of the profit. Whenever an agent who is given money by the principal to purchase property in the principal’s name uses the money instead to acquire title for himself, most courts will treat him as a trustee for the principal.

Resulting trust- This is intended to carry out the true intent of the parties in those cases where the intent was inadequately expressed. A common example of a resulting trust can be seen when Mr. X pays the purchase price for property and title is taken in the name of Ms. Y. The presumption in this case is that the parties intended Ms. Y to hold the property for the benefit of Mr. X, and Ms. Y will be treated as a trustee. A problem arises in that often times it would be just as reasonable to assume that Mr. X intended to make a gift of the property to Ms. Y. In cases where the payor is a husband or a parent, a gift is generally the more favored presumption. A resulting trust does not depend on an act or agreement but is founded on a presumed intent arising out of the acts of the parties involved. It is created by implication and operation of law, so it need not be evidenced by writing. If the trust arises it comes from the same transaction in which the legal title vests, on consideration advanced before or at that time, and not on acts arising thereafter. It is always possible to prove that a trust was not intended and courts require specific proof to establish that a resulting trust exists. The burden of proof rests on the parties seeking to establish a resulting trust.

Charitable Trusts- In this sense the meaning is broader than everyday usage. This includes any public purpose contributing to education, advancement of arts and sciences, etc. Gifts to museums, foundations, and political or religious organizations have been upheld as charitable in nature.

The *cy pres* (French; so near, as near) doctrine applies only to charitable trusts. When a charity bequest is illegal or becomes impossible or impracticable, the courts will substitute another charitable object that is believed to approach closely the original purpose of the testator or settlor. For example, Isaac wrote in his will that $100,000 should go towards an organization to help Jews emigrate from the USSR. When he died, the USSR no longer existed. The court awarded the money to an organization devoted to Jewish relief efforts and the restoration of synagogues in Russia.

>Spendthrift Trusts- It is not uncommon to find a settlor who does not believe that a beneficiary can be relied upon to preserve the rights granted as such. The settlor will provide that the beneficiary cannot, by assignment or other means, impair his rights to receive principal or income and that creditors of the beneficiary cannot attach the fund or the resulting income. The term “spendthrift” refers to a provision in a trust instrument whereby the trust estate is removed from the beneficiary’s control and disposition and from liability for individual debts. Once income is actually received by the beneficiary, creditors may seize it or the beneficiary may do whatever he wants with it. Such provisions in a trust are generally held to be valid.

>Precatory Trusts- Sometimes it is not so easy to tell if a settlor really intended to create a trust. Words of request or recommendation may be used in connection with a gift implying or hoping that the gift will be used for the purpose stated. Instead of wording a bequest “I leave property to Mrs. Jones for the benefit and use of Jones, Jr.” a settlor may leave the property to Mrs. Jones “in full confidence and with the hope that she will care for Jones, Jr.” A “precatory expression” such as this may be as definite and certain as to impose a trust upon the property for the benefit of Jones, Jr. Whether it creates a trust or is nothing more than a gratuitous wish will depend on whether the court believes from all the facts that the settlor genuinely intended a trust. Often, the courts will view wording like “request” or “hope” as creating no legal obligation upon the recipient of the gift.

Functions of the Trustee- Family members, trusted friends, lawyers, accountants, or professional fiduciaries of bank or trust companies are usually named as trustees or executors of estates. Generally speaking, the term of a trustee is much longer than the term of an executor, since trusts often last the lifetime of another person, or until a child reaches a particular age it is often believed that a trustee must be some sort of expert at investing. Any person of ordinary intelligence can serve comfortably as a trustee. The individual can then hire an expert in investment matters just as would be done with an attorney or accountant. The most important qualities of the trustee are integrity and judgment. The trustee’s duties involve people and their needs. The capacities of legal, business, and tax moguls are important, yet secondary to looking after the overall welfare of the beneficiary.

A strategy used by some individuals is to have co-fiduciaries, an individual family member or friend and a bank or trust company. This set up can give balance to the administration of a trust. It also helps eliminate doubts that are commonly heard concerning an unpaid trustee; you get what you pay for with an unpaid trustee.

An important consideration involving trustees is the guardianship of minor children. When death leaves behind minor children, guardianship is essential. There can be one guardian for the children and another for the property of the children. This route is seldom taken. Any viable amount of property owned by a child is better held in trust than by a guardian. No parent wants to think about the conditions arising for guardianship. The reality is that such a contingency should be left in or with a will. If not, the local courts will decide who has custody. Guardianship can always be declined so it is important that the position be delegated to someone dead, estranged, or incompetent when the untimely hour of need arrives. The trustee and guardian do not need to be the same person. This is often the best solution, especially for the vast majority of us who have modest financial means. As the situation warrants such an arrangement may be wise. There may be disagreements between trustees and guardians, so it is wise for parents to leave precatory instructions concerning the child's religious, social, and educational upbringing. Many of the things a guardian or trustee of children's property should do seem like common sense. If the wishes are not written down, likely as not they will not happen.

When a Trustee does not Work- The failure of the trustee to carry out appointed duties will occasionally happen. At times the failure may be subjective and only in the eyes of the settlor or the beneficiary. The trustee is doing a good job, but the beneficiary wants more of the trust distributed for whatever reason. For whatever reason, the trustee falls out of the good graces of the other parties involved. This can lead to the resignation of the trustee. Nobody wants to stay in a job that does not pay, to get shot at, and possibly be the target of some future litigation. The ill will aimed at the trustee might be off base, but having to deal with such a problem will affect the objectivity of almost anyone.

A testator may include in a will or trust document a provision for the removal of a trustee. If the trust was created primarily for tax purposes, removal of the trustee can have tax consequences. When a settlor creates a trust during lifetime that seeks tax advantages, reserving the power to dismiss the trustee can create problems. If the power to do so is so strong that the creator could step into the vacancy, then the settlor could control the trustee's powers all along. Tax rules equate this with the creator being the trustee. This will destroy the tax advantage of the trust. This is true even if language is used that restricts the settlor from being the new trustee. The government still sees this as leaving the settlor with the power to make the trustee adhere to the settlor's wishes.

The next reasonable option would be to allow the beneficiaries to remove a trustee. The same logic applies. The trustee would be seen as serving at the pleasure of the beneficiary. From a tax standpoint, the result would be the same. If the trustee has the right under the trust to make discretionary principal payments to the beneficiaries, the beneficiaries hold the power to get at the principal through their ability to choose a trustee. The same argument would be made even if the trustee could only be replaced by a third party. The test is, any time a beneficiary can control the power to reach the trust principal, and they have constructive dominion over the *corpus* of the trust. This would not be the case if the power of the trustee is limited to making principal payments for the maintenance, health or educational pursuits of the beneficiary. These categories are protected.

One method of making the removal power an arm's length affair is to vest the power of removal with people outside the trust. Persons that are neither trustee nor beneficiary. Acting as a board of trustees of the trustee, they could oust the trustee if necessary. A scheme such as this could be expensive and may make it difficult to find somebody willing to have a group with summary powers breathing down their neck. If the trustee is removed, that person will prudently insist on an accounting before stepping down. The local court will look at all transactions under the departing trustee in great detail. This protects the trustee from any future accusations of misfeasance or liability claims. This will also allow the trustee to be paid anything due for services rendered. Again, this is a procedure that could get expensive. Present and future beneficiaries most certainly would be involved with attorneys all the way around. Any complaints would tend to make a tedious affair even worse. From another point of view, such an undertaking could actually forestall whining beneficiaries from summarily ousting the trustee. The fees for an accounting would be paid out of the trust, which eventually comes out of the beneficiaries' pockets. Because of this it would be imprudent for a beneficiary to insist on a trustee's ouster simply because of a personality conflict.

Allowing for a Substitute Trustee- Even if a beneficiary does not have a falling out with a trustee, some sort of contingency for a substitute trustee should be made. Over the life a trust, the trustee gets older, too. Finding an original trustee may be difficult. Finding a backup can only be worse. Still, trusts for children or grandchildren, other life interests or generation skipping trusts could easily last for 50 years. So, when a trustee is chosen, a balance must be struck between experience and youthfulness sufficient to run the life of the trust. A saving grace in here is that such trusts will probably have sufficient assets to warrant the employment of a professional fiduciary or trust department/company. Another tactic may be to allow the original trustee to name a successor. Nobody can say what will happen 20-50 years hence or where other relatives may be. If enough confidence was placed in someone to be trustee to begin with, the same person will have (presumably) enough skill to name a competent successor. At any rate, if no one can be found to handle the job, the courts will choose a successor trustee. That is part of their statutory duty. If the trust's beneficiaries are not acrimonious towards each other the court will most likely accept a suggested trustee.

Trust Usage can be Flexible- The trust traces its roots back to the Statute of Uses of 1536 in England. The concept has evolved into a flexible tool for making dispositions of property. When a person is elected to public office, a blind trust will be used to control their assets so that investment decisions do not affect their governmental duties. The "rabbi trust" is a funding vehicle for nonqualified deferred compensation payments. Part of our national wealth is held in pension and profit-sharing trusts. Billions of dollars are held in trust for charitable purposes. A trust may be the only method available to provide for people dear to the settlor but in tenuous positions. This includes paramours and illegitimate children. The rich even use the ruse of the intentionally defective trust to help shield assets. The layman thinks of trusts and conjures up images of John D. Rockefeller, Sr. and the Standard Oil Trust. The laws that dismantled this form of doing business are better thought of as "antimonopoly" laws rather than antitrust laws.

Conflicts Among Beneficiaries- The most common example of this is with a remainder trust. The current beneficiary is receiving income from the trust and the people to whom the principal will eventually accrue, called the remaindermen, get in a squabble (as sometimes happens). One possible source of conflict would involve a beneficiary who is desirous of high income yield. Pressure would be brought to bear from this quarter on the trustee to invest in the highest yield instruments available. The remainderman, on the other hand, would naturally be interested in maintenance and growth of the principal. There is a conflict here and the trustee is caught in the middle. A saving grace in such a situation would be for the settlor of the trust, anticipating problems such as this, to specify what types of investments were suitable for the trust. A middle-of-the-road investment policy could then be adopted by the trustee, seeking yield but not compromising the principal. We previously discussed the statutory limitations on the type of investments allowed a trust if the settlor is silent in the matter. This is another tool that can be used effectively in managing differences between the beneficiaries.

The same problem arises if the assets of the trust consist of real property. Say the beneficiary is receiving income from the rent payments to the trust from property tenants. Along with this the depreciation deduction is being taken, another benefit to the beneficiary. Do the remaindermen receive anything more than a run-down, fully depreciated building? Similar questions must be asked if the trust property is oil and gas or other mineral/depletable assets. Allowance for such a situation by the settlor can avoid much conflict down the road.

So we have a division of trust beneficiaries into two groups; those who will receive benefits currently and those who will have to wait for benefits at a later date, when the current beneficiaries are out of the way. It boils down to an interest in the **income and the principal.** The current benefit from the trust is income, be it from rents, royalties, dividends or interest. The income can be taxable for both state and federal purposes or it could be exempt on one or both levels. This is contingent on the type of investment.

Principal refers to the body of the trust or the fund itself. The trust could begin with the principal in one form, such as real estate, oil wells, or even some form of intangible property. For the benefit of the trust, over time the trustee can cash in, change or cause a general metamorphosis of the trust's assets. Current beneficiaries are entitled to receive income generated by the trust's assets. For example, a trust may be set up to provide income to the beneficiary on a monthly basis. The beneficiary will regularly receive the trust's income net of expenses associated with that income. The trustee cannot interfere with the flow of income. The situation may arise where the income is inadequate for the beneficiaries needs, even though the funds are fully invested. This is not an uncommon occurrence, especially when inflationary pressures affect the economy. A solution is for the trustee to draw on portions of the principal to supplement the income in order for the beneficiary to maintain a reasonable standard of living. Trustees can be given this power. Any remaindermen involved will naturally be opposed to this type of set-up.

Any capital gains generated by the trust are considered to be a part of the principal. They do not go to the current beneficiary when there are remaindermen. Taxes on any income reinvested are paid by the trust. The beneficiary pays tax on income paid out from the trust. A trust can be set up so that the tax on capital gains as well as on income is paid by the settlor, if so desired.

It is most common for broad authority to be granted to the trustee to make payments from the principal when the current income beneficiary is the prime object of the trust. A wife or only child, for example. Narrow authority to use principal is granted when the current beneficiary is not viewed with as high of regard as the future beneficiaries. The settlor deems to preserve the principal of the trust until after the current beneficiary is out of the picture, for whatever reason. It can go to such extreme that no authority is granted to the trustee to pay out principal to the current beneficiary. The only purpose may be for the marital deduction for gift or estate tax purposes. It may be that the trust beneficiary is a second or subsequent spouse and when this beneficiary dies, the principal goes to children by a previous marriage. In such a situation the settlor may decline to authorize payment from the trust's principal to the surviving spouse.

The Settlor or Beneficiary as Trustee

When a person creates a trust during their lifetime, they can act as trustee or have the beneficiary act as trustee. This is an acceptable strategy but it will deprive the trust of any tax advantages. By the same token, if a trust is created under the Uniform Gifts to Minors Act (UMGA) or Uniform Transfers to Minors Act (UTMA) the authority of the custodian proscribes from a tax standpoint the settlor and the custodian being the same person, although it may be possible for the spouse to be the trustee.

Depending on the situation, the beneficiary can serve as the trustee without compromising tax goals. We will look at tax aspects of trusts in another part of this chapter. What should be avoided is a beneficiary holding authority as trustee or co-trustee and in this capacity be able to make discretionary payments from income or principal to themselves. A configuration like this will cause tax problems. A more prudent course of action, and one allowed by the tax regulations, is for the beneficiary, as trustee, to pay themselves principal for support, maintenance, health or education. If it is desired to augment the authority of the trustee beyond this level, it is best to have someone other than the beneficiary as trustee. It may be best to have someone else as a co-trustee. That way tax advantages can accrue to the parties involved and the trust's principal can be made available for uses beyond support, maintenance, health, and education. In some states the only income beneficiary cannot be the only trustee. This gives all the more reason to appoint someone as a co-trustee.

The issue that must be kept in sight is that a trust's aim is to take care of the beneficiary. Needs change and vary between individuals. Trustees can be authorized in the enabling documents to pay various amounts of trust income to different beneficiaries. The trust could provide guidelines for expenditures. It can and should be made flexible. This becomes more important the longer the trust runs. This scenario describes a sprinkle or spray trust in which the trustees are empowered to distribute the pay as much income as they decide fitting to the individual beneficiaries. Undistributed income can be reinvested in the body of the trust. One child-or grandchild-may have special health needs that require payment. The child may be extraordinarily gifted, requiring lessons to hone a talent. A trust contemplated to run a long period will benefit grandchildren who will be born after the trust starts. It can be set up so as not to violate the Rule Against Perpetuities. The trust could be set up so as to run 21 years after a particular child's death. This would be styled as "life in being" plus 21 years. That way the trust can be counted on as an asset until the youngest grandchild is at least 21 years of age.

The Living Trust

A living trust is one created during the lifetime of the settlor. This type of trust can be revocable, meaning it can be amended or terminated during the lifetime of the settlor as long as that person is competent. A revocable trust is created by an individual (grantor or settlor) during their lifetime containing instructions about the management and disposition of assets (and the income from such assets) during life and at death. The grantor can act as his own trustee, with a successor to serve in the event of death or incapacity. A revocable trust, as its name denotes, can be revoked or amended, in whole or in part, by the grantor at any time. In certain situations and jurisdictions a revocable trust is the preferred primary method of estate planning—for example, if privacy is a paramount consideration. In most jurisdictions, the content of a will is public information but the dispositions contained in a trust remain private, unless the trust is contested and becomes the subject of litigation. In at least several states, however, a copy of the trust may have to be filed with the local probate court as an exhibit to the estate tax return filed for the deceased grantor's estate. Also, if the trust holds title to real property that is subject to a mortgage loan, the lending institution or the title company, or both, may require that a copy of the trust be recorded in the local county clerk's office. The trust also may be subject to public disclosure in the event creditors seek payment of the grantor's debts from the trust, or if the grantor files for protection under the bankruptcy laws.

These trusts are referred to in legalese as a **revocable inter vivos trust**. Such a trust can become revocable upon death. Living trusts are used primarily to avoid probate. They do not save on taxes. Living trusts are often set up in conjunction with a special type of will;

Pour-Over Will is a will that transfers property of the settlor at death to a trust. A trust must already be in existence to take possession of these assets. The will "pours over" assets to the trust by use of the probate transfer process. This type of will captures any assets that might not have been transferred to the trust during the settlor's lifetime.

One can also set up an **irrevocable inter vivos trust**. As the name implies, this type of trust is irrevocable. The settlor relinquishes all control over the trust once it is created. This type of trust is generally established for tax-savings purposes. When a person decides to move property to an irrevocable inter vivos trust they have two tax goals in mind;

-The removal of the income from the trust from their own taxable income.

-Any appreciation of the assets held by the trust will not be included in the gross estate of the settlor.

The economic cost as well as other costs must be taken into account before making such a transfer. This type of trust is of little benefit to individuals who have estates worth less than the current taxable threshold. Since the tax strategy affects relatively few members of the population, we will look at the pros and cons of the revocable living trust.

As stated previously, a person has the option of allowing their possessions to transfer either by the probate process or through a living trust when they die. For practical purposes a living trust is, and accomplishes the same goals as, a will. The living trust is one created during the settlor's lifetime that the settlor alone has the power to revoke. The difference between a trust and a will is that the trust is a present transfer of property rights subject to divestment by exercise of the power of revocation. On the other hand, the will creates only expectations. The basic advantage of a will is that it enables a person to settle the question of who shall succeed to their property after death without the trouble of parting with the property during their lifetime. The disadvantage is that with wills the testator's freedom of disposition is restricted.

An individual has the choice (while still living, that is) of allowing assets to transfer through the probate process or living trust at death. With probate, an executor approved by the court oversees transfer of assets. Living trust transfers enjoin a trustee appointed by the settlor to transfer assets through a living trust estate. The majority of estate legal work occurs before death this way. There are three basic funding variations to a living trust. Factors determining which funding method include health, age, extent of assets, and current family structure.

- Fully funded trust- All property interests in a client's name that would otherwise pass through probate are transferred into the trust during the person's lifetime.

- Partially funded trust- Only selected property is transferred into the trust. A good example is out-of-state property. This way, multiple probate in several states will be avoided.

- Unfunded standby trust- No property is transferred into the trust at the time of the trust's creation. It is available for funding at a later date.

Funding is accomplished by the transfer of assets to the trust. To fulfill probate avoidance goals, property must be titled in the name of the trust or otherwise identified with the trust pursuant to state law. Remember, living trusts do not in themselves save estate taxes. The primary purpose is to avoid probate.

The revocable trust can be a useful estate planning device. Use of a revocable trust rather than a will as the primary dispositive instrument should be carefully considered. An attorney should always be consulted and the use of a trust analyzed on a case-by-case basis. In certain complex situations involving substantial assets the tax laws can favor a will over a revocable trust.

Potential Problems- The revocable trust can contain provisions taking effect at death that in fact save taxes; the marital deduction, the charitable deduction, and the federal unified credit. The same tax-savings can also be contained in a will. Although there is no gift tax on transfers of property to the trust, there will be administrative and legal expense involved. The transfer of title into the trust may cause problems down the line. If a grantor wants to refinance their home, lenders or the insurance company might insist that title be in the name of the borrower. If a trustee is someone other than the settlor, separate income tax returns must be prepared and filed for the trust, an added expense. In most states, there is a statutory legal fee for the settling of estates. Normally this amounts to one or two percent of the estate. Now, on a $5 million estate that is a substantial sum of money. Often times attorneys will agree to a basic hourly charge that will end up less than the statutory fee. On estates of $100,000 or 200,000 (still a <u>big</u> estate by most folks' standards), the marginal differences between probate fees and costs of a trust may not make it worth the time to establish a trust. Once again, the economic benefits must be considered on a case by case basis.

There is some debate as to whether or not a revocable trust is harder to upset than a will. Duress, fraud, incapacity are the same grounds to contest as with a will. One thing is certain; a trust can more readily provide the primary beneficiary with the funds necessary to fight any sort of incursion. There are other drawbacks for living trusts;

♦ Protocol in operation- In operation of a trust, the formalities of operation must be observed <u>and recorded</u>. All the t's must be crossed and the i's dotted, so to speak. Many people do not find it difficult to maintain accurate records of proceedings they attend. Just as many more have a difficult time recording notes of any meeting, no matter how important. Accurate records must be kept for the trust for legal as well as tax purposes. Time and effort must be expended to do this.

♦ Gifts- Care must be taken in the method of distribution from the trust of any gifts utilizing the $13,000/year (for 2009, increasing over time) exclusion. If not done correctly it may be included in the grantor's estate.

♦ Borrowing money- Whenever financing is required, and the grantor wants to use living trust assets as collateral, the lender will require special steps be taken. Most likely the bank will require the property be transferred back into the name of the trust grantor. If not, the bank will have a more difficult time in attaching the assets in the event of default.

♦ Claims against creditors- A revocable trust avoids probate. One of the purposes of probate is to identify and pay the creditors of the deceased. Many months or years after the fact the creditors may become aware of the existence of the trust. The creditors may have the option of seeking remedy against the trust beneficiaries, even if the trust assets are depleted or the beneficiaries were unaware of the indebtedness.

♦ Cost of setting up the revocable living trust- Just the title of the document clues you that a lawyer's gonna be involved! Proper transfer of property into the trust is a necessity. There is going to be an initial expense involved in the correct drafting and funding of a comprehensive trust agreement.

♦ In the event of divorce- With testamentary disposition, legacies to a spouse are nullified in the event of a divorce. Such is not the case with a revocable living trust. A trust must be amended to terminate provisions for an ex-spouse under common law. This is a big problem if the grantor is rendered *non compos mentis.*

♦ Memorandum disposition of personal property- This type of disposition is effected by a will with permissive language. Personal property can be distributed without incurring any legal fees. Most states do not allow revocable living trusts to incorporate such a provision. The problem is easily remedied with a pour-over will incorporating such a provision. A revocable living trust should always be accompanied by such a will. If it is not, more costs will be incurred after death.

♦ Loss of probate estate- This tax planning strategy is lost to the extent that property has been placed in a living trust. With proper planning, the payment if income tax of an estate can be delayed by the timely distribution of assets from the probate estate to a trust and ultimately to a beneficiary. Congress has been moving towards equal treatment of estates and trusts from a tax perspective (see chart). This ability to put off paying taxes is lost without a probate estate. For many people the tax differences may be inconsequential. Still, there may be other tax issues that affect the estate. For example, a revocable living trust may be limited to holding subchapter S corporation stock for two years after the death of the settlor while a probate has a different or no limit. All tax strategies affecting trusts/estates should be discussed with a tax attorney or accountant.

♦

Advantages- One of the most forceful reasons for the use of the revocable trust is the orderly and expeditious management of a senior citizen's affairs. This also applies to anyone who might become unwilling or unable to manage their own affairs. The trust grantor can manage their own property with the help of a co-trustee. With the onset of incapacity, the co-trustee steps in without fanfare or further legal wrangling. The grantor receives the benefit of the trust income without the problems associated with overseeing the trust.

Federal Income Tax Rates for Trusts and Estates (Revised 2013) Uniform and Condensed Table for Estates and Trusts			
If the taxable income of the estate or trust is:			
Over-	But Not Over	The Tax is:	Of the Amount Over-
$ -0-	$2,450	15%	$ -0-
2,450	5,700	$367.50 + 25%	2,450
5,700	8,750	1,180 + 28%	5,700
8,750	11,950	2,034 + 33%	8,750
11,950	---	3,090 + 39.6%	11,950

It should be pointed out that the same purpose can often be achieved by the use of a durable power of attorney. Some states permit what is called a “springing” power of attorney. It takes effect when incapacity arises. The drawback here is that the Attorney-in-Fact is not allowed as much leeway in management of assets as a trustee. Many banks and brokerage houses are leery of powers of attorney unless it is on a specific form. Also, a power of attorney generally terminates at death of the creator. Assets under the control of the Attorney-in-Fact will have to go through probate.

There are other reasons to use a revocable trust as part of the estate planning process. The reasoning and strategies vary from state to state. For example, in Illinois, Connecticut, Michigan, Ohio, and Florida (all common law states) the revocable trust can be used to bar the grantor’s surviving spouse from obtaining a statutory share of the property under trust at the grantor’s death. In other situations a revocable trust can be employed to select a jurisdiction with favorable statutes to govern the disposition of assets. This happens when the law of the state where probate will occur has less favorable laws. Situations where this would apply would include the operation of the grantor’s business or concerning their creditors' rights. Other advantages that accrue to the living trust include the following;

Privacy- The grantor has the advantage of not going public with the information surrounding the trust. The assets placed in the living trust are not a matter of public record as with probate. If anything, proposed legislation will increase the privacy of living trusts.

Segregation of Assets- Trusts can be used to box out one or more groups of assets. If one spouse has assets from inheritance or a previous relationship, these assets can be kept separate from any that might be co-mingled with that of the current spouse.

Time and cost factors v. probate- Although there may be arguments to the contrary, proponents to the creation of living trusts maintain that, in the long run they are less expensive and less prone to delay than probate. Note that this is exactly the same argument used as a “disadvantage” to the use of revocable living trusts. This illustrates the fact that estate planning for individuals needs to be addressed on a case-by-case basis. The value of assets being considered as well as the make up of the family structure are important considerations.

Unaffected by Incapacity- The revocable lifetime trust avoids the necessity of a court declaration of incompetence and the management of the assets by a court appointed guardian or conservator. If the trustmaker is the trustee, the trust can provide that someone else takes over management during the period of incompetence. A power of attorney is automatically revoked upon the settlor’s incapacity.

Hard to Attack- The revocable trust is less vulnerable to attack by discontented heirs. A will can be challenged by kith and kin with “relative” ease. Even a legal challenge based on absurd logic is expensive and time consuming to deal with for the executor. Of course, a revocable living trust can also be attacked. The trust assets are not tied up in court like the assets under will.

Management Uninterrupted by Death- Assets such as real estate and securities can continue to be managed by the trust after the death of the settlor. The interruption in management of trust assets is avoided with this method of asset transfer. No delay is encountered in use of the assets by survivors of the deceased.

Probate Avoided in Other States- Frequently a person may own property in more than one state. Use of a living trust can remedy the problem of probate in multiple states. It is important to determine if the laws in the state where the real estate is located allow a trustee from another state to transact business on behalf of the trust as a non-resident.

Tax Advantages- During the life of the grantor of the trust, income generated by trust assets is taxed the same as other grantor income. Gift tax is not payable when property is transferred into a trust. Property in the trust is included in the grantor’s estate for federal estate tax purposes at death. The trust becomes irrevocable after death. Tax advantages available to the testamentary trust are then made available to the living trust.

Insurance Trusts

As we have just seen, trusts can be classified in many different ways. They are classed by purpose, by method of creation, or by revocable v. irrevocable. The use of a trust for the disposition of life insurance proceeds is a relatively new development. Life insurance trusts are becoming an important part of the estate planning process. For example, an individual can transfer ownership of a life insurance policy to a trust with a child as the beneficiary. The transfer is considered a taxable gift. Any gift tax on the transfer is minimal when compared to the advantage accrued from the proceeds of the assigned policy not being included in the grantor's estate. This is assuming all incidents of ownership are relinquished.

Many times, a trust of life insurance proceeds is combined with a trust of other types of property. This is the pour-over method of implementation of the estate plan. The testament directs the executor to collect all probate assets, pay all debts and taxes, and then pour over the remaining assets into a trust.

An irrevocable trust is similar to a corporation. It is a separate entity, distinct from the person creating it. The method of creation of the trust is the transferring of ownership of a life insurance policy from the insured to the trust, the new owner. The driving force behind creating an irrevocable life insurance trust is to reduce death taxes. The proceeds of the insurance policy will (hopefully) be removed from the grantor's taxable estate. The idea is that the trust owns the policy so the proceeds are not included in the decedent's estate.

A trust will pay the premiums on the policy. This avoids the problem of relying on another person to pay. The policy may lapse due to non-payment of premiums or the third party may take a notion to cash in the policy. The trust could be directed to keep the policy in force so long as the grantor is still living. Enough controls can be exacted through a trust that a grantor will feel secure in the fact that the policy will remain in force as it was originally intended. Strict requirements exist for implementation of life insurance trusts. In order to achieve estate tax savings the life insurance trust has to be irrevocable. Retention of the right to revoke the trust results in the insurance being included in the taxable estate. The grantor cannot be the trustee, this position must be held by a third party. An insurance trust must have been established at least three years before the death of the grantor. Otherwise, the proceeds are includible in the settlor's taxable estate. The trust is deemed non-existent for estate tax purposes.

In accordance with the trust agreement, the trustee is the owner of the insurance proceeds but the ultimate beneficiary is the equitable owner of this sum of money. Under a trust arrangement, the relationship between a trustee and the beneficiary is that the trustee is the legal owner of the trust property and the beneficiary is the equitable owner of the property.

Kinds of Insurance Trusts

There are two basic sorts of living insurance trusts; business and personal.

Personal Insurance Trusts; These are established by an individual without conditions. It will be used for the benefit of family members, close friends, or a charitable cause. One spouse may establish a revocable insurance trust for the benefit of the other. The trust assets, consisting of the insurance policy, is payable to the beneficiary, the trustee, for the benefit of the other spouse.

Such trusts may be funded or unfunded. It is funded when the trustee is provided the money with which to pay the life insurance premiums. Unfunded trusts do not charge the trustee with the duty of paying the premiums. The settlor, or grantor, pays the premiums.

An objective of the personal insurance trust is the consolidation of the testator's insurance estate. There are many examples and anecdotes of an insured having several life insurance policies in force, often with different insurance companies. These policies were 'accumulated', perhaps over several decades, for varying personal reasons and with different beneficiaries. The personal insurance trust allows the grantor to merge these policies in a trust under a single administration for the purpose of distribution to legatees.

Such a trust also allows a modicum of flexibility with regard to the evolving needs of the grantor's heirs. The policy purchaser bought the policy with some specific need in mind. With a trust in place, the trustee can address changing family needs and emergencies. College tuition, hospitalization, protection against spendthrifts and inflation are examples of situations that can be addressed by placing insurance proceeds in trust. When the trustee is an experienced financial professional, the family will be beneficiary of the advice offered on matters pecuniary. Of course, a personal insurance trust is used to avoid estate taxes. Insurance proceeds payable directly to the deceased's estate are taxable. The proceeds going to the trust are not included in the gross estate. Also, Proceeds placed in trust are protected from the claims of creditors, if the trust is structured correctly. As with all estate planning vehicles, the advice of legal and/or tax experts should be sought before any plan is put into effect.

Business insurance trusts; This type of trust is established for business purposes. Someone with an interest in a business originates the trust with the goal of facilitating the smooth transition of the business upon the death of the business owner(s). Key man or key person insurance would be an example of such an arrangement.

Jane is the Chief Operating Officer of Six-side Bolt Company. The company creates a key person insurance trust by purchasing insurance on Jane's life and placing it in a trust. Language in the trust agreement outlines the disposition of the insurance to the business when Jane dies.

The purpose of the business insurance trust is to ensure smooth succession in the business interest. This would apply to any form of business ownership, be it a proprietorship, partnership, or corporation. A trust with life insurance is established in order to make sure that the plan of succession is carried out in an effective manner.

The design of the business insurance trust is to give the trustee the power to enforce the business intent of the trust's creator. If the trust was created to provide for the disposition or transition of ownership of a small business when the owner dies, the trustee carries out whatever duties are necessary to that end. Of course, the desired goal could be reached without the trust being in place. The trust is there to minimize problems along the way. It is a means of facilitation of the desired business goal with the trustee acting as a third party arbiter settling the business estate in accordance with the trust agreement. Emotional, ego, or personal conflicts are avoided that could arise with the task being carried on by a family member or business associate.

Rights and Duties with a Policy in Trust- As with any other scenario involving insurance, the policy owner has specific rights under the policy. This includes the right to assign the policy, name or change the beneficiary, and to select the dividend options. So, if the policy owner as settlor decided to take a cash value loan on the policy the face value is reduced by the amount of the loan. This may or may not affect the trust arrangement. The rights of the named insured or policy owner may be limited by the trust agreement. Such rights and duties must be accurately spelled out in the agreement. The trust agreement must also name the party responsible for payment if the insurance premiums. When dealing with an unfunded agreement, the trustee is relieved of this responsibility and the premiums become the duty of the grantor. If funded, the premium payments are paid by the trustee and the grantor provides the money to the trust for the payment of the premiums. If the trustee breaches this duty and the policy lapses, the trustee could be held liable for the omission.

After the grantor's death, the policy proceeds are exempt from all forms of federal income taxation. When the policy is paid in installments, the interest portion of the payment is taxable income to the recipient. The proceeds of an insurance policy are exempt from state income tax in most states.

A fiduciary relationship exists between the trustee and booth the grantor and heirs of the grantor. The trust agreement will specify the precise nature of these duties. When the death claim is made, the trustee's duty is to collect the insurance proceeds on behalf of the trust. The trustee has the same rights in this capacity as any other beneficiary. In the event the claim is contested, the trustee is empowered by the trust to pursue collection of the money through legal channels. Even if the trust is funded, it is doubtful there would be resources for a protracted legal struggle. For this reason the trustee should have the authority to solicit funds from heirs, banks, etc. in order to pursue the claim.

The policy proceeds can be used to purchase annuities for the survivors if the trust so authorizes. This may be needed with personal insurance trusts to keep the money from dissipating rapidly. The trust agreement can give this authority to the trustee. All or part of the proceeds could be used in this manner, if it is the best interests of the beneficiaries. As with any other beneficiary, policy options can normally be exercised by the trustee as seen fit. If the trustmaker does not want to use any of the insurance company settlement modes, this desire can be stated in the trust agreement.

Irrevocable Life Insurance Trust- The purpose of this type of life insurance trust is to shift ownership of property to another generation. This strategy reduces the value of the gross estate for the grantor. It also provides cash for expenses related to the estate as well as for the benefit of heirs. Once the settlor creates an irrevocable life insurance trust all ownership and control is waived. In other words there are no incidents of ownership. The trust's assets are excluded from the grantor's estate. The mechanics are simple; The policy or policies are placed in trust as a gift. After the trust has been set up premium payments periodically will be required. The insured/grantor makes gifts of cash to the trust as needed to pay the premiums.

Policy Value- The transferred life insurance policy is taxable at less than the actual face value of the policy. When transferred as a gift, it is subject to gift tax based on the policy's presumed terminal reserve value. This will normally be the same as the cash surrender value of the policy. To qualify as a gift of present interest and receive the $14,000 (for 2014, increasing over time) gift tax exclusion, the trust assets must be a gift of present interest. As a result, the Crummey withdrawal privilege must be provided. The situation can be turned around so that the trust assets become gifts of future interest. This happens if the beneficiary, or donee, permits a lapse in their right to transfer assets out of the trust. To the extent that lapse of this right exceeds the greater of $5,000 or 5% of the trust assets means that a gift of future interest has been created and a taxable gift exists.

When the grantor makes a gift of an existing life insurance policy to the trust and then dies within three years of the transfer, the value of the proceeds is included in the donor's gross estate for tax purposes. In cases where a new policy is used, the donor has no residual incidents of ownership. Specifically, the trust purchases a new insurance policy on the life of the would-have-been-donor. This person never exhibits any incidents of ownership and death benefits are not included in the estate even if the grantor dies within three years of creation of the trust. To avoid problems, this is the recommended method of setting up a policy in trust. The reality is that health problems may preclude or drive up the cost of purchase of a new policy by the grantor. Transferring a policy is the only option. In such a case the economic decision must be made concerning the cost of premiums on a new policy (if available) as opposed to the potential expense of estate taxes.

Tax issues also relate to the so-called **generation skipping transfers (GST)** to a person two or more generations younger than the grantor. Transfers like this may be the subject of estate or gift tax levy. Gifts subject to the Crummey withdrawal privilege cannot pass through the grantor's generation without incurring GST taxation. Gifts of life insurance or cash to pay life insurance premiums go tax free to the next generation if the grantor makes the gift using their own unified transfer credits. Some of the generation skipping exemptions must be allocated to the gifts. Up to $1 million of generation skipping exemptions can be used by each grantor. It can be used for transfers to grandchildren or the trusts that contain assets that will pass to grandchildren.

Other Trust Vehicles

There are myriad other types of trusts. Many are beyond the scope of this book. Presented here are several with their subsequent summarization. Some may be discussed in greater detail elsewhere in the book.

Qualified Domestic Trust- This is a variation of the QTIP trust used when one spouse is a noncitizen of the U.S. and the ultimate aim is to defer payment of estate taxes until the death of the second spouse.

Dynasty Trust- Benefits for successive generations is provided without the initial payment of gift, estate, or generation-skipping taxes. Funding is created to take advantage of the $5 million (for 2014) estate exemption equivalent. At some point however, federal and state taxes must be paid. This is a tool for people with unique, high value assets. The distribution of principal and income can take place over several generations.

Discretionary Trust- The trustee is allowed to parcel out income and principal among various beneficiaries and to control the disbursements as they see fit.

Trusts for Tax Savings- This is illustrated by the generation skipping trust (GST). This is a way for families to defer the payment of taxes until the advent of a successive generation. Up to $5 million can be passed this way. Taxes will most certainly have to be paid one day. The family is banking on the fact that the assets in trust can be put to work and generate more money now than would be the case if up to 50% were paid right away in the form of estate taxes.

Chapter 3 What Older Americans Need to Know

Estate Planning Pointers for Senior Citizens

A thousand years are… but as a watch in the night Psalm 90:4

When people come to the end of their watch, two things need to be accomplished: First of all, acceptance of that fact; second, keeping up with their affairs on earth so that a smooth transition of assets can be accomplished to the next generation. Item one is beyond the scope of this book, but the second goal is all about estate planning. We devote space to the needs of senior citizens because they are unique when compared to the needs of younger citizens.

Advance planning is the key to the orderly transfer of property at death. It is only natural that many people put off any type of planning as a form of denial. When the problems of old age set in, rational thought to produce a logical and economical asset transfer scheme may no longer be possible. Health problems can wipe out a lifetime of savings quickly, leaving a person with nothing for themselves, much less to pass on to the next generation. Mental and physical deterioration causes a loss of control over the person's life. Government programs available to those 65 and older can be used to the senior's advantage in conserving wealth. Medicare supplement insurance and long term care coverage are two other topics that must be addressed in planning for senior needs.

The Talk Families Must Have

When parents get older, burdens, blessings and batons are passed on to the children. The younger generation gets a chance to take the helm and, over the years have (hopefully) absorbed the accumulated wisdom of the older folks. They too will have to pass this on one day to a succeeding generation. The blessing for many people is the chance to inherit some of the wealth built up by the previous generation. This will allow them to be a little bit ahead in the game of life as far as assets are concerned.

The burdens falling on far too many people these days are the time and expense of caring for seniors who lose their health and well being. Perhaps the parent did not know or did not care that health habits followed when younger will affect a person in old age. Maybe an environmental or work related malady, over which there was no control, caused health problems for the senior. It could be that the senior's idea of financial planning consisted of playing the lottery or going to Las Vegas on a regular basis. Whatever the reason, the children (fast approaching middle age themselves) find they must tend to parents as well as their own children.

It is never too soon for adult children to start talking with parents about the need to plan for the contingencies of old age. If this talk never takes place, the children will be in a scramble when the parent dies. Looking for wills, insurance policies, titles to property and the like to avoid squabbles concerning who gets what from the estate. More to the point, they will not have the basic instruments necessary to protect the parent's interest if they are unable to act for themselves.

It is generally agreed that four things are needed to assure a smooth transition when a parent dies or becomes incapacitated; a will, a durable power of attorney, a health care proxy and a schedule of assets. Many experts feel that the preparation of a durable power of attorney is the most important step in this process. The document allows children to sign tax returns, transfer assets, and make financial decisions when a parent becomes incompetent. Wills are of no help here. Keep in mind that basic life insurance doctrine teaches that a person is six times more likely to become disabled than to die.

Parents often do not want to give power of attorney to the children too soon. There is a fear of abuse. Money may be spent or unwise decisions made. A method of avoiding this pitfall is to leave the durable power of attorney with a lawyer or other agreed-upon third party until the appropriate time comes. The durable power of attorney lapses upon death. For this reason, it is important that the will be available take over at that time.

Another critical item is a health-care proxy. A parent can delegate the right to make health-care decisions with this document. Laws are different in each state, but often a living will is incorporated into the document, describing specifically the measures that are acceptable to the parent to prolong life. We will look at these issues further along in this chapter.

The list of assets and where they are located is important for obvious reasons. Once the parents are gone, it takes a tremendous amount of work to reconstruct the family assets without any standards with which to operate. In this electronic transfer age, it's difficult to imagine finding valuable stock certificates socked away in the attic. More commonly, it is hidden jewelry, bullion, or wads of cash that are hidden away and found years after the parent's death. When scheduling out assets, it is always a good idea to record the purchase date and price as a cost basis for tax purposes later.

Retirement Issues and the Estate

When an individual retires, they are normally entitled to social security benefits. They may also be due benefits from military service, public or private pensions, or other retirement programs. Retirement planning and estate planning are two different topics, but they are related. Often, a surviving spouse has rights under a pension plan that will allow a comfortable standard of living. The opposite could also be true, with no income stream or not enough to take care of the surviving spouses' medical expenses. Life insurance purchased for the wage earner may be the answer if the stream of income is going to stop. These variables need to be taken into consideration when deciding what to do with an estate.

Senior citizens are the fastest growing segment of the population. A discussion of their needs includes the topic of estate planning. When a person turns 65, they automatically become eligible for the Medicare program. Part of the Social Security tax is the prepayment of Part A of Medicare. The retiree will normally enroll in Part B of Medicare. A premium is paid for Part B on a monthly basis, normally being deducted from the Social Security payment itself. The Medicare program includes deductibles, copayments, and certain excluded procedures. It does not cover all medical expenses, there are some gaps.

A large hole in the Medicare program is the lack of adequate nursing home coverage. Less than 3% of all nursing home expenses are paid by Medicare. Time in the nursing home can jeopardize the value of an estate. The nursing home expenses are paid out of pocket by the senior citizen. Because of the potential financial impact of health related expenses, total estate planning should give appropriate attention to this issue.

The 21st century finds many people living longer and healthier lives. At the dawn of the new millennium, the population over age 65 exceeded 35 million. They walked many different paths in life, but one thing seniors have in common is a continuing need for medical treatment. This need can only increase as longevity increases.

Premature Death

An important estate planning consideration concerns the premature death of the breadwinner. When he/she dies before becoming eligible for retirement benefits, do any benefits go to surviving children or the spouse? How much? How long? Answers must be available to these questions as a part of the estate planning process. It is important for married couples to know what rights a surviving spouse has to the deceased's retirement plan.

Social Security will make payments to a surviving spouse and minor children. This may not be the case with private pension plans. No law requires employers to offer pension plans. If they elect to do so, the Employee Retirement and Income Security Act (ERISA) requires that pension plans explain eligibility for coverage. The plans do not have to include all workers,
but they cannot be set up to benefit only the highest paid workers or some other select group and still have tax advantages. Every company must have a plan administrator to explain the plan and who is eligible. A summary plan description must be made available to explain how a plan operates. ERISA requires that all plan participants be given a plan summary within 90 days of the date that a person starts participating in a pension plan. The plan summary should contain the information pertinent to survivors' rights to pension payments under the plan.

Social Security

Here is the economic definition of social security: A system of government-financed income transfers designed to effect a distribution of income considered desirable. The main component of most social security systems is welfare benefits, given to those in poverty. It can be done two ways: 1.) by identifying groups that are likely to be poor (the unemployed, the elderly, and the disabled), and giving benefits to them irrespective of their actual income; 2.) by identifying, through some sort of standard, people who are poor.

The Social Security program in the United States is an offshoot of option one above. It is officially called the Old-Age, Survivors, Disability, and Health Insurance (OASDHI) program. Almost 95 of 100 workers are employed in occupations covered by Social Security. There is continued worry that this vast program will eventually run out of money. Still, it keeps on making regular payments to millions of Americans and will (hopefully) continue to do so. The political and economic fallout from a collapse of Social Security is almost unimaginable. The program usually begins payment at age 65, but starts at earlier ages for blind or disabled people. The earlier benefits are at a reduced rate.

The idea of social insurance began in the early part of the Industrial Revolution. With technological change, the European population shifted from reliance on agricultural economies to capital intensive economic systems. People moved from the countryside to the city. This caused basic social change: People were no longer self sufficient, they could not live off the land. Family members lived far apart, in different cities or in the countryside and could not rely on one another other for help. Business cycles caused prolonged periods of economic depression unrelated to the natural calamities (flood, fire, famine, etc.) with which the human tribe had historically dealt.

These natural phenomenons could be suffered through, explained away, or accepted stoically by human kind. The new conditions could not. Economic insecurity, distressed conditions, low wages and unsanitary living conditions helped lead to the appearance of the socialist philosophy. Do not confuse the concept of social insurance and the doctrine of socialism. Socialism is a doctrine that seeks to place in the hands of the people, directly or through their government, the ownership and control of the principal means of production and distribution.

The old Soviet Union said that their brand of socialism was a step on the road to Communism. Lenin taught that eventually the state and then the dictatorship would wither away once Capitalism was stamped out. Democratic socialists in the West always described the Communist system as neither socialistic nor democratic. It was state capitalism. Neither the state nor the dictatorship showed any signs of withering away; rather it was killed off by economic stagnation.

Many scholars think that the concept of social insurance was a response to socialism. Chancellor Bismarck in Germany was the first to initiate laws concerning social insurance in the 1880's. The general ideal of social security includes the right to a job, to fair pay, to sufficient food and clothing, adequate shelter and medical care, and protection against poverty in old age.

As high-minded as these goals may sound, people today have begun to question whether the government should be in the business of supplying limited entitlements for which there is an unlimited demand. Do such programs create a social safety net? Do they create a new aristocracy made up of the poor, the infirmed, the disabled, and the senior citizenry riding on the backs of a heavily-taxed working and middle class?

The Great Depression of the 1930's caused a break with past U.S. political philosophy. Previous to this time each person, each family, had a duty to take care of its own financial security. The shift from farm to city living resulted in economic interdependency. The Social Security Act of 1935 marked the beginning of society's acceptance of the responsibility of interdependency. The government would now accept some of the responsibility for the provision of individual economic security. The key word is 'some'. The original concept was that social security was to be a floor upon which individuals were to build further economic savings.

Not a Public Assistance Program

Public assistance, or welfare, is one type of solution to social and economic problems. It is not the same thing as social insurance. They are both 'transfer payments' in economic terms. The government takes money from one group, the taxpayers, and gives it to another. Insurance operates on the principle of transferring money. Dollars are taken from all exposed to a potential loss and given to the few who experience the loss. Social insurance is not a public assistance program.

In an insurance program, recipients of compensation have paid a price for it. No such payment is expected of welfare recipients. People who receive social security benefits do make contributions for the benefits they receive, the same as any insurance program. The difference is, for low-income groups, social security benefits are disproportionately large relative to their contributions. Social security recipients do not need to demonstrate financial need to receive benefits. This is another difference between social security and public assistance. The richest contributor is entitled to benefits as well as the poorest.

Some aspects of social security resemble a welfare program. The total amount of survivor benefits a family receives after the death of the breadwinner is determined by the number of dependent children as well as the amount of social security taxes paid. In this case, the greater the need, the greater the benefits. This is an example of groups receiving more than their actuarially fair share of the benefits. For the most part, Social Security benefits are paid when they are earned regardless of need. Public assistance program's principle (if not the practice) is that no benefits are paid when need is lacking.

Not Quite a Private Insurance Program

There are important differences between a private insurance program and one operated by the state;

- With few exceptions, participation in social security is compulsory. Free choice guides decisions on private insurance purchases.

- Social security benefit levels are predetermined by law. With private insurance it is a matter of choice.

- The tax levying authority of the government backs up the social security program. It operates on a self-supporting pay-as-you-go basis. Private insurance must meet solvency requirements and be fully funded at all times. A private insurer could be liquidated and its liabilities could be met. This type of solvency has never been contemplated for the social security program.

- Social security benefits can be changed by legislative action. Private insurance agreements are contractual in nature and benefit changes require agreement by both parties.

A Unique Form of Insurance

Social security is social insurance administered by the federal government. The major perils covered by social security include premature death, disability, outliving income and medical care for the elderly. Private insurance protects against the same perils. As with any insurance system the costs of the perils are transferred from the few who experience them o all who are exposed to them. The system uses the pooling technique of combining similar exposures to loss and then applying actuarial principles to predict losses in the future. When losses are accurately predicted in advance of occurrence, the system can be operated on a financially sound basis, even though it is not fully funded.

Differences between the Insurance Industry, Public Assistance, and Social Security

	Insurance Industry	Public Assistance	Social Security
Benefits can be changed	no	yes	yes
Mandatory program	no	no	yes
Supported by general tax revenues	no	yes	no
Program fully funded	yes	no	no
Actuarial prediction of losses with cost transferred to all covered	yes	no	yes
Value of benefits based on ‘need’ of recipient alone	no	yes	no
Benefits funded by recipient	yes	no	yes

Social security benefits fall into four broad categories;

- Retirement Benefits
- Survivor Benefits
- Disability Benefits
- Medicare Benefits

Social Security and Estate Planning

As related to estate planning, the social security program extends benefits to various classes of family survivors of covered wage earners. Payments are not based on the earnings record of the survivors. It cannot be stressed enough the importance of these benefits. It is the responsibility of the breadwinner’s survivors to take maximum advantage of the benefits offered. The reality is that for the vast majority of Americans estate planning consists of applying for social security benefits. The U.S. has an abysmally poor savings rate. For whatever reason, most people live beyond their means. A somewhat larger share of the population can expect both social security benefits and a life insurance payment upon the death of the breadwinner. This is a step in the right direction. The public needs to begin planning. Conservation of a few dollars can result in peace of mind and a more comfortable situation for survivors upon death of the breadwinner.

The benefits available to survivors of covered wage earners are listed here. These benefits are payable regardless of the earnings record of the beneficiary;

- When the deceased spouse is over 65 at death, a widower or widow who is 65 or older receives 100% of the deceased spouse's Social Security benefits. If the surviving spouse is between ages 60 and 65, there is a reduction in benefits. Remarriage after age 60 has no effect on the benefits. A surviving spouse is not permitted to receive double benefits, both on the basis of the deceased spouse and because of their own Social Security contribution. The surviving spouse can choose the largest payment.

- Unmarried children up to 18 (or 19, if attending high school full time) receive benefits.

- Children disabled before age 22 can get benefits for as long as they are disabled. This program is beneficial to parents with a mentally or physically disadvantaged child who will need continuing lifetime care.

- Divorced widows or widowers, if the marriage lasted at least ten years, receive payment for life. It's possible for both a surviving spouse and an ex-spouse to collect Social Security based on the same deceased wage earner. A divorced widow or widower can receive full benefits at age 65, and reduced benefits from age 60.

- Under certain circumstances, grandchildren, great grandchildren, and dependent parents age 62 or older may be eligible for payments.

- Social Security pays one lump-sum death payment of $255 to the surviving spouse or child eligible for benefits.

Keep in mind that people receiving survivor's payments and who earn income and are below 70 years of age may have the payments reduced if the earnings exceed a certain level. Also, the decedent's last monthly Social Security check must be returned. There is no prorated amount. Benefits are paid in arrears, that is, a month late. So if Mr. Jones dies on July 1, the check received in August must be returned.

Tracking Your Benefits

It is important that individuals keep up with their social security benefits during their working career. This way, a person can plan ahead based on data received from the Social Security Administration. The *my Social Security* personal online account is a valuable source of information beginning in the working years and continuing throughout the time a person receives his or her Social Security benefits. Go to the Social Security website (www.ssa.gov) to create a personal account. To create an account, a person must provide some personal information about oneself and give answers to some questions that only he or she is likely to know. Next, create a username and password that will be used to access the online account. This process protects confidentiality and keeps personal Social Security information private. **Note:** Individuals may sign in or create an account to access his or her own personal information only. Unauthorized use of this service is a misrepresentation of identity to the federal government and could subject the person gaining access to criminal or civil penalties, or both.

The benefit tracking feature should be included as a part of every person's financial planning. It is important for every wage earner to be aware of their position with regard to future benefits.

The Personal Earnings and Benefit Statement just reviewed are also available by mail. Due to ongoing budget issues in Washington, it is unclear what age group, how much longer and in what format an individual's benefits can be tracked by mail.

Medicare

In 1965 Congress added the Medicare program to social security. Medicare regulations are a maze within a maze. We will look at the broad outline of the program and how it relates to seniors and conservation of assets. Medicare is separated into two parts; basic hospital insurance benefits and voluntary supplementary medical benefits. Participation for Part A, Hospital Insurance Benefits, is compulsory. Items covered;

Inpatient hospital care- This is provided for up to 90 days for each 'spell of illnesses. Deductibles apply to this, and many other Medicare benefits.

Skilled nursing facility services-A patient must be hospitalized for at least three days for eligibility. Confinement must be for medical reasons, custodial care is not covered. A maximum of 100 days coverage is provided.

Home health care services- Visiting nurses, physical therapists, visiting nurses, and other health professionals provide these services. Part A covers an unlimited number of home health-care visits made under a plan of treatment established by the patient's physician. Again, custodial care is not covered.

Hospice care- Terminally ill beneficiaries are covered for up to 210 days if the care is given in a Medicare certified hospice.

Part B of Medicare is voluntary. It covers physician's fees and other related medical services. Mostly everyone in Part A is covered automatically under Part B unless coverage is voluntarily refused. Bart B beneficiaries pay a monthly premium usually deducted from Social Security checks. Aggregate monthly benefits amounted to $41.10 per capita in 1994. Of that amount, the federal government supplements a portion out of its general revenues. In 1992 (the most recent figures available), contributions from the federal government accounted for 72.3% of all Part B income. Enrollee premiums accounted for 24.6% and the remaining 3.1% was paid by interest on the trust fund assets. It obviously makes good economic sense-from the beneficiary's point of view-to enroll in Part B. It is a very good deal for them. Benefits include;

Physician's services- These are covered in the doctor's office, the hospital, and other places. Also covered are medical supplies used, the cost of the nurse, and drugs administered by the doctor.

Outpatient hospital services- Care, diagnosis, and treatment in an emergency room or outpatient clinic are covered along with lab tests and x-rays.

Home health-care visits- These are covered under Part B to the extent they are not covered under Part A.

Other medical and health care services- Items covered include diagnostic tests, radiation treatment, and certain ambulance services, prosthetic devices, physical therapy and durable medical equipment used at home.

Medicare Part D (outpatient Prescription Drug Insurance) is the part of Medicare that provides outpatient prescription drug coverage. Part D is provided only through private insurance companies that have contracts with the government- it is never provided directly by the government (like Original Medicare is). Part D is optional for most people; whether someone should take it depends on his or her current drug coverage and needs.

If Part D is desired, the individual must choose Part D coverage that works with his or her Medicare health benefits. If the covered individual has Original Medicare, a stand-alone Part D plan should be chosen.

Medicare Part C is not a separate benefit. Part C is the part of Medicare policy that allows private health insurance companies to provide Medicare benefits. These Medicare private health plans, such as HMOs and PPOs, are known as Medicare Advantage plans. If someone would like to, he or she can choose to get Medicare coverage through a Medicare Advantage plan instead of Original Medicare.

Medigap Insurance

Cost sharing, cost shifting, limitations on charges, exclusions mean that Medicare pays for about half of the medical expenses incurred by the elderly. This is especially true of the costs associated with custodial nursing homes. Most senior citizens purchase some type of Medigap insurance policy to supplement their Medicare protection. Insurers are required to have open enrollment periods of six months for beneficiaries who enroll in Medicare Part B. Beneficiaries 65 and older cannot be refused Medigap insurance or stuck with higher premiums if they enroll during this open enrollment period.

So as to avoid confusion and as a means of protection for senior who might otherwise be vulnerable to high pressure sales tactics, Medicare supplement policies are regulated by federal law. Ten standard Medigap policy formats were developed by the National Association of Insurance Commissioners. There is a basic core policy with extra tacked on to the more comprehensive policies. The policies are designated A through J and the letter designation cannot be changed in sales literature.
Medigap insurance exists because five major categories of expenses remain unmet under Medicare. They are;

- The deductible and coinsurance provisions. They change on a regular basis and can add up to a large amount.

- There is a 90-day limit on hospital stays for each ‘spell of illness’ along with a 60-day lifetime reserve.

-Physician’s bills that overrun the value of Medicare reimbursement.

- Health care expenses that are not contemplated by Medicare. This includes prescription drugs, dental care, eyeglasses, and hearing aids.

- Long-term care coverage is not adequate under Medicare. Types of conditions and the number of days covered are limited. Plan participants afflicted with a chronic disease or mental debilitation requiring a number of years of nursing home care are not covered by the Medicare program.

About 70% of people eligible for Medicare have purchases some form of private insurance to cover the outside expenses. Normally such policies cover the first three items listed above. Supplemental insurance can also have caps and gaps. This is especially true for long term care, the biggest consumer of resources for infirmed seniors.

Long-Term Care

Americans are living longer. This fact, coupled with Medicare's limitations, means resource-depleting perils lie ahead for people making wrong decisions or assumptions concerning long term-care. Many are under the impression that private insurance or the government will somehow fund their long-term care needs. Here are some particulars that need to be considered;

-Two of every five (about 40%) people 65 or over will need long-term care.

-Private as well as Medicare insurance is limited in what may be paid for nursing home care.

-Average stay in a nursing home is 2½ years

-About one-half of people entering nursing homes will spend their entire net worth before death.

-70% of married couples now 65 will have at least one of the spouses entering a nursing home.

-Around 33% of people over 65 have a mobility impairing disability.

-Surveys show that, among seniors, financial planning for long-term care is one of the top priorities in saving for retirement. However, the majority of those surveyed have no contingencies for nursing or long-term care while almost half never heard of long-term care insurance.

Everyone has heard of the go-go, slow-go, and no-go system of classification for retirement communities. Knowing the services provided and which one is right for a particular family member is a different matter. To conserve assets, to protect the loved one, to avoid problems in the future it is important that planning be in place for long-term care. Integral parts of the long term care plan are documents that spell out your wishes for that time when a person is still alive, but unable to think or act for himself.

Power of Attorney

This is an instrument in writing by which one person, as principal, appoints another as his agent and confers upon that person the authority to perform certain specified acts or kinds of acts on behalf of the principal. The primary purpose of a power of attorney is to evidence the authority or the agent to third parties with whom the agent deals.

The time may come when a person can no longer make decisions due to illness or mental incompetence. At such times someone you trust should be given the right to act for you through a power of attorney. In times past the power of attorney lapsed when the issuer lost their mental capacity. This situation led to the development of the durable power of attorney. The power of attorney is ‘durable’ if it has specific provision stating the authority of your agent continues despite the principal’s ensuing disability or incapacity. It remains enforceable no matter what a person’s mental condition. Powers of attorney become void upon death. They cannot be used to make testamentary dispositions.

The power of attorney gives another person the authority to conduct your business and financial affairs. When you name your son or daughter as agent, they have permission to sign your name pursuant to the terms and conditions of the power of attorney. What authority can be granted to the agent? The scope of authority can be limited to specific dealings or it can be broad enough to cover anything you do. In many states the durable power of attorney allows the agent to carry on a **statutorily** prescribed list of activities, which can be added to as seen fit. For example, Mr. Jones may want to specifically state that his daughter has the authority to make gifts of his property. This way, the annual per spouse gifting of $13,000 (for 2009, increasing over time) per person will not be impaired because a person is incompetent or ill.

The purpose of the power of attorney is to avoid the need for a court-appointed trustee. It is simpler and less expensive. Obviously, the potential for abuse exists so an agent who is completely trustworthy must be chosen. The power of attorney is subject to written revocation. An example of a statutory power of attorney form is shown below.

STATUTORY POWER OF ATTORNEY

SAMPLE

Notice: *The powers granted by this document are broad and sweeping. They are explained in the Uniform Statutory Form Power of Attorney Act. If you have any questions about these powers, obtain competent legal advice. This document does not authorize anyone to make medical and other health-care decisions for you. You may revoke this power of attorney if you later wish to do so.*
You may have other rights or powers under state law not contained in this form.

I,__________ , of the County of __________, State of ________, appoint _______________, of the County of _________, State of ________, as my agent (attorney-in-fact) to act for me in any lawful way with respect to the following initialed subjects:

To grant one or more of the following powers, initial the line in front of each power you are granting. To withhold a power, do not initial the line in front of it. You may, but need not, cross out each power withheld.

Initial;

________ (A) Real property transactions (when properly recorded).
________ (B) Tangible personal property transactions.
________ (C) Stock and bond transactions.
________ (D) Commodity and option transactions.
________ (E) Banking and other financial institution transactions.
________ (F) Business operating transactions.
________ (G) Insurance and annuity transactions.
________ (H) Estate, trust, and other beneficiary transactions.
________ (I) Claims and litigation.
________ (J) Personal and family maintenance.
________ (K) Benefits from social security, Medicare, Medicaid, or other governmental programs, or military service.
________ (L) Retirement plan transactions.
________ (M) Tax matters.

Special instructions;
On the following lines you may give special instructions limiting or extending the powers granted to your agent.

____

____

Unless you direct otherwise above, this power of attorney is effective immediately and will continue until it is revoked.
This power of attorney will continue to be effective even though I become disabled, incapacitated, or incompetent.
(Strike and initial the preceding sentence if you do not want this power of attorney to continue if you become disabled, incapacitated, or incompetent.)

I agree that any third party who receives a copy of this document may act under it. Revocation of the power of attorney is not effective as to a third party until the third party learns of the revocation. I agree to indemnify the third party for any claims that arise against the third party because of reliance on this power of attorney.

Signed this _________day of ____________, 200__ . Signature ____________

Social Security Number

STATE OF)

COUNTY OF)

This document was acknowledged before me on _____________________, 200__
by _________________________
Witness my hand and official seal.
My commission expires:

Notary Public

Warning: The law regarding powers of attorney may vary in different states. This form should be considered a sample only. Check with authorities in your state to determine specific laws and forms required to achieve your goals.

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The forms vary from state to state so it is important to use a form appropriate for your needs and valid under your state's law.

Health Care Proxy and Living Wills

When the issue is money, business, or taxes the power of attorney discussed above will work fine. It was created long ago and serves well the purposes of day to day living and economic transactions. This document does not address the subject of a personal well-being. If you are in an accident and lapse into a coma, your utility bills and bank account will be addressed by another. Other questions remain, however. Should you undergo brain surgery? Will you remain on life support? When should they pull the plug? These questions remain unanswered by a power of attorney.

The question of medical care in scenarios like the one above defies rational decision making. On one side is the medical care provider. This entity wants to give the best care available because their orientation is to save lives, to provide heroic life saving measures. The financial rewards are also very high. Another consideration is that pulling the plug or provision of some level of care less than "extraordinary life preservation methods" may have legal ramifications-the hospital/doctor knows this, they have been down that path before.

On the other side of the issue is the family of the stricken individual. Many people find this to be a moral quandary. As long as there is hope, many people cannot bear the thought of terminating the life of a loved one. However, critical care for a person in a coma is expensive. Family assets will be rapidly depleted. There are other expenses and life must continue. Again, situations such as these almost defy a rational decision making process. It is not every day that one decides if life support systems should be kept going for a terminally ill person. The same is true about performing surgery on an elderly person or someone who is unable to act for themselves.

Some would want no expense spared in keeping them alive, no matter what. Other folks would want to avoid pain or being a vegetable. Nobody knows for sure how they will react when the time for such things comes. There are probably as many points of view on the subject as there are people. The most important thing here is that each individual give some thought to the matter now while they are capable of rational thought. Compare it to the 'arms-length transaction' test for economic transactions.

When one buys a car or real estate on the open market, it is safe to say that a fair price was paid for it. Two parties came together in the market place, both knowing what they wanted, and willing to accept the market price for the commodity in question. Others may pay or accept a little more or a little less for similar goods, but rational decision making guided each individual in concluding the matter. This is known as an arms-length transaction. When the car or property is purchased from a relative, someone who owes you a million dollars, or the Head Muckety-Muck of the Golden Pushrods Gymnastics Club (which you have been trying to get your daughter in for the last three years), that is not an arms-length transaction.

Administering health care needs in a crisis situation can get away from even the most level-headed individual. Deciding to withhold nourishment or hydration, pulling the plug, or any of the myriad other decisions that must be made at such a time cannot be done on an entirely rational basis. These are not arms-length transactions.

What are the desires of the stricken individual and how can they be expressed with the force of law? The concept of the 'living will' describes that for which the person is looking. In some states it is officially known as a power of attorney for health care, in others, a health care proxy. Either way, the document is set up to allow a person to express how they feel about prolonging life under extraordinary circumstances. They are set up so the individual's will can be carried out concerning medical procedures. Without such a document, a person's desire not to be kept on life support systems will probably not be respected. The legal system wants a person's wishes spelled out exactly on such matters, not generalities or third party hearsay. There is a prevailing assumption of self-preservation.

What's in a Name?

There can be a difference between a living will and a health care power of attorney. A health care power of attorney is considered to be more flexible than the living will in several ways;

- A health care power of attorney establishes a person to act as your agent if you are unable to act. The advantage here is that at decision time an agent can judge the pros and cons of treatment decisions according to your wishes.

-The health care power of attorney applies to all decisions, unless the principal decides to include limitations.

-It can have specific instructions concerning any treatment the principal would like to embrace or avoid.

The living will is a statement of the author's desires concerning specific medical procedures. The communication must be followed if the writer is unable to provide instructions at the decision making time. This is recognized procedure in most states, but it generally applies to decisions about life-sustaining procedures in cases of 'terminal illness.' The living will applies to particular decisions near the end of a person's life.

The events that activate the conditions of the document will differ. Some states use a narrow definition of terms such as 'terminal condition', permanent unconsciousness', or persistent vegetative state'. No matter what the terms, by executing an advance medical directive a person is helping ensure that in the event of illness or serious injury, his wishes will be carried out. A recent study showed that people with living wills spelling out their desires spent about one-third as much on final hospital stays as did people without such provisions. Still, fewer than 15% of U.S. citizens have a living will or its equivalent to help reduce the estimated $10 billion spent annually to prolong the lives of those who said they did not desire to do so.

Several things should be kept in mind when an advance health care directive is executed;

-All states now have laws governing advance directives. The law may vary among states. It is important the documents signed are valid in the state where the principal resides. When a person spends time in several states it is important to have properly executed documents for those states, also. The appropriate forms can be obtained from an attorney, senior citizens' groups, or any of the special interest groups that disseminate information on advance directive rights. A search of the Internet turns up several such organizations.

- Determination should be made concerning the philosophy of the principal's health care provider, chosen or desired health care facility, and especially the person chosen as agent. If the designated health care agent believes in prolonging life no matter what, the principal will have a hard time becoming un-hooked from the machine. Sometimes the religious views of a hospital can make it difficult to carry out particular instructions.

- The principal must keep in mind that an advance directive becomes effective only when he or she can no longer make decisions for themselves. It must be made clear to the health care agent and family members exactly what you want done. The medical directive, along with a clear understanding on everyone's part as to exactly what the patient's desires are, will cut through much of the red tape and emotion of such an issue.

A Winter of Discontent

Here is an example of what can go wrong when our directives are not made known. Edward H. Winter had seen his wife of 55 years die slowly after suffering a heart attack. To make matters worse, she suffered brain damage from shock resuscitation administered by medical personnel during the ordeal. Winter determined that nothing like this would happen to him when the time came. He told his children and his doctor the same thing, simply let him die.

His time came. In May 1988, he collapsed with chest pains. Placed in a hospital coronary care unit, he told his doctor that if his condition deteriorated, he did not want to be resuscitated. The same instructions were again given to his three daughters. The doctor entered the instructions on Winter's chart. The instructions were not recorded on the monitor by his bed. Three days later he experienced ventricular fibrillation, an indicator of impending death. The nurse on duty, unaware of his request, applied electrodes and revived him.

Had the nurse at St. Francis-St. George Hospital in Cincinnati not revived him, Mr. Winter would most likely have died of a heart attack at age 82. Such was not the case. Two days after he was revived by the nurse he suffered a paralyzing stroke. Winter was angry that things turned out the reverse of what he had expected. He filed a lawsuit against the hospital for wrongfully saving his life. The suit accused the hospital of negligence in failing to follow Winter's instruction and with battery for giving him the jolt of electricity in the resuscitation process. Had it not been for the hospital's interference, he could have died with dignity.

One of his daughters said, "He said he could have died in peace if they had left him alone and that now he was completely dependent. He was upset being the way he was. My father is a pretty staunch Catholic, and would never have taken his own life, but he didn't believe in dragging people back to life."

The medical bills topped $100,000 by Winter's 84th birthday. With his life savings depleted, his doctors gave him little chance for physical improvement; in fact he could linger on for years. The hospital's position was that saving a life can never be considered, in legal terms, an injury that can be compensated. The suit was settled out of court after Mr. Winter died.

You have a "right to die," but the desire to do so must be expressed clearly while you are still competent. Communications to hospitals, doctors, and nurses are all important. Your wishes must be expressed clearly. The entanglement of religious, medical, legal, ethical, and moral values in this subject ensures that this will not be resolved soon. Science and technology are extending life. This affects the family financially in a big way. With people living longer, estates, assets, and inheritance will be fundamentally affected.

In 1990 Congress passed the Patient Self-determination Act. The Act provides that health care providing entities which receive Medicare or Medicaid funds (almost all of them), provide adult patients with written information concerning the person's rights under state law to make decisions concerning medical care, including the right to accept or refuse medical or surgical treatment and the right to draft an advance medical directive. An advance directive or living will spells out a person's wishes in regard to life-sustaining procedures. It is the best evidence as to when an individual wants life-sustaining procedures withdrawn or withheld. As said before, if you do not state in writing that you do not desire life-sustaining treatment, the presumption is that you do.

Below is shown a sample of a statutory form of power of attorney for health care. It is not intended to take the place of nor satisfy the legal requirements in a particular state. It is a sample form. A person should use the form that is valid in their particular state. This form should not be used without proper legal advice.

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DURABLE POWER OF ATTORNEY
FOR HEALTH CARE
( )
SAMPLE

I,__________ , hereby appoint: ______________,

as my agent to make health care decisions for me if and when I am unable to make my own health care decisions. This gives my agent the power to consent to giving, withholding or stopping any health care, treatment, service, or diagnostic procedure. My agent also has the authority to talk with health care personnel, get information, and sign forms necessary to carry out those decisions.
If the person named as my agent is not available or is unable to act as my agent, then I appoint the following person to serve:

By this document I intend to create a power of attorney for health care that shall take effect upon my incapacity to make my own health care decisions and shall continue during that incapacity.
My agent shall make health care decisions as I direct herein or as I make known to her or him in some other way.

Special provisions and limitations:

BY SIGNING HERE, I INDICATE THAT I UNDERSTAND THE PURPOSE AND EFFECT OF THIS DOCUMENT.
Dated _______ , 200__

Witnesses
The foregoing instrument was signed or and declared by__________ , to be his/her declaration, in the presence of us, who in his/her presence, in the presence of each other, and at his/her request, have signed our names below as witnesses, and we declare that, at the time of the execution of this instrument, the declarant, according to our best knowledge and belief, was of sound mind and under no constraint or undue influence.

I further declare that I am not related to the patient by blood, marriage, or adoption, and, to the best of my knowledge, I am not entitled to any part of his estate under a will now existing or by operation of law.

Dated at __________, this_______ day of _________, 200__.

____
Signature

STATE OF)

COUNTY OF)
SUBSCRIBED and sworn to before me by

witnesses, as the voluntary act and deed of the declarant, this_____day of__________, 200__
My commission expires:

Notary Public

Warning: Because the laws regarding medical treatment may vary in each state, this form should be considered a sample only. You should check with authorities in your state to determine specific laws and forms required to achieve your medical treatment goals.

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It would seem best to combine the living will and health care power of attorney into one document.

The reality is that the two documents developed separately over time, and for separate purposes. For this reason the documents have unique signing protocols. It was stated earlier that an ordinary power of attorney is for economic transactions. The relatively recent development of the ‘durable’ power of attorney, still valid in the event of incapacity of the principal, is now recognized in all states. Legal experts believe that the existing durable power of attorney statutes are broad enough in scope to include health-care decisions. To avoid any confusion, states are recognizing through statute the unique health care power of attorney, creating specific forms and procedures for the document. This way the specific health care power of attorney carries its own ‘moral weight and judgment’, an excellent idea considering the gravity of the subject it addresses. For this reason a person is well advised to execute a separate health care power of attorney.

DNR

A "**do not resuscitate**" or "**DNR**", sometimes called a "**No Code**", is a legal order written either in the hospital or on a legal form to respect the wishes of a patient not to undergo cardio-pulmonary resuscitation (CPR) or advanced cardiac life support (ACLS) if their heart stops or they stop breathing. The DNR request is usually made by the patient or health care power of attorney and allows the medical teams taking care of them to respect their wishes. A DNR does not affect any treatment other than that which would require intubation or CPR. Patients who are DNR can continue to get chemotherapy, antibiotics, dialysis, or any other appropriate treatments.

Advance directives and living wills are documents written by individuals themselves, so as to state their wishes for care, if they are no longer able to speak for themselves. In contrast, it is a physician or hospital staff member who writes a DNR "physician's order," based upon the wishes previously expressed by the individual in his or her advance directive or living will. Similarly, at a time when the individual is unable to express his or her wishes, but has previously used an advance directive to appoint an agent, then a physician can write such a DNR "physician's order" at the request of that individual's agent. Note that an advance directive or living will is not sufficient to ensure a patient is treated under the DNR protocol, even if it is his or her wish, as neither an advance directive nor a living will is a legally binding document.

Chapter 4 Gifts & Their Purpose in the Estate

Sua munera mittit cum hamo[1]

A gift is defined as a voluntary transfer of property made without consideration, for which no value is received in return, which is accepted by the recipient. Gifts are generally regarded as an individual issue. No thought is given to the financial or estate planning aspect of birthday toys or Christmas ties. If a gift is valued at over $14,000 (for 2013, increasing over time) tax implications come into play. These are subject to the federal gift tax. The federal gift and estate tax rate are one in the same. The title of the tax is the "Unified Estate and Gift Tax." The idea is to tax 'residual' property at the same rate whether it is given away during or at the end of a lifetime. Taxable gifts decrease the $5.25 million (for 2013) amount that can pass free of estate tax at death. When lifetime taxable gifts amount to X, only the estate tax threshold minus X can be conveyed through the estate tax-free at death. Until the estate tax threshold value is exhausted, taxes are not due.

It is only natural that people are hesitant to make big, valuable gifts as merely a means to effect tax savings. People are more willing to give when the potential recipient really needs the money. No matter what the motivation, it can be of benefit to take advantage of the tax rules. Gifts can be thought of as another tool or means to an end in the estate planning process. Do not mistake a <u>gift</u> with a <u>charitable contribution,</u> which is a transfer of property to charitable, religious, educational, or other charitable organization without compensation for value. Keep in mind that these contributions also may be taken for estate tax purposes.

Issues Influencing the Use of Gifts

Gifts can be used in the estate planning process in different situations. The best examples concern property which will appreciate in years to come. Art and other substantial collections as well as real estate are examples of assets that normally will appreciate in value over time. Another advantage is that the <u>donee</u> (gift recipient) will receive benefit from the property during the <u>donor's</u> (gift giver) lifetime. Lifetime gift giving also reduces probate costs and estate settlement expenses while putting the assets out of reach of the claims of potential creditors. Dividends and interest on stocks and bonds represent potential income for the estate owner. Giving financial instruments to children reduces the tax bite for the donor and, presumably, allows the income to accrue to someone in a lower tax bracket. If a child is under 14, unearned income will be taxed at the parent's tax bracket. After a child hits 14 years of age, unearned income will be taxed at the rate that the child should normally be taxed. This should result in lower taxes. After the death of one spouse, the surviving spouse can employ the use of gifts with great effect.

[1] He sends his presents with a hook concealed.

A credit is an amount that reduces or eliminates tax. A <u>credit</u> is a dollar-for-dollar reduction of any tax due. The *unified credit* applies to both the gift tax and the estate tax and it equals the tax on the applicable exclusion amount. The taxpayer subtracts the unified credit from any gift or estate tax that owed. Any unified credit used against gift tax in one year reduces the amount of credit that can be used against gift or estate taxes in a later year. The unified credit on the basic exclusion amount for 2011 is $1,730,800 (exempting $5 million from tax) and is $1,772,800 for 2012 (exempting $5,120,000 from tax).

There is currently no limit to the quantity of property that can be transferred from one spouse to another without triggering federal gift or estate tax. In 1988, the gift and estate tax laws were modified to restrict transfers to non-citizen spouses. In addition to federal tax law, it is important that people who may be potentially affected by taxes be aware of the gift and death tax on a state level and how they may vary from state to state.

Assets left to a spouse-The unified tax credit allows the transfer of up to the value of the estate tax exemption threshold to whomever one pleases. Everything left to the spouse is transferred tax free. What is the minimum amount that can be left to a surviving spouse? It will vary from state to state. There are statutory amounts that must be left to the surviving spouse. In common-law states it is generally about a third of the estate while in community property states it is normally one half. The surviving spouse's share can be reduced if so desired with the employment of evasive techniques such as a revocable trust. Well written pre-nuptial agreements can also be used to avoid any misunderstanding concerning the distribution of assets after the death of a spouse.

Charitable Giving

Charitable giving not only furnishes a benefit to the charity, it can also be of benefit to the donor. There are four principal methods of making donations. Each method has advantages and disadvantages that must be weighed when deciding how much and what to give.

① Outright Gift- A direct gift during an individual's lifetime. Benefits; It is simple to do; the charity recognizes an immediate benefit and the donor can bask in the glow of recognizable appreciation. Charitable gifts are also deductible from income taxes. Any taxable gain is also avoided. The disadvantage is that such gifts are irrevocable.

②Bequest Under Will- Gift made after death. Benefits; Exempt from federal estate taxes if the charity is a tax-exempt organization. It is relatively simple to transfer through a will. Security is in the knowledge of where the money will go. Disadvantage; A will must be probated and the donor does not receive the satisfaction of seeing the bequest put to work.

③Gift to Charity Reserving Life Income- The donor names beneficiaries for current income generated by the asset. A final beneficiary is also chosen. This will always be the charity. The individual (or group) receives payment from the trust for a time frame defined by the trust. The trust instrument can make the payment period a set number of years or until the income beneficiary dies. The income beneficiaries only have a claim on the trust income during their lives; they do not own the trust property. It is not included in their taxable estate at death. Instead it is conveyed to the final beneficiary, the charity. There are various forms or types of charitable remainder trusts. These include a charitable remainder annuity trust, a charitable remainder unitrust, and a pooled income fund. Generally, the purposes of these devices are similar in that they provide income to the donor or other beneficiaries and then the trust property reverts to the charitable organization in the future. The estate tax advantage of a charitable remainder trust is determined by the value of the remainder interest that eventually is transferred to the charity.

The charity itself is usually assigned the task of trustee. As such, it assumes the task of payouts to current beneficiaries and accounting for the assets in trust. A vested interest in maximizing the residual (ending) value of the trust will naturally exist for the trustee. If the income beneficiary is someone other than the donor’s spouse, the payments from the trust will be considered a taxable gift if in excess of $14,000 (for 2014) per year. Another advantage is that the property is not included in the donor’s taxable estate. The heirs of the estate get tax relief. The net value of the trust assets, as of the date they become solely owned by the charity, is excluded from the taxable estate. The charity becomes

④Charitable Lead Trust With the Remainder to Family- This is the opposite of the Remainder Trust with regard to beneficiaries. Income from the trust property is given to the charity for a period of time described in the trust agreement. Afterwards, the trust property reverts to the donee or to someone else named by the trust to receive it. This kind of trust is not as widely used as charitable remainder trusts. It is not popular among estate planners. A big reason for this may be that it is difficult to think of final beneficiaries who do not need (or want) their inheritance right away. Still, a charitable lead trust created upon death of the grantor can be used successfully for saving on estate tax, giving to charity, and ultimately helping family or other beneficiaries.

Charitable contributions also play a part in estate planning because they reduce taxes. The charity pays no tax upon receipt of the gift and ordinarily pays no income tax on the investment income earned by trust assets. The following requirements must be met if charitable contributions are to qualify for tax advantages;

◎The charity must be qualified as such by the IRS. A qualified organization conforms to IRS regulations and would include churches, schools, Boy and Girl Scouts, Daughters of the Republic of Texas, Sons of Confederate Veterans, etc.

The gift must be in the form of property. The value of time or services cannot be considered.

⊚The contribution consists of the value in excess of any value received by the donor. The difference between a cash contribution, for example, and any token of esteem received for same is the amount considered a deductible gift.

⊚For a deduction to be allowed for current income taxes, the contribution must be made before the close of the donor's tax year.

⊚If the gift is made by the donor and not a third party, the charitable contribution is deductible upon the death of the donor.

⊚All contributions exceeding $5,000 must be conveyed with an appraisal.

Using Life Insurance for Charitable Purposes

Life insurance is an ideal form of contribution to charity. The reasons are;

▪Presuming the premiums are paid, the death benefit is a certainty for the charitable cause, in cash.

▪Death proceeds are not subject to tax, probate, or administrative costs.

Life insurance given as a gift is valued in one of several ways. If a life insurance policy is given right after purchase, its value for gift tax purposes is the gross premium paid by the donor. If the policy given has been previously purchased and continued premium payments are necessary, then the value of the policy is its interpolated terminal reserve which is usually a sum approximately equal to its cash value. If the policy given is a paid up policy, its gift value will be equal to a comparable single premium policy for a similar face amount on the life of a person who is the insured's age at the time of the gift.

For tax purposes, the value of the gift is the terminal reserve plus unearned premium on date of sale. Terminal reserve value is determined through actuarial means. If this value is greater than net premium payments, the deduction for the gift of the policy is limited to the cost basis (value of premiums). This is replacement cost.

The replacement cost of a paid up policy is the single premium that would be charged by the same insurer for the same type policy at the donor's current age. Replacement cost of a continuous premium policy is the policy's actuarially determined terminal reserve plus unearned premiums while replacement of a newly issued policy is simply the gross premium paid.

Annual Gifts as Tax Strategy- A person has the option to dole out $14,000 (for 2014) per year to whomever they would like. This is another opportunity for tax-free transfer that exists in addition to the $5.25 million (for 2013) exemption created by the unified estate and gift tax amount. This is the annual gift tax exclusion. A person can give $14,000 each and every year to a daughter until the money is exhausted or they expire. This is separate from the personal lifetime exemption amount (whatever that may be in a particular year). If the donor is married, the annual exclusion can be doubled if the spouse consents to the use of their annual gift tax exclusion. The money does not have to come from the spouse, only the consent. The spouse’s consent must be indicated on the gift tax return when it is filed. The money can come from funds controlled by the original donor. This annual $14/28,000 exclusion can be used with larger gifts. The value of the gift is reduced by the exclusion used.

It does not matter if the gift is in the form of cash or property. If a gift is in some form other than cash or securities, the question of value is bound to arise. The IRS has the right to declare later that the gift is worth less. It is important that an accurate appraisal of value is made that will stand up to scrutiny.

Tax-free Gifts to Children- The $14/28,000 annual gift exclusion applies to children, obviously. It is good planning to make gifts at the first of the year so death will not constrain the use of gifts later in the year. People want to make big gifts during the Christmas season. This is done for sentimental reasons, but it makes more sense to make the gift at the first of every year. An unlimited amount can be paid for tuition expenses at an education al institution or for medical care of a child (or any other person). This will be free of gift tax. The payments must be made to the education institution or medical care provider, not to the beneficiary. On the other end of the spectrum, one can disinherit adult children in every state except Louisiana, where forced heirship rights are protected by the state’s constitution.

Enforceability Guidelines for Gifts- Court decisions and statutory law give indications as to what is enforceable in a will or trust. Careful consideration of the proper legal language will help avoid problems further along. As with other aspects of estate planning, proper legal consul should be consulted to help draft appropriate legal language with enforceable terms and conditions. Some guidelines to consider include;

- Avoid obscure or vague language- Definite and selective terms should be employed to make the choices clear and unambiguous. “I leave the ranch and my Acme Co. stock to my cousins” will not work. Cousins will crawl out of the woodwork.

- Against public policy- The imposition of unreasonable conditions upon heirs are routinely struck down by the courts. Requiring a child to disown one of their own progeny, conditional upon divorce or marriage of so-and-so are not acceptable conditions. Attainment of a certain age is an example of an acceptable condition. Likewise, the promotion of unlawful activities is unacceptable. An individual's personal political agenda aside, leaving assets to an outlaw group will not withstand a challenge in court.

- Addresses tax strategy- all gifts should meet IRS conditions for deductibility. A tax expert should be consulted to discuss any strategies involving estate planning <u>before</u> the plan is implemented. This is critical. With estate planning, more than any other type of financial planning, there is no room for “oops!” after the fact. The IRS is going to get its due and the donor will no longer be on the scene to correct any problems.

 Noncontestability clause- Any type of provision designed to disinherit those beneficiaries who contest the will. Courts consistently decline to recognize such language in a will and it is a waste of time to include it.

Intention of the Donor- As stated above, a gift is a voluntary transfer of property without receipt of consideration in return. A permanent transfer of property with no strings attached. The test is the giver's intent. Another important point is that the recipient has control of the gift. Giving real estate is often a complicated process in this regard. The gift of real estate to children or other family members is often disallowed by the IRS because the donor retained some form of control over the property. Examples are the right to continue receiving rents from a property or the right to veto a sale or mortgage. This may be viewed as simply a long-term loan by the IRS.

When an asset is given to someone else, the recipient gains unrestricted possession of the property. As long as the issue of 'control' is straightforward, there is no problem. The problem can become difficult when the gift is based on a future event. If the future contingency is objective in nature, there is no problem. James receives property X "when he graduates from the University of Oklahoma", is straightforward. "When he graduates and gets a steady job" is not. Using the same logic, property placed in a revocable trust is not a gift because the grantor retains elements of control over the trust. The trust beneficiaries receive income from the trust but have no legal right to the trust property. No transfer has occurred.

Types of Gifts- The plain vanilla gifts include cash or equivalents, physical assets, or anything else of material value (patents, copyrights, royalties). There are other kinds of gifts, usually actions (or inactions) on the part of the donor;

⇨Interest free loan- low or no interest loans are gifts under tax laws. Low interest rates are those determined to be below market rates. Careful, because depending on the circumstances the "market rate" does not necessarily refer to the prime rate or a rate ½ % above the current T-bill rate. It can be a risk-based rate just like with credit cards or the loan company. When the loan is repaid, a gift has been made of the interest cost.

⇨Transferring property to an irrevocable trust created for the benefit of another. This is the opposite of a living, or revocable trust. A gift has been made in this case.

⇨The withdrawal of funds someone else has deposited in a joint bank account. Of course, this does not apply to community property accounts of spouses.

⇨The irrevocable assignment of a life insurance policy to another person.

⇨Assignment of a mortgage or court judgment without receiving compensation.

⇨A non-commercial transfer of property into joint tenancy with another. The unique case of joint bank accounts was mentioned above.

⇨Debt forgiveness- No, not like in the Lord’s Prayer. This is a concept similar to the interest free loan. A common example of this was seen in the ‘80’s with foreclosures. When a mortgagor walked away from a property, commonly a home, the lender was left with foreclosed property. Property values were in a downward spiral and there was a negative gap between the amount loaned on a house and the current market value of the property (known as “underwater” in real estate jargon). Lenders, soon to be broke themselves, did not have the resources to pursue all the borrowers who defaulted. That dollar difference between loan value and market value on the property represents forgiveness of debt. An IRS Form 1099-C is issued when a debt (home, credit card, student loan, etc.) is cancelled. It means the debtor received money when the debt was initially incurred, but he or she never had to pay it back. Because the debtor is not paying the debt back, the original debt was actually income, and it must be reported on the tax return as such. Many lenders resorted to sending out IRS 1099-C forms with the amount in question listed as income to the debtor. This happened again in the housing bubble/credit crisis of 2007-2009.

The Uniform Gift to Minors Act

The Uniform Gift to Minors Act (UGMA) is federal legislation that allows an adult to make gifts of securities, cash, life insurance, or annuities to a minor child. This scope of this legislation is extended by the Uniform Transfers to Minors Act (UTMA) of 1983. The types of gifts allowed now include many different types of property. One of the main tenants of the law is that, since the gift is to a minor, the gift is held by the donor in a custodial arrangement. The gift is styled “Mr./Ms. X, custodian for the minor ....” and held until the child reaches majority. Depending on state law, that is age 18 or 21. That can be extended up to age 25 under terms of the UTMA. This type of gifting avoids some of the problems associated with other types of gifts. One difference is the requirement that the gift be irrevocable, it is a permanent transfer. Other conditions include;

Only one child per custodial account,

Only one custodian per account,

Gift to be used for the benefit and support of the minor child,

Custodian and donor can be the same person but no fees can be charged in such an arrangement,

The child’s Social Security number must appear on the account

There is no difference in taxation between the UGMA accounts and other types of gifts. Any unearned income is subject to the $1,000 standard deduction. If under age 19, the child’s unearned income in excess of $2,000 (for 2014) is taxed to the child at the rate of the parent’s tax rate.

The primary purpose of using gifts as an estate planning tool is to shift wealth and lower taxes. This goal makes it imperative that an examination of financial situations take place. The donor and recipient's tax status must be determined in order to optimize the asset transfer. Giving assets away reduces the financial security of the giver. Being reduced to a pauper is not a long range goal. All parties involved must sit down and determine what the desired effects of the transfer will be and how to do it. Assets with long range growth potential may be right in one instance while fully appreciated property could by the right asset to give in another. For example, stock in a closely-held corporation may be an ideal asset for a gift. However, care must be given with regard to the amount of stock given away. If a close corporation does not hold enough of its own stock, it may jeopardize its position with regard to a partial redemption of stock to pay death taxes (Section 303 redemption).

Beyond type and timing of gifts, another aspect to consider is the gift method. An outright transfer of title to an asset is generally thought to be the only way to give. It may be that a gift be made in trust for the donee. With the establishment of a trust or some other form of asset superintendence, the donee is relieved of all of the responsibility for managing the gift. Oftentimes a form of property management is considered in the following situations;

- Recipient is unable or unwilling to care for property due to age, inexperience, physical or mental impairments.

- Donor wants to keep the asset within the family and prevention of the donor disposing of the asset is a goal.

- The donor desires to extend beneficial ownership among several beneficiaries.

- The donor desires to retain financial control over the donee.

Mechanics of Federal Gift Tax- Gift and estate tax are examined to greater extent in another chapter. As a form of illustration we must look briefly at how the tax works. Gift tax applies to gifts made by U.S. citizens and residents. It also applies to gifts of property by nonresident aliens if the gifted property is physically located in the U.S. (commonly real estate). As pointed out several times, the first $5.25 million (for 2013) of a person's taxable gifts and estate can be transferred free of gift and estate tax because of the unified credit. In addition to this an annual exemption exists for gifts valued at $14,000 (for 2014, increasing over time) per person, per year. A gift tax return must be filed if the gift is valued at over $14,000. Rather than paying the tax at the time of the gift, the IRS requires that the amount of the gift tax be used to reduce the donor's unified estate/gift tax credit. Paying the gift tax now and conserving the unified credit for later use is not an option. Gift tax is based on the fair market value of the property at the time it is given.

The unified estate/gift tax credit is the amount due on an estate valued at $5.25 million (for 2014). The tax credit is whittled away until it is depleted. Once a person gives enough in taxable gifts to consume all of the unified credit, gift tax is payable from that point forward. The entire value of a person's taxable estate will also be subject to estate tax after death. Suppose Raymond, a widower, gives a first time gift to his housekeeper Mrs. Smith of $20,000 in 2014. $14,000 of Raymond's gift is excluded from gift tax under the annual gift tax exemption. The balance of $6,000 is subject to gift tax and a gift tax return must be filed. Raymond does not pay the gift tax now. The computed tax is subtracted from the then-current unified credit. If no other gifts above $14,000 are made, when Raymond dies the remaining unified credit will be applied against the estate. This allows all but the value of the tax on the 2014 gift to be transferred free of federal estate tax (assuming the decedent Raymond's estate is valued below the estate tax threshold).

The tax rate is cumulative. In determining the gift tax rate to be applied to a particular current gift, the value of all taxable gifts since January 1, 1977 must be totaled. This negates the benefit of the gradual distribution of estates in small chunks.

Gift of present interest- To qualify the gift must be of present interest instead of future interest. Possession and enjoyment of the property for the recipient must take place when the gift is made. A $14,000 cash gift results in immediate ownership and enjoyment for the donee. A gift of present interest has been made. If the $14,000 is placed in trust so that the recipient is constrained from using it for five years, a gift of future interest has occurred.

Power of Appointment- A power of appointment is the right given by the donor to the donee allowing the donee to stipulate the recipient of the donor's property at some future date. A general power of appointment removes any restrictions as to who will receive the assets in the future. Any restrictions on who the ultimate appointee is means that a limited power of appointment has been conferred. With the unlimited marital deduction, for example, the donor gives the spouse property outright. In addition the donee spouse must be given a general power of appointment.

Here is a report from several years back that employs the charitable trust to facilitate estate planning. The strategy employed is for wealthy people. However, studying this and other aspects of the estate planning process will open new vistas when planning methods are employed for individuals with down-to-earth incomes.

Estate Problem Solving with Charitable Trusts

For years, charitable trust proponents have touted the truly incredible benefits that can be achieved for their high net worth clients. Countless numbers of financial services professionals devote time and effort to learning the "ins and outs" of these often complex wealth transfer vehicles. Yet, in the end, many producers become disillusioned. Despite seeing the myriad benefits, "clients just don't buy." What they means is, clients don't buy the life insurance.

One reason for this disappointing outcome is that the tail often wags the dog. Too many producers focus excessively on the "wealth replacement trust" aspects of the transaction. They fail to emphasize the underlying needs for which charitable trusts can, indeed, provide unique solutions.

Charitable trusts work best when they are positioned as solutions to problems, not as ends in themselves. This requires a concept driven marketing approach that de-emphasizes product. As one of the nation's leading charitable trust experts recently told me, "wealthy clients hate salespersons, but they love advisers."

If the purchase of life insurance is to happen, it must be seen as a necessary by-product, not the central focus, of the needs-marketing process.

The following illustration demonstrates how charitable trusts can be positioned as the irresistible answer to commonly encountered estate, business and retirement planning problems.

The Facts: A and B, both in their mid sixties, started a small business on a shoestring more than 30 years ago. Now it has evolved into a thriving, profitable, cash-rich enterprise. Through a fact-finding process the financial services professional will discover several problems common among small business owners in this position: How can a market be found for closely-held stock? If they can find a market, how can they dispose of their stock without incurring enormous capital gains taxation on all that locked-in profit? One objective is to reduce current and future income taxes. Another is to provide retirement income security while avoiding wealth erosion due to estate taxation, particularly respecting small business

The Solution: The Charitable Bailout. The charitable bailout employs a charitable remainder trust (CRT). In its simplest form, the CRT is a device into which a donor contributes property. The trustee then pays an income stream (usually back to donor) for a certain period of time. Afterwards, the trust principal goes to a charitable organization.

A and B can each donate some of their closely-held stock to a CRT. They immediately solve three of their problems. First, they each receive an income tax deduction for the fair market value of the "remainder interest" that will eventually go to the charity. With creative planning, this technique can generate a series of ever-increasing tax deductions, the benefit of which can also be carried forward for several years. This reduces their income taxes both currently and for a sustained period into the future. Second, they are able to dispose of their highly appreciated stock with no immediate capital gains tax.

Recognition of capital gains can be spread out over a long period of time. Finally, the donated stock is removed from exposure to estate taxation. Compare this result to what would have happened if they had been able to find a non-charitable market for their stock. The capital gains tax would have been payable immediately and in full upon the sale. This would have left a greatly diminished principal with which to generate income. Instead, they now have the full value available to maximize current and future values.

Here is how this income is derived If the charitable trustee is required to pay them back an income, there seems to be no way to generate cash flow if the sole trust asset is closely-held stock that pays no dividends The answer is the charitable bailout. In an arm's length transaction that can be prearranged but in which the parties may not be legally bound. The charitable trustee offers the stock for sale back to the corporation.

If it agrees to redeem the stock, A and B avoid the negative income tax consequences of a partial redemption. Further, the "excess" retained earnings that were forcing an untenable choice between double-taxed dividends or the accumulated earnings tax can now leave the corporation tax-free. The stock comes back into the corporation without affecting A or B's ownership percentage, where it can be left as Treasury stock or be used to address business continuity needs through an ESOP.

The Result: With the cash it now obtains from the corporation, the CRT pays A and B a tax-favored income stream. Converting a non-liquid asset into a liquid asset on a tax-favored basis is one of the best ways to generate retirement income. This solves yet another of the problems identified in the fact pattern. Eventually, their favorite charities will receive a large cash benefit, allowing A and B to satisfy their eleemosynary desires.

The only ones who seem to lose out are the A and B children and grandchildren who would have inherited whatever was left of their respective estates after estate taxes and business liquidation.

This is where life insurance becomes a solution. If A and B love their descendants and/or hate taxes, family wealth preservation and distribution can only be assured via life insurance on their lives. The face value is usually calibrated to track the property value that will go to the charity.

Clients usually do not object to acquiring life insurance, they object to paying for it. Experienced producers know that the problem is not finding the need, it's finding the money. If A and B are properly enthused about all of the business, estate and retirement benefits created by the CRT, implementation of a wealth replacement trust flows as a natural by-product of the technique.

The charitable bailout generates a constant stream of dollars from assets that could not otherwise be used effectively for this purpose. In addition, prior to retirement some of the charitable trust income stream can be also be allocated toward the purchase of life insurance to fund a cross-purchase buy-sell agreement respecting the balance of the stock they retain.

Achieving a comfort level with the many advanced planning techniques appropriate for the high net worth client can be frustrating for some financial services professionals. A great deal of time and attention must be devoted to areas seemingly unrelated to the life insurance purchase. It becomes tempting to prematurely focus on the insurance to the exclusion of the needs for which the insurance is the most compelling solution. This has been particularly true for many who plunged into the charitable market. The best success has been achieved by those who focus on needs and present solutions to problems.

Chapter 5 Wills and the Estate

Wills

In law, a will is a document that disposes of a person's property. It takes effect after the person's death. The one who makes the will is called the testator. Any will should be reviewed by a legal expert in order to be sure that it effectively disposes of property and that it may not be successfully contested by those who disagree with the terms. For example, if different parcels of real estate are going to different persons, each piece should be adequately described to ensure proper identification. The same holds true for personal property.

The testator may dispose of his or her property in any way they choose, as long as the disposal is not contrary to law. The will usually names some person as an executor. It is this person's duty to see that the wishes of the testator are carried out after his death. If no executor is named, the court that has jurisdiction over estates may appoint an administrator, whose duties are the same as those of an executor. The general rule is that every executor, even a close relative, must give a bond, or surety, for the faithful performance of their duties. If the provisions of the will are not faithfully carried out, the bond is forfeited. If the will so provides, the bond may be waived.

Other Types of Wills- A formal will prepared by an attorney is desirable, but it is not absolutely necessary. Some states allow a person to make an oral, or *noncupative*, will that are acceptable to the courts. Such wills are acceptable under special circumstances, usually involving the will maker's perception of imminent death. Other states accept the *holographic* will, that written by the testator's own hand. Such a will may or may not require witnesses. Such special forms should be avoided because of the inherent confusion and ability to be challenged. A will should be in writing, signed by the testator and witnesses. Any person can dictate their own will in plain language and have it meet all legal requirements if the provisions are plain enough that they cannot be misunderstood. Videotape or film wills are not allowed under the laws of any state. However, a visual record of a person reciting a will or whom they give property to can be documentation that the testator was "of sound mind and body" when the will was executed.

The concept of a will goes back to ancient times. A copy exists of the will of an Egyptian named Uha dating from 2548 B.C. The code of Hammurabi says that property must pass to heirs upon death. Byzantine Emperor Justinian prescribed formal requirements for wills in the Justinian Code. A will can also be an expression of emotion and sentiment, containing other declarations of the testator's desires as to what is to be done after he dies so long as it disposes of some property. The fear of dying might be what causes so many people to refuse to make wills. This type of denial is surprisingly common in even the most rational and capable adult. The process of creating a will is a sign of a loss of power over their own assets and an indication of impending lack of control. Instructions in the will fix a permanent, quantifiable relationship between property and kinfolk. To many people, putting off this chore somehow equates to living (a little longer) until the job is ultimately done. However, such attitudes do not protect children or spouses, apportion property without a fight, or provide for children and grandchildren.

“I don’t have enough property to justify a will”, is a common excuse for not making one. The lack of a will in a modest estate will cause disproportionate amounts of pain and expense to the surviving family members. A total of $3,000 spent on probating a $50,000 estate is a much larger proportion gone than the millionaire who spends that same amount drawing up a will beforehand. Although most attorneys charge a nominal fee for a simple will, many people feel they do not have enough money to justify estate planning. Actually, the poorer you are, the more you need a will. Heirs of poorer people often are bogged down in bonds, accountings, and legal fees that rich people can more easily afford. Intestacy, or death without a will, means that state law will determine the estate’s distribution. That can often result in dispersal contrary to that which any thoughtful person would want. Children could end up inheriting more than the mother. Dying without a will can be expensive. Somebody will end up paying filing, court, and attorney’s fees. Much money and time can be saved if the will contains a sentence such as, “I leave my entire estate to my husband, John, and I make him my personal representative, to serve without bond.” Such an action would help many people.

Seven of ten U.S. citizens die without a will, probably not realizing that if a person dies without a will, each state has already decided for them how the property will be distributed. The laws vary from state to state. Many divide separate property between the spouse and the children. The family may pay more than necessary in federal and state transfer taxes if a will does not exist. If a living trust exists, a will is still advantageous as a vehicle to provide for the guardian of minor children or to “pour over” non trust assets into the trust.

Make Your Own- Pre-printed fill in the blank wills are called statutory wills. They are permissible and available in some states, including Maine, Michigan, Wisconsin, and California. They are readily available online and are meant for people with simple needs. Statutory wills are limited in scope and are not useful for people with even slight complexities in their financial affairs. California was the first state to adopt the concept of statutory wills. Choices provided in the statutory forms are limited and cannot be changed or modified to fit individual situations. The California Statutory Will, for example, allows only one cash gift. All other property must go to the spouse or children. The Michigan form allows only two separate cash gifts with the rest going to spouse or children. If a person wants to leave property to a charity or a sibling this type form will not work. Still, there are numerous self-help books and software on the market that give the details of will-making on a state-by-state basis. Do it yourself willmaking is business. Few people understand the legalese needed to make a document stand up in court. Fewer still understand that their utterances today can have a long lasting effect on how their property will be disposed of tomorrow. An attorney should see the finished product before a will is signed by the testator.

Inheritance

The laws of inheritance regulate the disposition of private property after the owner's death. The ability of an owner to dispose freely of his or her property posthumously is embodied in the legal instrument of the WILL. Today in all Western countries and in many others, one may inherit under the provisions of a will or, if there is no will, of statutes called intestacy laws that designate the order and proportion by which relatives and spouses shall inherit.

History of Inheritance- In many early legal systems property belonged to the family, clan, or tribe, and within the family the father generally controlled its administration. Various provisions existed for distribution on the father's death. In Mesopotamia the widow managed the property for the duration of her life, and on her death it was divided among the children. In India inherited property could not be sold, but sons had the right to divide it. In Sparta the eldest son was entitled to all the father's property; in Athens the sons shared equally; in ancient Israel the eldest son was given a double share--a rule that was followed in parts of colonial New England. In Muslim countries one male had the share of two females. Thus in early civilization property devolved automatically, according to the laws of each society.

The Right to Make a Will- Quite simply, this is the right to designate heirs. A will gives one the power to dispose of property after death; it is recognition of the right of private property rather than of family, clan, or tribal ownership. Early examples of wills are from Athens where, under the reforms of Solon (c.639-559 BC), a childless man could will his property to anyone, whereas before that time his estate went to his clan. By the time of Justinian's Code (AD 529), Roman law recognized many types of wills, including oral wills declared in the presence of seven witnesses or before a public official.

In Anglo-Saxon England, wills of land could be made only with royal approval and could not be revoked. Early in the Norman period (c.1100), primogeniture, the practice by which land devolved automatically on the eldest legitimate son, came into wide use. There were, however, pockets of contrary custom, where land went to the youngest son (borough English), or to all the sons equally (gavelkind). Only legitimate children could inherit. To make it impossible for the heir to sell his land, the unique English concept of the entailed estate was utilized. Land could be conveyed, for example, to "A and the heirs of his body." "A" did not fully own the land but merely had the right to its use during his lifetime. At "A's" death the land went to his heir under the rules of primogeniture. The entailed estate was common in England until the 19th century.

Until 1540, when enactment of the Statute of Wills enabled landowners to will some or all of their lands as they chose, a landowner could achieve the effect of a will through the TRUST device, which allowed him to transfer property to one or more trustees on condition that he be permitted to use and profit from it until his death. The trustees would then convey it to the person or persons named in the trust. This trust device is still used today both in England and the United States, whose inheritance laws are in large part derived from English laws. Called an inter vivos, or between-the-living trust, it is utilized to avoid the payment of inheritance taxes that would otherwise be levied at the owner's death.

The Inheritance Process and Women- In early Rome a male was always responsible for the care and support of the family's women, and the question of women as heirs was irrelevant. Mosaic Law, however, permitted women to hold property, and a daughter could inherit if there were no sons. In English law, also, brotherless women could inherit, and a woman could own property and could will it to the same extent as a male. A wife, however, could not be her husband's heir because she was not of his bloodline. Nevertheless, under the right of dower, a widow could own one-third of her husband's lands for the duration of her life. Today, in states of the United States that follow English common law, the right of dower has been replaced by the rule that a widow must receive a statutory portion of her husband's estate, ranging from one-third to one-half. In southwestern and far western states the system of community property, derived from Spanish and French law, provides that all property belonging to the married couple is shared half-and-half.

Inheritance Practices Today- Within the Western world, and in countries whose legal systems are the legacy of a colonial power, inheritance practices are broadly the same: private property is, for the most part, freely available for its owner to will as he or she desires, with certain limitations on the disinheritance of children or spouses. Probate, the process by which a will is proved valid, and the administrative procedures of estate settlement differ in detail from country to country (and, in the United States, from state to state).

Pablo Picasso died intestate at the age of 91, leaving behind $300 million in assets. Picasso had refused to make a will and this lead to tremendous complications. He had made at one time a noncupative (oral) will donating his valuable collection of paintings by other artists to the French government. The only item of property assigned in writing by Picasso was his painting “Guernica”. He directed it be returned to Spain after the re-establishment of democracy there. Picasso’s estate consisted in part of a large amount of his artwork. His heirs included his widow, Jacqueline, and four children. One of the children was by his first wife, one was from a mistress while the other two were born out of wedlock by another mistress. The wife and legitimate son, Paulo, claimed to be the sole beneficiaries as Picasso had won a legal action in 1971 in which he refused to acknowledge the paternity of the illegitimate children. Many complications arose from intestacy under French law. For instance Jacqueline, the widow, had a right of usufruct of one-fourth of Picasso’s estate. Usufruct is the right to use and enjoy property vested I another, and to draw from it all the profit and utility it may produce. The surviving spouse's usufruct is calculated on a fictitious sum that includes all property that the decedent disposed of while alive as well as the property in the estate at death. The other heirs on posting bond can compel the surviving spouse to accept an annuity of equivalent value. The amount of French Francs spent on sorting out the estate can only be guessed.

Much richer than Picasso, Howard Hughes apparently did make a will (or wills). Fifty-two different documents were presented as wills during litigation of Hughes' estate. Over four hundred prospective heirs showed up to claim part of the estate. Among the claimants was Melvin Dummar and the "Mormon Will", a three page holographic document with Mr. Dummar as a substantial beneficiary. He claimed to have come to Howard Hughes aid in the Nevada desert in 1968 and a grateful Hughes bestowed a testamentary reward. When the dust ultimately settled, 21 cousins were awarded the estate. It took almost 15 years of litigation and nearly $30 million in legal fees, not to mention the multi- state death taxes caused by Hughes lack of clear domicile. Howard Hughes disliked lawyers, but more than one made a living as a result of Hughes' intestacy. The fear of death, ineffectiveness at quantifying relationships in dollar terms, and inability to face up to the loss of dominion brought on by death are justifications for not making a will. The truth is that not making one brings on a unique set of problems also.

Wills are very significant to a well-planned estate, everyone should have one. It is also important to know what the spouse and other close family members' wills provide. They are no guarantee that a pitched battle amongst family members will not ensue, but they are a step in the right direction. Again, it cannot be emphasized enough the importance of a properly written will with competent legal advice. Will and estate challenges are expensive. Often the party most traumatized in such a contest is the decedent, and they can no longer complain.

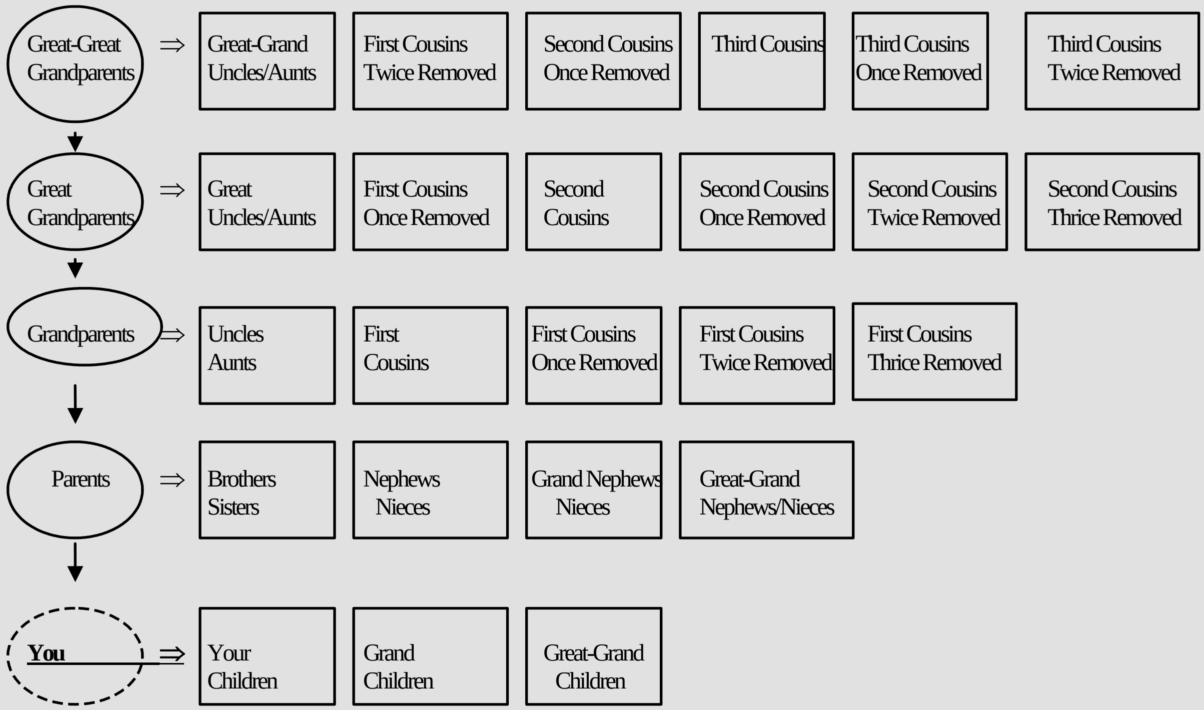
No Contest- As a means of discouraging contestants to the will, a frequent tactic is the insertion of the *In Terrorem* clause. In Latin this means "in fear". It is a condition subsequent placed in a will or contract that, although unenforceable, has the purpose of intimidating the beneficiary and thereby perhaps securing compliance. Normally, such a clause states that beneficiaries who challenge the will may forfeit all dispositions made for them. The general legal rule followed by a majority of the states is that *in terrorem* clauses are valid unless the challenger has probable cause for bringing the contest. Probable cause means "the existence, at the time of the initiation of the proceeding, of evidence which would lead a reasonable person, properly informed and advised, to conclude that there is a substantial likelihood that the contest or attack will be successful." Some states enforce no-contest clauses even if there is a probable cause to attack the will, unless it is on the limited grounds of forgery or revocation by subsequent will. Florida and Indiana are the only two states that statutorily prohibit *in terrorem* clauses in wills. Whenever there are people involved who would have statutory rights of inheritance in the absence of a will, a no-contest clause should be taken into account. This would include persons disinherited or others who would receive less under a will than might be given under a distribution by law. It is a trade-off. A no-contest clause will unnerve a will disputant if the specter of losing something of real value hangs in the balance.

Estate Administration and Intestate Succession- When a person dies the title to his property must pass to someone; the law insists that the title to property be somewhere. If the decedent leaves a valid will, property will pass as he directs, subject only to certain limitations imposed by the State, such as the widow's right to dower. If, however, no valid will has been executed, the decedent is said to have died "intestate" and the State prescribes who shall be entitled to the property.

The rules set forth in statutes for determining, in case of intestacy, to whom the decedent's property shall descend and be distributed not only assure an orderly transfer of title to property but, also, purport to carry out what would probably be the wishes of the decedent. The fact that the rules of descent are statutory reflects the dominant principle recognized in most jurisdictions that inheritance is a privilege granted by the sovereign and may, therefore, be regulated by it. · The State may, at any time, change the rules. If A expects to be the heir of B upon the latter's death, it is within the constitutional power of the State to change the rules *before* B's death in such a way that A would not fall within the class designated as heirs. Until the death of B, A has no vested property right that the constitution will protect. Similarly, it would be legally possible, no matter how unlikely, that a State might provide that, after the payment of the debts of a decedent, all his intestate property should be public property, or that intestate property should pass to persons other than the next of kin.

State Law and Intestate Succession- State law has prescribed disposition of any part of the estate not effectively disposed of by will, trust, joint ownership, or other means. State laws can vary. One constant is that only the surviving spouse, blood and legally adopted relatives may inherit. The chart below illustrates the possible inheritors as described by state law. Numerous cousins and their status in relationship to an individual can be identified using this chart

Consanguinity Table



There are two general types of disposition;

Per Stirpes- A Latin term meaning through or by roots, family stock representation. The essential characteristic of a distribution of an intestate's estate per stirpes is that each beneficiary receives a share in the property, representing the actual fraction of the fraction to which the person through whom it is claimed from the ancestor would have been entitled. For example, Lisa dies without a will. Her husband died before her and she is survived by three children. A fourth child predeceased her but has left three children. With *per stirpes* distribution, Lisa's three children each receive one-fourth of the estate while the remaining 25% is distributed to the children of the fourth child who predeceased Lisa.

Per Capita- This equates to pro rata distribution. The surviving descendants will receive equal shares of the inheritance without regard to generational differences. James, a widower, dies intestate with the same survivor pattern as Lisa in the example above. James' children and the three children of the fourth child will all receive an equal share of the estate under this type of distribution system.

Real and Personal Property- The manner of its descent upon death is one distinction between real and personal property. This distinction is likewise statutory and varies from State to State. It used to be, under the common law, that title to the personal property of an intestate passed immediately to his personal representative while his real estate descended directly to his heirs. This distinction no longer has much practical significance and, in some States, by statute, it has been eliminated. The important difference between the two is that, in most States, the debts of the decedent must be first satisfied out of his personal property and, in some instances, this is the rule even where a debt is secured by a mortgage on real estate. Any present vested interest in property will descend to heirs. A vested remainder following a life estate which is not reduced to possession because it is possessed by such heirs when the life tenant dies.

The rules of descent vary widely from State to State but, as a general rule, and always excepting the specific statutory or dower rights of the widow, the intestate property passes in equal shares to each child of the decedent. One method is to provide that, if A dies intestate leaving a widow and children, the widow will receive one-third of the real estate (in fee or for life) and one-half the personal property, and all the rest of the real and personal property passes to the children equally. If the widow does not survive A, all the property goes to the children. If A dies leaving two children, B and C, and grandchildren D1 and D2 the children of a predeceased child D, the estate will go one-third to B, one-third to C and one-sixth each to Dl and D2, the grandchildren dividing equally their parent's equal share. This result is legally described by the statement that lineal descendants take property per stirpes or those lineal descendants of predeceased children take by representation of their parent. If, in the example, A had executed a will, he might have provided that all his lineal descendants, regardless of generation, would share equally. In that case, given the above example, A's estate would have been divided into four equal parts and the descendants would be said to take per capita.

If no children but only the widow and other relatives survive the decedent, a larger share is generally allotted the widow. She may then receive all the personal property and one-half the real estate or, in some States, all the real estate. Regardless of who the other relatives are, whether children, brothers, parents or cousins of the deceased, a surviving spouse cannot, without his or her consent, be cut off from a dower or statutory share.

At common law, property could not lineally ascend; parents of an intestate decedent did not, in any event, share in his estate. Today, in many States, if there are no lineal descendants, the statute provides that parents are the next to share. Most statutes make some provision for brothers and sisters in the event no spouse, parents or children survive the decedent. These, together with nieces, nephews, aunts and uncles are termed collateral heirs. Beyond these limits most statutes provide that, if there are no survivors of the named classes, the property shall be distributed equally among the next of kin in equal degree. The common law did not consider a stepchild an heir or next of kin; that is, as one to whom property would descend by operation of law, and this rule prevails today in nearly all jurisdictions. Legally adopted children are, however, recognized as lawful heirs of their adopting parents.

Dispersal of Wealth Through Inheritance- Literally trillions of dollars will change hands over the next few decades as a result of testamentary bequest. With so many bequests and so much money at stake, it seems inevitable that the level of contestation of testamentary intent will increase dramatically. There is no “right of inheritance” in the Bill of Rights, the Constitution, or common law. Many people will be dismayed to find that certain rich relations left the bulk of their estate to a cause more worthy than butter and egg money. Many people think charity begins at home (or the home of third cousin thrice-removed Harry). Such an outlook can result in litigation. The tort known as intentional interference with the expectancy of inheritance could become the newest field of legal specialization. This tort recognizes that someone denied an inheritance because of the conduct of a third party can seek relief in the courts. In New York and several other states, only one who would inherit if the will were invalidated can sue to upset that will. The most significant aspect of this action is that it may be brought before the will maker has died. This is a considerable difference from will contests. They must be made after the testator has died. If the potentially denied inheritors can start stirring things up from a legal perspective even before the testator dies, the most carefully laid estate plans can unravel.

It is valid to incorporate into a will by reference another document which in itself is not a will for lack of proper execution. To incorporate a memorandum in a will by reference, the following four conditions must exist: (1) it must be in writing; (2) it must be in existence when the will is executed; (3) it must be adequately described in the will; and (4) it must be described in the will as being in existence. Assume that T dies leaving a will that leaves the residue of his substantial estate in trust "to be delivered by the trustee to such charities" as T "shall designate to his trustee." No charities are named in the will. Upon this fact situation, it has been observed: "The memorandum in the present case was not in existence at the time the will was made, nor was it described in the will as being in existence, but was described as something to be described in the future."

Legal Aspects of the Will

The concept of private property does not greatly antedate the principle that a man should be able to exercise some control over the transfer of his property at his death. Hand in hand with the principle of control at death over what was possessed during life has developed the competing doctrine that the sovereign might limit this testamentary power in accordance with what appeared, from time to time, to be socially or politically expedient. This doctrine was strongly indicated during feudal England when the voluntary transfer of land at death was all but forbidden, and it is evident today not only in the general statutory regulation of the manner and power to make a will but, also, in the substantial taxes imposed upon the transfer of property at death.

There is one major characteristic of a will which sets it apart from other transactions such as deeds and contracts: A will is revocable at any time during life. There is no such thing as an irrevocable will. If a document is binding during life it may be a contract (such as a promise to make a will) or a deed (conveying a vested remainder after a life estate in the grantor) but it is not a will. A will takes effect only upon and not until the death of the testator.

Whether a will is looked upon as an inalienable right or a privilege granted by society the fact remains that the execution of a will is, in a large sense, a moral responsibility and one that is too frequently ignored or forgotten by persons who own property. It is indeed a strange fact that persons who exercise the most extreme caution over their affairs during life neglect to execute a will, thereby allowing the State, by default, to direct who shall inherit their property. For a really different take on the implementation of a will, the reader can search the Internet for "The Great Stork Derby" (Snopes has an informative write up on this episode).

Ability to Will Property- Not every person can make a valid disposition of property at death. Two types of qualifications are necessary and these are described by the statement that, to make a valid will, the testator must have both the "power" and the "capacity" to do so. Both of these terms refer to restrictions imposed by statute or court decision but each has a distinct and separate meaning. The power to make a will is granted by the State to persons who are of a class believed generally able to intelligently handle their affairs without regard to personal limitations. Thus, in most States, children under a certain age cannot make valid wills. In Illinois, for example, a person must be eighteen years of age at the time of executing a will to have it recognized and enforced by a court.

The capacity to make a will refers to the limits placed upon particular persons in the class generally granted the power to make wills because of personal mental deficiencies. The will of an insane adult is invalid because he did not have the capacity to make a will. Since capacity is a personal matter it is not easy to set down any test that will, in all cases, measure this qualification. A person adjudged insane can, in a lucid period, make a valid will. An aged and enfeebled octogenarian may have the capacity to execute a will. If one rule appears clear, it is that it takes less in the way of mental qualities to meet the test of capacity to make a will than is required for the independent management of one's affairs during lifetime. A deed from X to Y may be set aside because of the incompetence of X, although X may validly leave the same property to Y by will. Proof that the testator held beliefs not accepted by society in general will not impinge upon his capacity. A firm conviction in reincarnation or a devotion to the precepts of Zoroaster is not of itself inconsistent with the capacity to make a will.

Underlying the notion of capacity is the premise that, in order to be valid, a testator *must intend* a document to be his will. This requisite intent will be lacking if he is insane or suffers from delusions just as intent is presumed to be lacking in persons below the age at which persons generally are given the power to make wills.

Legal Requirements- By statute, today, in all jurisdictions, a will to be valid must comply with certain formalities. These are necessary not only to indicate that the testator understood what he was doing but, also, to help prevent fraud.

❁Writing. A basic requirement to any valid will is that it be in writing. The only notable exceptions to this rule are found in statutes permitting oral wills by soldiers and sailors and, less frequently, in statutes validating oral wills of personal property made on a death bed or *in extremis*. The writing may be informal so long as the basic formalities required by the statute are substantially met. Pencil, ink, and mimeograph are equally valid methods and valid wills have been made on scratch paper or on an envelope.

❁Signature- A will must be signed by the testator. The signature indicates that the will has been executed and it is a fundamental requirement in almost all jurisdictions. What constitutes a valid signature will vary with local custom and from case to case. The initials "A. H." or "father" at the end of a will is valid if the signature was intended as an execution. On the other hand, a person who makes a couple of strokes of the pen and then stops, saying, "I can't sign it now" has not made a valid signature. Most statutes require the signature to be at the end of the will and, even in jurisdictions where this is not specified, careful draftsmanship will so provide to avoid the charge that the portions of a will coming after a signature were written subsequent to the execution and, therefor, without the necessary formality of a signature. Fortunately, legibility is not a prerequisite to a valid signature.

❁Attestation- With the exception of a few isolated types of wills noted later that are valid in a limited number of jurisdictions, a written will must be attested by witnesses. The number and qualification of witnesses and the manner of attestation are generally set out by statute. Usually two and sometimes three witnesses are required. It is good practice to have a will attested by one more than the legal minimum number to increase the likelihood that at least two will be available at the time the will is offered for probate. Similarly, although a witness generally need not be a resident of or domiciled in the jurisdiction of the testator it is not expedient to have witnesses who will not be easily available at probate. Age is no barrier to a witness, provided he is generally competent although, again, for obvious reasons, an elderly person may be a risky witness from an actuarial point of view. The function of witnesses is to acknowledge that the testator did execute the will and that he had the requisite intent and capacity. It is important, therefore, that the testator sign first in the presence of all the witnesses and it is usually essential that they attest in his presence and the presence of each other.

The most common restriction on a qualified witness is that he must not have any interest in the will he witnesses. This requirement takes at least two forms under statutes. One type of statute disqualifies a witness who is also a beneficiary under the will. The other type voids the share of the interested witness thereby making him a disinterested and qualified witness. What constitutes an "interest" sufficient to disqualify a witness is not always easily defined. The spouse of a beneficiary under a will has been held to be "interested" and thus not qualified. Generally, a person is not disqualified simply because he is named as executor in the will. The attorney who drafts the will is generally a qualified witness because his function as attorney for the executor will depend entirely upon the free choice of the executor. Nor is usually a member of a church named as a beneficiary nor a shareholder of a corporate executor or trustee under a will so "interested" as to be disqualified. In all cases, however, caution should dictate that the witnesses have not the slightest connection with persons or institutions entitled to share under a will.

✽Publication- It is sometimes said that a testator must declare that a document is his Last Will and Testament and that this should take the form of an oral declaration to the witnesses. This idea stems from the concept that there must be "publication" of a will. It is generally an unnecessary formality.

Duress or Fraud and the Will- The requisite testamentary intent must always be present in order to create a valid will. Any document purporting to be a will that is the creature of an intent other than the testator's is not a valid will. This is the basis for the rule that a will which transmits property as a result of undue influence or a fraud is no will at all. What constitutes "undue influence" cannot be generally defined. Certainly, a wife can urge her husband to leave all his property to her and, out of love and affection, he will probably accede. This influence is not "undue." Nor is a general influence over the testator sufficient to make a case of improper pressure. The influence must be directed specifically to the act of making the will. Most frequently, the charge of undue influence is made when a testator leaves his property to a person who is not a blood relative, such as a friend who took care of the testator in his last illness or during his last years. If the evidence demonstrates that the beneficiary under the will was in close contact with the testator and that natural objects of his bounty are ignored in the will, there is a suggestion of undue influence.

The charge of fraud is similar. A dies leaving all his property to B upon the representation by B that he is A's long lost son. B in fact is not A's son. In such a case, the will may be set aside because the misrepresentation was made with the intent that A rely upon it. Fraud sufficient to set aside a will exists where a mother dies willing all her property to one of two daughters because the daughter who takes under the will falsely represented to the mother that the other daughter was scheming to have the mother committed to an institution. The burden of proving undue influence and fraud rests with those who make the allegation, and where a will is in proper form, signed and attested, either of these charges may, as a practical matter, be extremely difficult to establish.

The Concepts of Ademption and Abatement- Abatement is an occurrence generally resulting from a reduction in the value of the estate of the testator after the execution of his will. It can have serious implications. The first items that abate in a will are all the residue or remainder after provisions for specific devises and legacies. These specific gifts must be satisfied first. Thus, if John, a widower, after making specific gifts, leaves "all the rest, residue and remainder of my estate to my daughter, Mary." Mary may receive a great deal less than her deceased father intended. For example, suppose at the time John executes his will he estimates his worth at $150,000. He leaves $20,000 to his church and $20,000 to the Salvation Army and he assumes that Mary will receive approximately $110,000. John dies five years later without changing his will but having suffered substantial business and market reverses. His executor reports that there is only $50,000 in the estate. Mary will receive $10,000 less than each of the charitable bequests and only a fraction of what her father expected her to enjoy. Unless the specific bequests are small or the testator has confidence in the stability of his estate, specific bequests to persons outside his family or to institutions should be based on a percentage of the net estate of the decedent.

Ademption may not be as serious as abatement but the consequences may be regrettable. It occurs when a testator neglects to change his will after changed circumstances have rendered impossible of performance a provision in the will. X buys a farm "Blackacre" and wants it to go on his death to a favorite nephew who is studying agronomy at college. After so providing in his will, he sells "Blackacre" and, with the purchase price, buys "Greenacre." The general rule is that the nephew will not be entitled to Greenacre. More difficult problems can be easily imagined. Ademption is always a question of trying to determine the testator's intent. Did he want the legatee or devisee to have that particular item and no other? If X leaves "my 200 shares of General Motors stock" to Y and at his death he has no such securities, his executor will not be authorized to purchase 200 shares and give them to Y. But, if X leaves "my 100 shares of Southern Commonwealth stock" to Y and, upon his death, he has only 50 shares of Eastern Commonwealth, Southern having merged therewith and a 1 for 2 stock reorganization having transpired, Y will be entitled to the 50 shares.

In his will, A leaves $5,000 to B, $5,000 to C and "my faithful Collie, Rex" to D. At the time of A's death, after payment of his debts, there is only $5,000 in his estate and a Siamese cat by the name of Queenie, faithful Rex having been disposed of after biting his master. B and C will each receive $2,500 and D will receive nothing, Queenie going to whoever takes the residue of A's estate. The gifts to B and C are said to have abated while the gift to D, not being in existence at the time of A's death, has "adeemed."

These generalities should be accepted as such; few fields of the law of property are] so strictly a matter of statute, and the rights of heirs cannot be reasonably predicted without a knowledge of the exact terms of the applicable statute.

Modification of a Will

Tearing, burning, or otherwise destroying a will is a strong sign that the testator intended to revoke it and, in the absence of a showing that the destruction was inadvertent, this is an effective way of revoking a will. In some States, partial revocation of a will may be accomplished by erasure or obliteration of a part thereof. In no case, however, will a substituted or additional bequest by interlineation be effective without re-execution and re-attestation.

Revocation- By definition, a will is revocable by the testator up to the time of his death. Under certain circumstances, a will may be revoked by operation of law. This does not mean that certain formalities are not necessary to effect a revocation. In most jurisdictions, the methods by which a will is revoked are specified by statute. The execution of a second will does not in itself constitute a revocation of an earlier will. To the extent that the second will is inconsistent, however, with the former will, the first will is revoked. The most certain manner of revocation is the execution of a later will which contains a declaration that all former wills are revoked. In some but not all jurisdictions, a will may be revoked by a written declaration to this effect in a subsequent document such as a letter, even though the document does not meet the formal requirements of a will.

A marriage generally revokes a will executed prior to the marriage. This rule of law is based partly on the reasonable presumption that a person's wishes with respect to his property change with marriage, even though he may neglect to alter a prior will, and partly on the belief that marriage imposes new moral obligations which should not be impaired by a will executed before marriage. Divorce does not necessarily revoke a provision in the will of one of the parties for the benefit of the other party.

Children in the Will-The birth of a child after execution of a will may revoke a will at least as far as that child is concerned if it appears that the testator forgot to make a provision for the child. Statutory provisions are frequently to the effect that unless provision is made in a will for a child of the testator born after the will is made or unless it appears by the will that it was the intention of the testator to disinherit the child, the child is entitled to receive the portion of the estate to which he would be entitled if the testator had died intestate, and all devises and legacies shall be shared proportionately thereafter.

Spouses and the Will- Statutes provide for a right of renunciation of the will by a surviving spouse and set forth the method of accomplishing it. The purpose of such statutory provisions is to enable the spouse to elect which method of taking, e. g., under the will or under the Statute of Descent, would be most advantageous to him or her. Where a spouse dies owning real and personal property, the surviving spouse has an interest in the decedent's estate that cannot be divested by will, or otherwise, without his consent. The right to renounce a will may be exercised only by persons designated by the statute, and the right conferred on the surviving spouse is personal. A surviving spouse must execute and file a written renunciation of the will within the time prescribed. The right is absolute; and approval of the renunciation or its filing is not required. Upon renunciation of the will, the law determines the share of the estate taken by the survivor.

The one impression that the layman should take with him from even a brief glance at the law of intestate succession is the complete abdication of his control over disposition of his property that results from the failure to execute a will. In some cases, intestacy may result from an intelligent analysis of the consequences, but most frequently when a person dies without a will he has left to the State the decision as to the disposition of his estate.

Chapter 6 Probate

Probate Defined

Probate is defined as the act of proving that an instrument purporting to be a will was signed and otherwise executed in accordance with legal requirements for a will, and of determining its validity. The entire procedure is commonly referred to as probate. That is, all the steps necessary to establish the validity of a will. In many jurisdictions a probate court is a special court that handles matters relevant to the settlement of a decedent's estate. After the fact of a person's death has been proved, the person who has been designated executor presents the deceased's will to the court with a petition for probate. The court then sets a date for the probate hearing, allowing enough time for all interested parties, including possible heirs, to examine the will and decide whether they want to object to any of its provisions.

At the probate hearing anyone who thinks the will is not genuine may contest it on the grounds that the testator (the deceased) did not sign it and the signature is that of another person; that the witnesses did not actually observe the testator signing the will; or that the testator was unaware of signing it because of illness or was coerced into signing it. Unless affirmative proof is presented showing the will to be invalid, however, the court usually admits it to probate even if one or both of the witnesses to the will are dead or cannot be found.

Probate has been a function of the courts for quite some time, with the issue of probate and the state's right to regulate same early on going all the way to the U.S. Supreme Court. In the case of Calder v. Bull (1798), the Supreme Court of the United States was asked to interpret for the first time the *ex post facto* clauses found in Sections 9 and 10 of Article I of the U.S. Constitution. After a probate court in Connecticut had invalidated a will, Calder was given possession of property that the deceased had left to Bull. Two years after the decision, the legislature passed a resolution granting a new hearing and the right to appeal. On a second hearing, the probate court accepted the will and assigned the property to Bull. Calder appealed to the U.S. Supreme Court, arguing that the legislature had passed an ex post facto law, but the Court ruled against her.

Justice Samuel Chase held that the constitutional prohibition against ex post facto laws extends only to laws that make criminal an innocent action taken prior to the passage of the law; that make the punishment or scope of a crime greater than it was when it was committed; and that alter the rules of evidence in a manner that would permit less or different testimony to convict an offender. Since Connecticut had not enacted any such law, the retrospective action, which involved a civil procedure, was not held to be ex post facto.

The Uniform Probate Code: The National Conference of Commissioners on Uniform State Laws and the American Bar Association approved the Uniform Probate Code (UPC) in 1969. This was intended to facilitate uniformity in probate codes throughout the United States. In the face of widespread criticism of the present American probate institution, the adoption of a uniform, and in most cases, less expensive system of settling a decedent's estate is deemed desirable. The UPC is based on the major premise that the probate court's appropriate role is to be available to assist in the settlement of an estate when assistance is requested or required rather than to impose its unsolicited supervision to enforce every detailed formality upon completely non-contentious settlements. It remains to be seen how receptive the states will be to this concept.

The law is generally not as ready to invalidate or partially revise a will because of mistake as it is to adjust a contract based on an error. A mistake as to the identity of the instrument voids a will. But a stenographic error or a mistake in drafting such as the phrase *"40* acres" when the testator meant "80 acres" would not invalidate the bequest or devise. The power of the sovereign to restrict the right to dispose of property at death is exercised not only by affirmative regulations governing the method of passing property at death but also by imposing limits upon the receipt of such property.

Probate of Wills and Estates

Whether a person dies intestate or leaves a valid will it is obvious that an efficient and impartial method must exist to protect their creditors and to carry out testamentary instructions or determine who is entitled to the decedent's property under the applicable rules of descent. The rules and procedures controlling the management of the estate of a deceased are statutory and therefore vary in some respect from State to State. In all jurisdictions, the estate is managed and finally disbursed under the supervision of a court. The procedure of managing the estates of decedents is referred to as "probate" and not infrequently the court which supervises the procedure is designated as the Probate Court.

The first legal step after death is usually to determine whether or not the deceased left a will. His personal attorney may have the will or may know that one was executed; sometimes the existence or absence of a will is not determined until after careful search of the safe deposit box and personal papers of the deceased. If a will exists, it is probable that in it the testator named his widow, a friend or a trust company as his executor.

If there is no will, or if there is a will that fails to name an executor, the court will, upon petition, appoint an administrator. The closest adult relative who is a resident of the State is entitled to such appointment in the event there is no one else who qualifies as administrator, the public administrator may be appointed to fill the office.

An administrator or executor is required to post a bond to insure the faithful performance of his duties, although, if a testator directs that the executor need not post bond, this will be accepted by the court in most cases. Usually, this bond is an amount in excess of the estimated value of the personal estate of the decedent. Once approved or appointed by the court, it is the executor or administrator who holds title to all the personal property of the deceased and who accounts to the creditors and the beneficiaries. The estate is his responsibility.

Steps Involved in Probate- The will of a deceased person must be presented to the probate court, with an application to probate the estate, within a statutory time period (usually four years) of the death of the person whose will is to be probated. The law specifically states that no will be admitted to probate after the statutory time period has lapsed from the date of death of the person whose will is to be probated. It is essential that the person who has custody of the will take it to an attorney to have an application for probate filed with the probate court.

If there is a will, it must be proved before the court by the witnesses. They will testify to the signing of the will by all signatories and as to the mental condition of the testator at the time of the execution of the will. If the witnesses are dead, proof of their handwriting is necessary. If the court is satisfied that the will is proved, a formal decree will be entered admitting the will to probate. Proof of heirship is required whether there is a will or whether the decedent died intestate. This step requires testimony by any relative who is acquainted with the genealogy of the family as to the heirs of the decedent. This testimony is obviously necessary where there is no will in order to establish those entitled under law to the property of the decedent. If there is a will, proof of heirship is required so that heirs may be notified in order to protect their interests. By custom, in most jurisdictions, the proof of heirship is made up partly of first-hand knowledge and partly of hearsay.

Assume Ms. Jones' father died. He left a will. However, his insurance and annuity named the mother as beneficiary, and his checking account, stock holdings and some CDs were registered The stock was sold and the other accounts converted to the wife's (Ms. Jones' mother) name. There is no other property, and no creditors to pay. Probate is not necessary if a person's will transfers no property. However, one should not throw it away either, because a later discovery of property would require that the will be probated. The main reason people go through probate is to legally transfer ownership of property. Once the will is admitted to probate, the court gives the executor "letters" which authorize the executor to act on behalf of the decedent's estate. "Letters" are needed to transfer title to many types of property, including stocks, bonds, real estate, some bank accounts, and many other types of property. For many people, a will transfers only a small portion of the total estate, because most property is transferred via beneficiary designation on a life insurance policy or retirement plan, or by survivorship on bank and brokerage accounts.

Soon after the admission of the will to probate or the issuance of letters of administration, the personal representative of the decedent (i. e., the executor or administrator) must file an inventory of the estate. Frequently, independent appraisers must be appointed to value the personal assets. A bank account will be opened in the name of the estate, and the personal representative will commence his duties of collecting the assets, paying the debts and disbursing the remainder. In his position the executor or administrator occupies a fiduciary position not unlike that of a trustee and his responsibility for investing proceeds and otherwise managing the estate is equally demanding.

Notice Required- One of the first duties of the personal representative is to publish a notice that all claims against the decedent's estate must be filed and proved within a certain period of time. It is the duty of the personal representative to demand proof of the claims and pay those which are valid. In most jurisdictions, certain claims are entitled to priority over general creditors of the decedent. At the top of these preferred claims are estate and inheritance taxes. By statute, the widow generally is entitled to a cash allowance pending final disposition of the estate and this "widow's award" is regarded as a preferred claim against the estate.

After settlement of these obligations and the funeral expenses, general creditors of the decedent whose claims are filed and allowed must be satisfied before any amounts are paid to beneficiaries or heirs. Corporate securities, government obligations, and items of personal use are all part of the assets of the decedent that pass into the hands of the personal representative. The personal representative may exercise the same powers incident to the ownership of such property as the decedent might have exercised during his life. Thus the personal representative may vote stock owned by the decedent or exercise conversion privileges attached to such securities.

Insurance on the life of the decedent passes directly to the named beneficiary and does not go into his estate unless payable to his executor or the estate itself. Thus, insurance will not be available to pay the debts of the decedent if it is payable directly to a named beneficiary other than the personal representative.

Taxes are imposed at death by both the Federal government and the State. It is the responsibility of the executor or administrator to pay these taxes. It is also his responsibility to file an income tax return and pay the tax not only for the partial year immediately preceding the death of the testator or intestate but also on the income received by the estate during its administration.

Problems with Probate

Probate Takes Time- It can take up to two years. The beneficiaries generally get nothing in the intervening period unless the judge okays an allowance for the family. A lawyer must ask the judge for the money in a court proceeding. This costs money. The money being solicited already belongs to the family. Having the assets tied up by the court makes no sense.

Probate is Public- When a will is probated, this document expressing the personal feelings of an individual becomes a matter of public record. The reality is that not just everyone goes down to the courthouse on an expedition to peruse wills. However, a disgruntled paramour, creditor, or relative may not like what is on file.

Probate Required in Each State- When a person owns real property in more than one state, a probate proceeding is required in the other states as well. A lawyer must be retained in each particular state.

Creditors Must be Notified- This has both good and bad points. With a probate proceeding the executor can demand that heirs turn over enough assets so that creditors can be paid. Creditors only have a set amount of time to submit claims for payment to the executor. About six months is allowed in most states. The creditor is out of luck after the deadline passes. If an estate is not probated, creditors' claims are valid longer. The creditor can seek out heirs and sue for recovery one or two years later. Under normal circumstances, the heirs pay off all outstanding debts owed by the deceased. It is part of the job for creditors for big ticket items to keep up with these things anyway. Most large consumer loans have credit life features. For small debts, it may not be worth a creditor’s time to track down the heirs and seek recovery.

A series of Los Angeles Times articles looked at probate and the additional issue of conservatorship. One is titled “Probate Judges Cracking down on Conservators”;

The article deals with Orange County probate judges who have been trying to stamp out abuses by a small number of professional conservators. These are entrepreneurs who control the lives and estates of mostly elderly people unable to take care of their personal and financial affairs. The judges are systematically slashing the fees that conservators propose paying themselves from clients’ estates. It seems a Los Angeles probate judge had to take the unusual step of hiring an outside law firm to investigate one professional conservator who cannot account for more than $1 million missing from the estates of 46 of his clients. The law firm says in court documents that the conservator, Rodney P. Swanson, embezzled the funds. A Riverside County, California probate court also instituted new procedures after discovering that a professional conservator paid her own home-care business thousands of dollars from the estates of 15 clients who were also billed hefty sums for her conservatorship fees.

The article goes on to note that the supervising probate court judge of Orange County recently looked into the relationship between one prominent local conservator and a Silverado Canyon board-and-care home housing some of her clients, that the conservator’s husband had made arrangements to buy. Such conflict of interest problems are exacerbated by the growth in California’s graying population. State lawmakers are considering legislation to regulate professional conservators, establishing professional standards and prohibiting them from hiring businesses in which they have a financial interest. Other pending legislation would create a statewide registry to protect the elderly and infirm from being defrauded by caretakers who may be barred by the courts from doing business in other counties. A statewide conservators group’s leader applauded the efforts to set up uniform guidelines for people managing millions of dollars for helpless people. The article quotes James Moore, co-president of the Professional Fiduciary Association of California saying, "We’re taking care of the most vulnerable people in the state.”

The current push for regulation comes two years after lawmakers enacted legislation prohibiting attorneys from preparing wills and trusts that made them beneficiaries of their client’s estates. The LA Times had previously revealed how Orange County probate lawyer James Gunderson improperly inherited millions of dollars in cash, stock and real estate from some elderly clients whose wills and trusts he had prepared, and then pillaged. Gunderson also had acted as conservator for some of the clients.

Former bank trust officers, retired social workers and former employees of public guardian offices are among people switching jobs to cash in on the growing demand for conservator services. The article notes that these services can range from payment of clients' monthly bills to making critical decisions about medical care. The conservators may have multiple clients with the potential to serve as custodians of millions of dollars in assets. There are no specific qualifications for the conservators, the article notes. Nor or there any ethical standards governing behavior or rules concerning the use of clients' money. No limits are imposed on the amount in fees a conservator can bill an estate.

Orange County probate judges say they have both the authority and the duty to determine if fees charged by conservators are reasonable. Several months past, they set up a new process to study the fees that professional conservators charge. According to the article, court officers want to know why Orange County conservators have been billing their clients' estates at a constant rate of about $75 per hour services as varied as arrangement of medical care to restaurant outings. Conservators must disclose under the new program their plan for managing clients' estates and hourly rates for various services. The supervising probate court judge in Orange County, Richard O. Frazee, notes that the new requirement is meant to head off the fee challenges that often occur when conservators wait and then submit an invoice for 12 months worth of services. Judges have been methodically reducing some conservators' fees to the $35 per hour that the public guardian's office charges for the same services.

The article in The LA Times goes on to say that probate experts note the allure of large sums of money in their care is more than a few conservators can resist. Mr. Swanson, the Los Angeles County conservator mentioned earlier, was suspended from operating in 1994 after he could not account for assets missing from one estate. After audit by a Los Angeles law firm of his accounts, Swanson is facing accusations in probate court that he cannot account for more than $2 million from the estates of 46 conservatees. Most of these people are helpless, incapacitated seniors. A Riverside County case with much lower stakes also triggered a probate court rule change. A former Orange County public guardian named Bonnie Cambalik admitted to hiring Care World Enterprises, a home-care firm in which she was an investor. The bill from the home-care firm exceeded $45,000 in one case, according to court papers. Other cases had payments to Cambalik's firm from clients from several hundred dollars to $13,000. Cambalik insisted her company made no profit on her clients' business but admitted it was a "mistake" not to have notified the court of her involvement with the firm.

Riverside County Superior Judge William H. Sullivan said that the Cambalik case triggered formulation of new rules requiring conservators to appear before him and gain approval before hiring a home-care agency. The article concludes with a comment from Cheryl Thompson, a deputy public defender in Riverside who represented two of Cambalik's clients. She said the Judge's new policy was "an important step. It's putting constraints on conservators. I think he needs to put on more constraints."

Changing or Eliminating Probate

As pointed out above, probate can become a time consuming process. The more complex the ownership of assets becomes, the more difficult will be sorting out matters after death. Consumer advocates are beginning to push for laws that encourage probate avoidance. Reform is needed to make transfers of property after death easier. Attorneys and bank trust officers defend the current probate process by saying it allows various options under the law, small estates are handled quickly and paperwork is held to a minimum. Reform groups argue that court filing fees must be paid, attorney's fees must be paid, fiduciaries appointed and one must adhere to the *corpus* of probate law. In contested cases attorneys carry out important tasks related to issues like the validity of creditor's claims or determination of heirship. More often probate is just an extended exercise in form filing. The legal system in the U.S. today is filled with legal terms like "discovery" and "motion". These terms do not refer to space shuttles or football penalties, but they also can cost you big. These legal practices run up legal bills and cause interminable delays. It can take several years for a cause of action to move from filing to a court date.

Alternative Dispute Resolution (ADR) is the mode du jour for solving disputes outside the formal legal system. With ADR, the parties to a suit arbitrate or mediate disputes without direct court supervision. Through mutual agreement or court mandate, the opposing sides meet and present their side of the story. Considering the facts at hand, a mediator brings both parties to an agreement. Costs and time expenditure are held to a minimum. Perhaps a similar system could be fashioned for resolving disputes under probate.

Avoiding Probate

Lawyers cost money. This is the first thing that enters the mind when talk turns to making a will or getting an estate in order. Like so many of life's chores, attitudes concerning the ultimate disposition of assets are all over the map. It was pointed out earlier that a majority of the population dies without a will. These people stay in denial of their ultimate fate to the very end. At the other end of the spectrum are people who leave a will and detailed plans concerning disposition of assets. The reason for leaving a final testament is not necessarily related to estate size. The larger the estate, the more that planning will be driven by economic and tax necessities. The majority of Americans do not have large estates. Their desire to leave a last testament is driven by an emotional urge to have everything in order when they depart this life. Naturally, the bulk of estate planning occurs in this market. This was pointed out many times previously. The person in middle income regions, with savings, a house, and perhaps a modest amount of additional assets, has less margin for error in estate planning than a high income individual. Lawyers still cost money. To pay one for estate planning, for benefits the client will never see, is anathema to many people.

There are two different ways to approach this dilemma. One can think of it as pay me now, or pay me later. Consulting an attorney now can save time and expense later when an estate plan is put in motion. Do it yourself is the other option. As with home repair, there will always be people who can, and will, do a large portion of the estate planning legwork themselves. The chief reason for this is to cut costs. For whatever reasons, the public has decided that avoiding probate is an effective place to start economizing for estate planning. There is no need to pay more than necessary to put an estate plan in order and ultimately handle the estate. An adviser wants to be paid for time and for dealing with estate issues. Ownership of assets, including insurance death benefits and retirement accounts, must be transferred upon death. Living trusts, direct transfers and probate are some of the pipelines available for distribution. Direct transfers include beneficiary designations, joint ownership with rights of survivorship, and payment upon death accounts. Individuals and their estate planners, (that’s YOU for do it yourself-ers) must be familiar with how assets will be transferred.

Costs of Probate- For most people, probate is not the big concern. Probate consists of acceptance of the Will by the court as a valid document. This normally is an uncomplicated task. Most people fear that the estate will become mired in endless, expensive court proceedings after they are gone. In some states this is true. The executor must make several trips to the courthouse to receive official blessing for steps taken to dispose of the estate. Avoiding probate in such states may be worthwhile. It is ironic to note that an attorney would best be consulted to determine if a client’s state of residence is such a state.

Determining the estates' obligations for taxes, and debts can be kept up to date and handled by a competent survivor. How money is to be raised for such liabilities is an issue that must be addressed. Insurance and retirement benefits must not be overlooked. Probate does not address taxes. Personal security concerns, as well as estate and tax planning, require an individual to retain sole title and ownership rights. Examples may include life insurance policies, dwelling, and retirement funds.

These assets can be transferred by the probate process or the living trust process at death. Issues always arise that need to be addressed. There are claims that are disputed, such as a doctor's final bill. There are business problems that make waves; back claims for income tax; contests with the government in the estate tax proceeding; and maybe lawsuits that were pending when the Will maker died. Even worse: a disappointed heir may challenge the Will; a former spouse may have grievances; the surviving spouse may seek to upset the premarital agreement; the decedent's partner, who survived, may be rocking the business boat; the nice couple who contracted to buy the decedent's home may try to back out; and a beneficiary may assert that a bank account in joint names of the deceased and someone else should go into the estate, and not to that someone else. Things such as these create problems that must be resolved, often with a big legal fee.

Probate transfers require a court approved executor to transfer the assets through the probate estate with numerous court-supplied forms. Living trust transfers require an appointed trustee to transfer the assets through a living trust estate. The legal work for a probate estate occurs after death. The majority of living trust estate legal work occurs before death.

Cost is the biggest concern for people going through probate. How does one keep an already small estate from becoming even smaller? The estate executor has a right to be compensated. Statutory fees defining what is ‘reasonable’ vary from state to state. For example, Texas law provides the executor’s fee is not to exceed 5% of gross fair market value of the estate. A decreasing percentage fee is found in New York with a limit of 2% in fees for an estate valued over $5,000,000. Often times an executor will hire an attorney and/or accountant for the estate’s legal, tax, and accounting needs. These costs may be the same or more than that of the executor. Combined, the fees could be as high as 10% of the gross estate. Logic dictates that competition will hold down the level of fees. Also, the use of uncompensated family executors and trustees can help hold down costs. The probate process is simplified when a state adopts the Uniform Probate Code or other simplified procedures for probate.

The public still retains the mindset that probate costs are artificially high because the process is out-of-date and caught up in paper pushing. After the paper chase ends a plan must be made to distribute the estate to the beneficiaries. The plan must include when, how much, and with what assets. Beneficiaries of an estate are going to turn to the executor with questions about their inheritance. For protection, the executor is going to have the estate resolved at some point in time. This requires an accounting for the transactions made and their approval by some third party. This must be done whether or not an estate is probated.

The revocable living trust was mentioned as a tool for probate avoidance. An argument frequently proffered on its behalf is that enormous savings are achieved at death. This is because the assets in the trust are not part of the grantor’s probate estate. Many self-help books can be found at the library on the subject of how to avoid probate. The main thrust of such books is often the use of revocable trusts. Such tools and advice are best deployed on a case by case basis. Assets in a living trust escape probate, true enough. These assets are still subject to taxation, creditor’s claims, and disposition to heirs. Administration of such matters still takes time and resources. In a state where attorneys' fees are not statutorily set, the legal fees for representing the estate would be fairly constant whether or not a revocable trust was used.

A savings in legal time charges might arise, however, because title to the decedent's trust assets would not have to be transferred to the estate, but this time was already charged by the attorney during the person’s lifetime. In states like California, where the statutory legal fee to settle an estate in court is $110,000 on a $10 million probate estate, or in Florida, where the statutory legal fee is less for nonprobate assets (1%) than for probate assets (2%), money might be saved by diminishing the size of the probate estate. Still, the savings on probate legal fees are not great except in the context of large estates. Furthermore, even though the statutory legal fees are deemed reasonable by the courts in California and Florida that does not necessarily mean that attorneys are able to charge those amounts for administering an estate. In many cases, attorneys will agree to administer an estate on an hourly time charge basis rather than for a statutory legal fee.

Tax Concerns

Many tax issues can be unwittingly created by trying to avoid probate. Tax issues are addressed in great detail in another chapter. Here are a few highlights concerning joint ownership with rights of survivorship;

•With property held in joint tenancy between spouses, only half of the value is included in a deceased joint tenant's estate. The surviving spouse's half interest acquires a stepped up basis. In community property states both halves acquire a stepped up basis. This adjustment is a big incentive for classifying property as community property. Questions concerning basis arise when moving from a community property to a common law state.

•Property held in joint tenancy with a nonspouse can trigger gift tax issues with death. The entire interest of the property is included in the estate of the joint tenant first dying, unless the estate is able to prove the amount of consideration furnished by the survivor. The contribution of the survivor must not be traceable to the decedent. There is an exception where the property was acquired by the decedent through inheritance.

- •Creation of a joint tenancy between spouses does not create a taxable gift because of the unlimited marital deduction.
- •Gift tax can be triggered by unequal contributions to a joint tenancy with a nonspouse. The gift usually occurs when the noncontributor claims or takes a portion of the joint interest. When a donor conveys to themselves and a donee as joint tenants and either party has the right to sever the interest, there is a gift to the donee in the amount of half of the value of the property.
- •Use of joint tenancy can result in overqualification of the marital deduction. This can cause property to be taxed a second time in the survivor's estate.

The transfer or charitable gift of retirement plan assets may have a relatively small after-tax cost because these assets are potentially subject to income tax, estate tax, generation-skipping tax, and special excise taxes. Most retirement plan assets are composed of pretax contributions and earnings and are subject to income tax when the assets are received by an heir after the owner's death. The value of the retirement assets is includable in the owner's estate and subject to estate taxes. If the owner gives these assets to grandchildren, they are potentially subject to generation-skipping tax. If the retirement plan has excess accumulations or makes excess distributions, it will be the subject of special excise taxes. The combination of these various taxes can consume more than 80% of the value of the plan. The real economic value of such a charitable gift may end up being less than 20% of the value of the retirement plan assets. These are just a few examples of tax issues that can arise. Again, to save money over the long haul, it is wise to consult a tax or legal expert before making any moves.

When Probate Should be Avoided

This is done on a case-by-case basis. It was said before that some states have expensive procedures involved in going to probate court. Another good reason is privacy. When a person leaves a will, it is a matter of public record in probate court. A trust is generally a private matter. This is important for people who need matters handled discreetly. A trust also provides more protection from attack than does a will. Discreet transfer of assets can also be accomplished with an insurance policy or a jointly held account (watch out for gift tax consequences, as mentioned above). A benefit of using a trust is that the trustee can work with the trust assets immediately. The trust assets are part of the gross estate for federal estate tax purposes. This translates to a free step up in basis for trust assets at death and the avoidance of capital gain. Appreciated assets can be sold directly after the date of death if raising cash is a goal. With a will, an executor must be named and installed by the probate court before the assets can be sold. This can take time, especially if some sort of delay is encountered. The same is true with other forms of asset transfer. A properly constructed trust can hold a person's bank accounts, mutual funds and the like. Transfer of assets after death is not a major undertaking. For assets passed under will, it can take weeks or months. Until the transfer occurs, the executor cannot use or sell the asset. This presents big problems for surviving family members.

Some Mechanics of Probate Avoidance

The first thing to do is make a will. There will always be personal property that needs transfer at death. Small items, low value items, sentimental objects are too numerous and time consuming to mention. This is the pourover will mentioned before. Its chief function is to take care of and direct such items to someone who can be trusted to dispose of them properly. The next step is to create a trust. An attorney must prepare this document. The idea is that a little spent now will help avoid spending a large sum later. A trust should contain some or all of these characteristics; the benefits are enjoyed by the trust grantor, hence the title living trust. It simply means the created the trust for their own benefit. The right to change or cancel the trust remains with the grantor. This total control of the trust and its assets precludes the triggering of any federal gift tax event. If the trust is never nullified, at the grantor's death it takes the place of a will for the assets it carries. Disposition of the assets is addressed by the trust and carried out by the trustee.

It is important that assets be actually transferred to the trust after it is created. Often a trust will be created and nothing transferred into it. This accomplishes nothing but the generation of fees for lawyers. In such a case the pour-over will controls disposition of all assets. Before a person gets to the age where lack of capacity is an issue, it is important that the assets be transferred to the trust. With incapacity the other alternatives are a court appointed guardian or the issuance of a power of attorney. Guardians can be an expensive route to go while powers of attorney can be questioned if issued long ago. When a living trust is used for estate planning purposes, consideration should be given to the age health, wealth and family status of the potential grantor. This information is important to decide which of the funding variations of the living trust to use. All of the grantor's assets are transferred when a fully funded trust is used. There is no probate of assets when the grantor dies. All of the assets that would have gone through probate are in the trust. With a partially funded trust, only certain assets are placed in the trust. An example would be real property in another state. Such a transfer would avert the problem of probate simultaneously in two or more states. No property is transferred into trust with the unfunded standby trust at its conception. The trust is at hand for future funding. It must be said again that care must be taken so the trust does not remain unfunded permanently.

One line in “The Marseillaise” alludes to the fact that the Revolutionaries will, “cull out the impure blood and irrigate our fields with it”. The days of the French Revolution are long gone but this graphic image can serve as the basis for a metaphorical construct of the estate planning process. Whichever method of asset transfer is chosen should be carefully thought out by all parties concerned. The transfer is similar to irrigation in the valley. The water flows to the various fields or beneficiaries (see chart). The amount and timing of the flow is controlled by the grantor through some form of testamentary disposition. Flow is controlled with title and transfer of assets. One field that most people would just as soon not be irrigated is Uncle Sam’s in the form of taxes. Another potential for leakage is excess administrative and legal costs. A properly constructed estate plan will anticipate problems and keep such leakage to a minimum.

Direct Transfers can be Used to Avoid Probate- The sidestep of probate at death is one of the main uses of the revocable living trust. Probate can be costly and time consuming. No matter what size an estate is, the use of direct transfers can be used as an effective and economical planning tool. They can be used to avoid probate. Establishment of a trust is not required in conjunction with their use. The large majority of Americans have simple estates with a moderate amount of assets. These direct transfer procedures can be used separately or in conjunction to transfer some or all estate assets;

Joint Ownership with Rights of Survivorship- This is a frequently used tool for probate avoidance. It is a single estate in property, real or personal, owned by two or more persons, under one instrument or act of the parties, with an equal right in all to share in the enjoyment during their lives. And on the death of a joint tenant, the property descends to the survivor. Joint tenancy originated as a technical feudal estate in land. It has now been applied through legislative action to personal property such as stocks, bonds, and bank accounts.

Manner of Holding Title	Probate Required
Joint tenancy with rights of survivorship	N
Tenancy by the entirety	N
Tenancy in common	Y
Partnership	Y

Tenancy in common is an interest held by two or more persons, each having a possessory right, usually deriving from a title. The right can also originate in a lease. Tenancy in common can apply to real property or to personalty. Co-tenants might have unequal share in a property, but they are each entitled to equal use and possession. Thus, each is said to have an undivided interest in the property. An estate held as a tenancy in common may be partitioned, sold or encumbered (liened, mortgaged, etc.).

Tenancy by the Entireties is a special type of ownership set up in some states for the benefit of husband and wife. It has the same survivorship characteristics as joint tenancy but while living neither party can alienate any part of the property without consent of the other. The survivor immediately becomes entitled to the entire asset without probate. The death certificate of the deceased joint owner establishes title of the survivor. If a legal instrument does not exist demonstrating joint tenancy, it is presumed the property is held as tenancy in common. Thus, it is important that the title instrument clearly state the intent that the property be held in joint tenancy.

Advantages of joint tenancy include;

+It is easy to create

+There can be two or more joint tenants, as long as each owns an equal share

+Protection from creditor's claims occurs. After one owner dies, joint tenancy property is subject only to claims for debts that are the responsibility of all tenants.

+It can be used for many different types of assets.

+Transfer of title is easy for the survivors

Disadvantages include;

–It may trigger imposition of gift and estate taxes depending on the specific facts involved.

–The addition of a joint tenant requires making a gift of an equal share in the property.

–Creditors can attach an individual's interest in the property while living.

–Shares of each owner must be equal.

–Availability for some types of property varies between states.

[>**Insurance and Annuities-** Assets can be passed by contract or beneficiary designation in order to avoid probate. Different types of settlement options are provided by life insurance companies. Care should be taken to name contingent beneficiaries. If the primary beneficiary does not survive the insured, time consuming problems will arise. A form provided by the insurance company or sponsor organization should be completed by the owner of the policy and reviewed periodically. A form filled in by a third party with no regard for estate planning goals can result in disaster. Subsequent divorce, remarriage, births and deaths of loved ones always have effect on such forms.

[>**Retirement Plans-** There is currently no estate tax exclusion for qualified pension or retirement plans. The complicated tax laws relating to such plans are best left to the interpretation of experts. Designation of a retirement plan beneficiary is always part of the estate planning process. When death comes and a person has money left in a retirement account, distribution will take place with a minimum amount of paperwork. Care must be taken because such funds can be subject to both income and estate tax. When the beneficiary withdraws money from the retirement account the tax deferral ends. Unlike other inherited assets, the money is treated as taxable income for the beneficiary. Also, tax laws are constantly tinkered with by our balance budget-minded Congress.

The choice as to who will inherit retirement funds is important. Married people normally leave the retirement account to their spouse. State and federal laws have been enacted to make it difficult to leave the funds to anybody else. The reasoning is that a certain portion of the account belongs to the spouse anyway, from one-third in common law states to one-half in community property states. The surviving spouse is not required to pay income tax on the money until withdrawals are made. Required withdrawals begin the year after the deceased spouse would have turned 70½. The spouse can name their own beneficiary to inherit the funds. If the surviving spouse is under age 59½, it is not necessary to pay the 10% early withdrawal penalty that would apply to their own retirement account. Single or widowed individuals can leave the account to whomever they please. After a person dies, the beneficiary can take out the money as they please. The beneficiary can also leave the money in the account and it will continue to earn tax-deferred income. Part of the beneficiary's decision rests on how old the account owner was when death occurred;

<u>Under 70½</u>- The beneficiary other than a spouse has two choices with respect to minimum withdrawals;

1.) All the money must be withdrawn within five years of the death of the original account owner.

2.) The money can be withdrawn over the actuarially projected life span of the beneficiary

For small amounts, it may be best to take out the money in one lump sum. Larger amounts can be spread over several years. This way, income tax due on the withdrawal is postponed. Larger withdrawals can also serve to bump the recipient into a higher tax bracket.

[>**Payable-on-Death Accounts-** The Uniform Probate Code created various forms of ownership designed to avoid the need for probate. One of these is the payable-on-death (POD) bank or savings and loan account. Under this form of registration, the account remains the sole property of the depositor (unlike a joint account where some other person has authority to make deposits and withdrawals from the account). However, the account owner can designate a beneficiary to take the account at death. Such an account would typically read "John J. Doe, POD Mary J. Doe." Upon presenting proof of the death of the primary account owner, the funds would be delivered to the designated beneficiary. Great flexibility can be accomplished by creating a POD account and giving the designated beneficiary a power of attorney over the account. By combining the POD designation and the power of attorney, probate is eliminated, and lifetime incapacity would not require the appointment of a guardian or conservator. Payable on death accounts are known by other names. Depending on which state, it could by a tentative trust, an informal trust, or a revocable bank account trust.

Banks in many states refer to the payable on death account as a “Totten trust”. New York State (*In Re Totten)* decided by the courts there in 1904. The court ruled that a person could open a bank account as the trustee for another person whose rights to the money on deposit commenced after the trustee’s death. After this decision, states began to codify the features of the Totten decision into statute. Banks, savings and loans and credit unions offer payable-on-death accounts. Normally all that is required is to list the beneficiary on the signature card and provide their address. In all states, the spouse is entitled to a certain share of the deceased’s assets. In community property states it is one-half. Other states (known as common law states) may allow a lower amount as the statutory share. The purpose of the payable-on-death account is to avoid probate, not to somehow cheat the spouse out of their rightful share of an estate.

With stock, bonds, and brokerage accounts, numerous states have passed laws allowing their transfer outside of probate. When the account is set up or ownership registered, a request can be made for a beneficiary form. The beneficiary has no rights to the stock while the original owner is still living. The owner can sell, change beneficiaries, or close the account. The law may apply in states that have not passed the transfer-on-death legislation. The law is normally written so that if the stock owner or issuer has any association to a state that has passed the law, then transfer-on-death registration is valid.

[>**Relief for Small Estates-** Many states have a break for people who have estates valued in the lower end of the wealth spectrum. Various states allow transfer by affidavit that does not exceed some dollar amount. The purpose here is to avoid court proceedings that will make an already small estate even smaller.

Deciding Whether to Avoid Probate

Many candidates for the estate planning process will want this question answered for them: Should I try to avoid probate? The answer will be, (equivocating all the way!)

maybe yes, and maybe no. The smaller the estate, the less money there is to spend on court and attorney fees. Many families are perfectly capable of sorting affairs and starting arguments among themselves without consulting attorneys. The other side of the coin is that once the opportunity for legal advice has passed, the chance may never come again. Consulting a legal professional may be the best way to put to rest questions the family has concerning estate matters. There are no pat answers in the legal field. Every estate must be examined on a case by case basis. The fact that money will be saved now appeals to many people, especially the vast majority of Americans who do not have unlimited budgets. The fact is that self distribution of the estate takes a lot of legwork. Time spent wrapping up affairs is time that could be spent in other worthwhile endeavors. Most people want to avoid probate as a means of avoiding attorney's fees. If a pourover will is required, there will still be attorney's fees. Living trusts will have to be prepared and handled. Costs will still occur. There is no cure all to avoid probate. Like everything else in life, it is a trade-off and a cost vs. time vs. value analysis must be done on any plan to make sure it is worthwhile. If a living trust continues for a long while, the sum of the annual expenses could well be more than that paid for the probate. This is especially true if a bank or trust company is acting as trustee. If privacy is a concern, a trust may also end up invaded by people seeking information. Creditors might seek payment of the grantor's debts from the trust. If real property is held by the trust, it could be mortgaged. Lenders often require that a copy of the trust be recorded in the county clerk's office.

Turning Down an Inheritance

As implausible as this may seem, it may be the best course of action sometimes. Such a thing can be brought on by family or tax considerations. If a person does not wish to receive their share of an estate, disclaiming some or all of the interest in the estate may be a good strategy. A person who is advanced in years may be wise to have any type of inheritance pass directly to the next generation. Such a selfless act may save income, estate, gift, and generation-skipping taxes on the estate. The disclaimed interest for all transfer tax purposes will bypass the estate of the renouncing heir if tax law requirements are met. The refusal must be irrevocable and unqualified in nature. Four conditions of the Internal Revenue Code must be satisfied; 1.) The refusal must be in writing. 2.) Before making the disclaimer, the disclaiming heir must not have accepted any benefit of ownership of the assets in question. 3.) Interest in the property must pass to someone else without direction by the disclaiming heir. 4.) The refusal must be made within nine months of the date of the decedent's death or nine months after the disclaiming heir turns 21 years of age. Disclaimers can be made for an undivided portion of an asset as well as for a separate interest in property. Remaining joint tenants may file a qualified disclaimer.

Chapter 7 Ethics

For a society to function, rules are necessary. Without rules and enforcement, there can only be anarchy. Ideally, the values basic to a civilized society are handed down to individuals through customs. These are rules of behavior that over generations have been found to help make it possible for people to live together peacefully. Observing these rules is largely a result of family training and peer pressure.

Ethics and the Law

There are always individuals who through ignorance, lack of training, or sheer perversity will not follow the rules. Penalties for rule-breakers make up the basic legal system of a society, backing up customs with force. Every civilized society is founded on law, and none has ever survived without it.

Ethics goes further than law in determining everyday behavior. Law cannot cover every aspect of human relationships. Personal ethics, or individual morality, has been called "what one does when nobody is looking." Law, on the other hand, sets standards for behavior in situations involving other people, and backs those standards with the power invested in law enforcement.

The subject of ethics has been prevalent in the insurance industry since the early days of insurance. In Europe, regulation was found to be a means of enforced ethics within the industry.

Rise of Regulation

In America, the original pattern of expansion filled legitimate needs. The insurance industry, as well as of other forms of business, grew eventually into a relentless drive for more and more success.

The results of this uncontrolled expansion and unethical practices brought on a demand for regulation. In the insurance business, state laws and licensing practices gradually developed to set required standards for companies and agents.

At the beginning of the 19th century there were only five million people in the United States, 90 percent of them farmers. There were only six cities in the country with a population of more than 8,000.

The growing cities produced an increasingly complex society in 19th century America. Individuals working for wages in a cash economy could no longer live the self-sufficient lives of their rural ancestors. In this setting, insurance rapidly became a recognized necessity for the protection of families and property.

Early insurance companies had waited for customers to come to them. As time went on and more insurers competed for business. It became the practice to advertise and send out agents in an aggressive effort at expansion. Many of these agents had little training or understanding of the principles involved in the policies they were selling.

Insurance stock companies were organized to take advantage of the growing market, and unregulated expansion continued. From 1830 to 1850, insurance in force increased by more than 3,000 per cent. After the Civil War, the growth rate of the industry was even faster. The amount of insurance in force increased at 50 per cent a year, reaching a total of two billion dollars by the end of the 1860s.

The Civil War brought unprecedented demand for manufactured goods. After the war American enterprise continued at a fast pace. New industries sprang up. Railroads crossed the continent. Cables crossed the oceans. Coal, copper, iron mines fed the factories. America was on its way to becoming the industrial colossus of the world.

Standards Decline

In the excitement, attitudes changed. Business and political life were no longer governed by the ethical standards once taken for granted. Tax and other scandals rocked Washington during the Grant administration. Business was drawn into wildcat schemes, stock-watering, and embezzlement.

Insurance executives and agents concentrated on achieving personal power and prestige through business success. There were exaggerated advertising claims, carelessly written risks, and recklessly raised commissions.

Ethics Made into Laws

The Massachusetts legislature in 1858 was the first to pass a law making a version of Wright's legal reserve principle a requirement for insurers. A state insurance department was created to enforce the new law and Elizur Wright became its head.

As the western part of the country was settled, the insurance industry again expanded its horizons. New companies grew up to offer insurance in the growing western cities as transportation and manufacturing facilities followed the trails blazed by the pioneers.

People moved about more, and travel restrictions were removed from insurance policies. Prudential pioneered insurance for low-income groups and it became widely accepted. By the end of the 19th century, the total of insurance in force in the United States had risen to seven and a half billion dollars.

Rapid growth again led to difficulties. Since insurance companies were the custodians of much of the nation's wealth, attention focused on them as a new "muckraking" phase of attacks on questionable business practices began shortly after the turn of the century. There was a renewed public demand for investigation of the insurance industry.

The Armstrong Investigating Committee in 1905, with Charles Evans Hughes as its chief counsel, turned its attention to insurance practices in New York. Its recommendations, backed by responsible insurance companies, resulted in the adoption of the New York Insurance Code in 1906. State supervision of insurance practices was tightened by this code, and eventually public confidence in the insurance industry was restored. Throughout the 20th century insurance regulation has grown.

The National Association of Insurance Commissioners (NAIC), a group made up of insurance officials from all states, has drafted model legislation which has been widely adopted by state legislatures.

The unfair trade practices act recommended by the NAIC defines unfair claims settlements, false advertising, defamation, and unfair discrimination and prohibits all these practices. This NAIC model has been adopted by nearly every state.

The resulting laws give state insurance commissioners the power to investigate when such practices are suspected and to levy fines and suspend or revoke licenses when violations are found. Marketing and disclosure standards for life insurance agents also are recommended by the NAIC. These make deceptive practices designed to mislead clients not only unethical but also illegal.

Any statement misrepresenting the benefits or coverage offered by a policy is a deceptive practice which can lead to the loss of an agent's license. Implying that future dividends provided by a participating policy will be enough to take care of premium payments would be such a misrepresentation. So would an implication that future policy dividends are guaranteed.

To tell a prospect that certain benefits in a policy being offered cannot be found in any other policy, or that an offer must be taken at once or the opportunity will be lost, would be considered unacceptable tactics. Any misleading use of figures as to cost comparisons or other significant policy features would come under the guidelines. So would statements defamatory to competing agents or insurers.

Legitimate agents recognize such actions as unethical.
They also have been made illegal in states that have adopted the NAIC recommendations. There are other prohibitions, such as offering a rebate to make a sale, or persuading a client to drop a policy just for the sake of selling a replacement that will be discussed later in detail.

While an ethical agent would not knowingly violate these guidelines, it is necessary for any insurance professional to be aware of the particular legal provisions in effect in the state with jurisdiction. The laws are to be followed first, supplemented by one’s own ethical standards.

Licensing
Insurers must be licensed by a state to issue policies there. A state's guarantee fund usually covers only insurers authorized to do business in that state. An agent representing an unauthorized company may be held personally liable for losses on a

contract placed with an unauthorized insurer. The agent needs to be sure the company being represented is authorized to do business in that state.

It is also important for both the agent and the company office to be aware that laws can change. Actions of the state legislature and regulations issued by the state insurance commission both can vary with time and the pressure of public opinion.

Court decisions in insurance cases can make a change in liability affecting those in the industry. The legal system in this country is not static, but fluid. Company officials need to keep abreast of such developments and let their agents in the field know about them.

Court Decisions

Suits to recover damages in cases of disputes over insurance coverage are increasingly frequent. The growing tendency to consider insurance practitioners as professional people carries with it increased legal responsibility.

Court decisions in many cases do not take into account any responsibility on the part of the insurance purchaser to be aware of policy provisions, even of easy-to-read policies. The outcome in many liability suits has made the agent or insurance company responsible for providing adequate coverage.

In a Louisiana case a plaintiff, the operator of a Laundromat in a leased building, asked his insurance agent to get as much property damage liability for him as possible. The agent told him $100,000 was the maximum coverage obtainable, and the plaintiff told the agent to get that amount. Through an error, the policy was written for only $10,000. A boiler explosion caused $18,500 in damages at the Laundromat, and the plaintiff sued to recover the $8,500 that was not covered by the $10,000 policy.

The court appeared to place no responsibility on the owner for reading the policy, the declarations page, or the bill for the premium on the $10,000 coverage. The decision was that the insured was justified in believing that the agent had obtained the limit of liability they had discussed. The resulting point of case law is that an insurance provider cannot count on having any responsibility placed on the insured to analyze the coverage provided.

The issue of professional responsibility on the part of insurance agents and agencies is playing an increasingly important part in court cases. In a Georgia decision involving business interruption policies, an insurance agency had been provided with a client's books to use in determining what coverage limit was needed. The agency used the gross profits figure rather than gross earnings to determine the coverage needs, leaving the client underinsured.

Professional Responsibility

The plaintiff's argument in the court case was that the insurance agency had held itself out as an expert in the field with the needed qualifications to examine the books and determine coverage limits. The agency agreement with the client was to maintain adequate business interruption insurance based on yearly audits, and this agreement, the court held, was violated.

Such court decisions set the precedent of requiring a high standard of competence on the part of insurance professionals. Both agents and agencies need to be aware of this situation.

In addition to staying well informed and exercising due care, the responsible insurance practitioner can have professional representation available for claims protection by carrying Errors and Omissions (E & O) insurance. The E & O carrier will investigate claims situations and provide legal representation if necessary.

In the case of claims, the insurance professional needs to be prepared to deal with the claimant in a calm and competent way without overstepping limits on giving legal advice or otherwise prejudicing the case. Quick adjustment and settlement procedures are desirable in case of claims to uphold the reputation of the insurance provider, but it is important to have all the facts at hand before action is taken.

In dealing with a claimant, the insurance provider needs to remember not to give advice or promise to get the claim paid. It is also important, however, not to deny a claim without positive knowledge that it is invalid. Also, a claim should never be paid without certain authority. Any of these actions can create legal liability.

It is helpful in avoiding legal difficulties for the agent to maintain friendly relations with clients and establish a reputation for being trustworthy over the long term. A personal relationship of trust and confidence between agent and client may help avoid lawsuits and make settlements easier.

Ethics Commissions

In addition to court cases, changes in the law can be brought about by an increasingly important agent, the ethics commission. Under pressure from activists, consumer protection groups and others, Ethics Commissions have been set up in state and national legislative bodies as well as in local government agencies.

Ethics Commissions tend to focus on lobbying, gifts to officials, conflicts of interest, and election procedures. They also, however, can consider other areas of public concern and produce legislation in response to consumer complaints.

An ethics commission can hold public hearings. It can determine what legislation needs to be passed in order to prevent abuses. It can investigate whether behavior of a public official has violated existing laws.

Congressional committees in both the Senate and the House have been conducting investigations into insurance cases with a view to possible federal legislation supplementing state level regulation of the industry. A Senate committee probe has centered on offshore insurers and reinsurers which are not subject to state regulation.

One reinsurer listed as its primary assets $22 million in "treasury bills" claimed to have been issued by a Texas Indian tribe. Senate investigators believe this group to be fictitious. One of the tribe officials known as "Wise Otter" is thought to be a British subject.

The House investigation that followed the failures of large domestic insurance companies has focused on the possibility of setting up a federal support mechanism similar to the banking industry's Federal Deposit Insurance Corporation in order to protect policy holders beyond state agencies' limits.
It is important for insurance professionals to keep abreast of such legal developments affecting the industry and its traditional standards.

SEC Requirements
Financial planning, a relatively new field for insurance providers, requires some specialized knowledge relating to securities and investment regulations. The Securities and Exchange Commission through the Investment Advisers Act sets high ethical standards for professional providers of investment advice.

Any transaction or business practice intended to deceive a client or prospective client is strictly forbidden under the act. The agent acting as a securities representative is legally required to act with due diligence, meaning that documented financial information must be furnished on companies whose stocks or bonds are being sold.

Guidelines
In contrast to due diligence for securities salesmen, the standard established in court cases for agents only involved in selling insurance is due care. The client is given financial information on request, but the state insurance department is the agency responsible for requiring reports from companies authorized to do business in that state. The agent's legal obligation is to sell policies of insurance companies licensed in that state and not to sell policies of companies the agent knows to be insolvent.

Claims Defense
An agency can establish a back-up line of defense against claims arising from insurance company insolvency. This can be done by showing proof that the agency has maintained a system for tracking financial conditions in the industry through figures from the various reporting agencies and by other means available.

It is important for the insurance agent to know the specific do’s and do not’s that constitute ethical behavior. Specifics that will be discussed are advertising, commissions (rebates), agent conduct, clients’ files, illustrations and underwriting.

Agent Compliance

Advertising

When the agent advertises, he/she is making the product known to the public at large. There are many different ways to advertise. The following are the major methods, of advertising.

- Printed and/or published materials.
- Newspaper, radio, television, computers, billboards.
- Ads, circulars, leaflets, descriptive literature.
- Business cards, business brochures, prepared sales talks.
- Telephone solicitations.
- Any material used to sell, modify, update or retain a policy of insurance.

Agents wishing to advertise must-obtain approval from their respective insurance company. All advertisements for life, accident, and health insurance must include and identify the insurance company the agent represents.

Advertisement that would not require prior insurance company approval would be one in which the only information given is the agent's name, address, telephone number, and description of the services being offered. Agency history and a simple statement of products offered, such as life, health, and/or annuities would also apply. There must be no reference made to specific policies, benefits or cost.

Requirements

The agent must do the following in all advertising:

Make clear that insurance is the subject of the solicitation; clearly identify the type of insurance being sold, and the full name of the insurer.
Include all limitations and exclusions affecting the payment of benefits or cost of a policy, as well as disclose any charges or penalties, such as administrative fees, and surrender charges contained in a life or annuity policy, or withdrawals made during the duration of the contract years.
If a policy offers optional benefits or riders, disclose that each optional benefit or rider is available for an additional cost.

For a life insurance policy with accelerated death benefits, clearly disclose the conditions, care or confinement which will initiate any acceleration of payment of the death benefit and/or other values under the life policy. If a policy includes a payment endorsement, disclose that fact.

The agent MUST NOT do the following in all advertising:

Be deceptive or misleading by overall impression or explicit information.

Refer to considerations paid on an individual policy or annuity, including policy fees.

Use terms such as "Financial Planner", "Investment Advisor", "Financial Consultant", or "Financial Services" in such a way as to imply the engagement in an advisory business in which compensation is unrelated to insurance sales, unless this is actually the case.

Use a service mark, trade name or group designation without disclosing the name of the actual insurer, if specific coverages benefits or costs are described.

Make unfair or incomplete comparisons of policies.

Disparage competitors, their products, their policies, their services, business or marketing methods.

Make untrue or misleading statements with respect to another company's insured assets, financial standing or relative position in the insurance business.

Imply group coverage, certificate or enrollment when the policy offered is actually an individual policy.

State that the policy is a limited offer and the applicants will receive advantages by accepting the offer, and that such advantages will not be available at a later date, if this is not the fact.

Advertise a free gift, bonus, or anything of value outside of -the policy contract, which is an inducement to buy and considered rebating.

Advertise for life, health, accident or annuities, use the existence of the GUARANTEE ASSOCIATION as an inducement to buy.

Use misleading words or symbols or imply the material is being sent by a government entity.

Use the phrase "low cost" without providing disclosures and the caveats associated with the particular plan.

Advertising can be one of the best career enhancing tools, when utilized effectively, legally and ethically.

Commissions

Rebating
Commissions are the direct result of work performed by the agent with a new or existing policy owner. The agent's compensation is paid direct from the respective insurance company for the type of product and services recommended and are willing to provide. In addition to the initial commission, most insurance companies provide "renewal commissions", as an inducement to continue servicing the existing policy owners.

The Concept
This concept, initiated many decades ago, was intended to accomplish two primary objectives:

Compensate the agent for future servicing needs the policy owner will require -- such as beneficiary changes, bank draft changes, endorsements, etc.
Provide the agent with an opportunity to perform periodic reevaluations of the policy owners' needs, thereby resulting in additional sales opportunities.

The agent, as a licensed insurance person, shall not directly or indirectly rebate or attempt to rebate all or any part of a commission for insurance. Rebating is illegal in most states, and is strictly prohibited. It can be punishable by fine, cancellation of contract with insurance company, and loss of license, or a combination of all three. Rebating can be described as offering any type of inducement other than what is contained in the policy itself, in exchange for purchase of insurance. Examples include, but are not limited to the following:

Any verbal or written agreement for the agent to pay any part of a policy owner's premium.

Any payment, allowance, or gifts of any kind offered or given as an inducement to purchase insurance.

Any paid employment or contract for services.

Returning any part of the premium to the policy owner.

Offering any special advantage regarding the dividend, interest, or other policy benefits to the policy owner which are not specified in the policy.

Offering to buy, sell, or give any type of security (stocks, bonds, etc.) or property, or any dividends or income from securities or property, to the policy owners' benefit.

Giving anything of value to the policy owner in return for buying an insurance product.

Borderline Situations
Rebating, or the attempt to rebate, is an offense not only under the Code of Ethics, but

also under state insurance laws. There may be borderline situations in which it is difficult to determine whether rebating has taken place.

It is fairly common practice, as an example, for an insurance agent to entertain policy owners or prospective purchasers with a meal and perhaps give a nominal or token gift such as a policy wallet. Such things are considered to be normal business practice, and not in the nature of a rebate. However, should the agent contemplate anything more than such token gestures of appreciation, then the greatest caution and good judgment must be exercised. Excessive benefits or gifts conferred upon policy owners or prospective purchasers, will at the very least be considered in bad taste, and at the worst, depending on all the circumstances, may expose the licensee to a charge of rebating. In no circumstances should a gift of anything of value be given as an inducement to purchase insurance.

The rules for rebating do not apply to splitting of business with another licensed insurance agent. Joint case work is very common throughout the industry, and splitting of commissions is normal business practice. This practice does not apply to equity and variable life products, since they are sold under the rules and guidelines of the Securities Exchange Commission.

Agent's Conduct

As an insurance professional, the agent becomes part of the insurance industry's public relations arm. The agent meets the public every day, and the manner and conduct exhibited leaves a lasting impression with everyone with whom that agent had contact.

A big part of professionalism is the attitude toward competition; therefore, agents should avoid criticizing other agents. Such activity is detrimental to everyone in the business. Any criticism of another company's policies should be avoided. An incomplete comparison is not only misleading and harmful to the public; it can also result in license revocation for the guilty party. Respect for competitors helps to keep policy owners satisfied.

The agent is under an obligation to make accurate and complete disclosure of all information which policy owners or prospective purchasers should have, in order for them to make a decision in their best interest.

Representing the Insurance Product

The agent is called upon daily to make many statements and representations, oral and written, upon which policy owners and prospects are entitled to rely. Such statements and representations must not only be accurate, but must also be sufficiently complete to prevent any wrong or misleading conclusions from being made by policy owners or prospects. It is just as wrong for a life underwriter to omit giving essential information, such as, failing to correct a mistaken impression which is known to exist, as it is to give inaccurate or misleading information. Representing insurance products as <u>exclusively</u> "retirement plans", "college education plans" or "savings plans", without noting that the life insurance is primary and the cash value features are secondary, can result in serious charges of misrepresentation of insurance products. Use of the word "deposit" versus "premium" can have a like effect.

Deceptive Practices

Deceptive practices as they pertain to our industry have countless examples, a few of which are:

- Passing off the agent's own goods or services as someone else's.
- Misrepresenting the benefits, uses, or characteristics of the product.
- Making disparaging remarks pertaining to someone else's products, services, company, by making false or misleading representations.
- Advertising the product or rates while intending not to sell them as advertised.
- Misrepresenting the agent's authority as a sales person, representative, or agent to negotiate the final terms of the contract with the policy owner.
- Offering, in connection with an insurance purchase, participation in a "multi-level distributorship" under which payments are conditioned on the recruitment of additional sales people rather than the proceeds from the product sales.
- Using the terms "corporation" or "incorporated" or their abbreviations in the name of a non-incorporated business.
- Failing to disclose information during a transaction with the intent of inducing a prospect or policy owner to do something he or she would not do otherwise.

The law allows courts to award an insured triple damages, court costs, and attorney fees, for deceptive insurance trade practices.

Insurance is not only a complex product, it is an extremely complex industry. The insurance agent must be very careful not to mislead the consumer regarding any aspect of an insurance transaction. Misrepresentations can be in the form of an oral or written statement, advertisement in any media, use of a business logo or advertising slogan, or anything else that communicates a false or misleading idea.

A few examples of misrepresentation include:

- o False or misleading statements about a particular policy.
- False or misleading statements about the financial condition of a respective insurance company.
- Telling a prospect or policy owner that dividends or current assumption mortality charges are guaranteed.
- Identifying a term life policy by a name that implies cash value accumulation, or vice-versa.
- Indicating that premiums on a policy are payable for a shorter time period, when the premiums may be payable for life.
- Indicating that the agent represents several insurance companies, when in fact the agent represents only one.

A high degree of ethical representation is good solid business. The agent's insurance career can provide financial gain and personal growth. Practicing as an ethical professional will bring both. The agent's actions will gain the respect of the policy owners as well as that of the insurance carriers. The agent’s reputation will be significantly enhanced, and people in the community will want to do business with that agent.

Documenting Clients' Files

Documenting the client files involves keeping track of the actions taken in dealing with the policy owner. A properly documented file should contain complete and accurate answers to all pertinent questions. This allows the agent to properly assess the need for insurance and substantiates the reason for the sale.

Paper Trail

After the fact-finding meeting, the agent should send a discovery agreement to the prospective policy owner summarizing the initial meeting and outlining the agent’s understanding of the policy owner's short-term and long-term financial goals. This document should also contain information about the policy owner's salary and expenses, and the amount of money in savings accounts and investments. It should also reiterate the amount of insurance in force and the amount of money the policy owner would be able to allocate for insurance premiums. In addition to this, the discovery agreement should thank the policy owner for the chance to work with them, and confirm the date of the agent’s next meeting.

The agent should always keep on file a proper ledger illustration. This should be an approved insurance company ledger, a sales proposal/idea that contains the following elements:

- Insurance company name.
- A full dividend/interest rate crediting disclaimer.
- A clear description of the product.
- The agent's name and illustration date.
- Guaranteed values.
- A page containing full explanation of any assumptions or special instructions.
- Data Note and Log

Effective case notes should also be kept in the policy owner's file. These should list the date and time of contact with the policy owner and concise summaries of all interactions. It is also recommended that the agent document the level of service provided to the policy owner. An effective log of all telephone calls should be kept, listing the date, time, reason, and follow-up action of all telephone conversations with the policy owner. The agent should also note all unsuccessful calls to the policy owner in order to verify the attempts to provide proper service, thus, once again, documenting the level of service provided.

A delivery letter should be sent to each policy owner with a copy kept in their file. This letter would reinforce the information already discussed, such as the reason for purchasing the insurance, and the type of plan as well as the face amount of coverage. The agent should reiterate the amount and duration of premium payments, as well as the premium payment method. The agent should also restate the impact on policy values as it relates to borrowing, partial surrenders, advanced premiums, interest requirements, dividend usage, and if appropriate, interest or dividend crediting performance.

Many companies provide a delivery receipt with the policy that must be signed by the policy owner upon delivery. If the company does not, it is recommended that the agent prepare such a document to be signed upon delivery to the policy owners. It should list the date the policy was received by the agent, the policy number, and the insurance company's name. It should also contain the owner's signature and the date they signed for delivery of the policy. All of this should be kept in the policy owner's file.

illustrations

Illustrations have been used extensively in the insurance industry for several decades to help secure sales. In the past, they were obtained from the respective insurance company, and were fairly bland and standardized for many years. They were straight forward and represented a close approximation of actual future performance.

Changes Cause Problems

Beginning in the early 1980's, a radical change began, primarily due to three events occurring simultaneously:

1. A significant reduction in mortality charges, due to advancement in medical technology.
2. Significant advancement in electronic technology -- also known as low cost personal computers.
3. A significant economic change resulting in double-digit market interest rates.

These three events, coupled with consumer demand, helped produce a product called Universal Life -- an unbundled, interest sensitive, whole life policy with a high degree of flexibility.

Insurance was viewed more as an investment product consisting of "mortality" and "side funds". Illustrations began to change and use historically high double-digit interest rates as the basis for projected values. As interest rates began to fall in the late 80's, projected values did not hold up to reality. Many policy owners received notices that premiums would have to be increased or death benefits reduced to keep policies in force. Policy owners became angry, and many accused agents and companies of unethical behavior.

It cannot be overemphasized that illustrations are mere projections based on current interest rates, current mortality charges and other expenses. These conditions are not contractual obligations. Agents who have competed on the basis of high interest returns will produce projections that are unrealistic. This blatant misuse of illustrations has led to policy owner confusion and dissatisfaction. Agents, companies, and the insurance industry have suffered tarnished reputations.

The results have been fierce disciplinary actions backed by a series of heavy fines on some insurance companies by state regulators. Some examples of illustration abuse are as follows:

- Falling prey to the allure of high interest returns.
- Use of "assumed" interest rates in competitive situations.
- The sales technique of "Vanishing Premiums".

Heavy emphasis on accumulated values verses death benefits.
Poor emphasis of contractual guaranteed values and the potential problems that could exist in the future.

Remember, the policy owner does not necessarily see the illustrations as hypothetical. Policy owner dissatisfaction has resulted in increased demands by state regulators for heavy regulations regarding illustrations. Some insurance departments are considering the elimination of current assumptions, and only allowing illustrations based on guaranteed values. The parameters of an illustration under these proposals would be strictly monitored. They have also suggested that disclosure of past performance will be all that is permissible.

Understanding the Hypothetical

Many companies provide guidelines regarding interest rates to be used in product illustrations. The agent is advised to stay within the company guidelines to avoid policy owner dissatisfaction. Policy owners should be aware that current illustrations are a snap shot of how a policy might work if the current rates remained unchanged. To help with this awareness, illustrations should have three distinct columns:

Guaranteed Values.
Current Return Values.
Current Return Minus 1%.

This type of diligence will reward the agent with greater policy owner understanding of how interest rates and dividend scales can affect cash values and premiums.

Illustrations are rarely valid for policy comparisons. They are designed to show how a particular product of a particular company works. There are too many inconsistent variables from one company to another to allow for valid comparison. Policy selection should be made on knowledge of the product and analysis of assumptions underlying each policy. Policy provisions, company financial condition, and quality of service are valid considerations. Illustrations only, can be a dangerous criterion for policy selection without additional considerations.

Transparency and Self-Policing
The vanishing premium concept has been particularly damaging to the public perception

of insurance industry ethics. This concept is based on the premise that premiums may be discontinued after a certain number of years through the use of cash value or dividends. It was used as a marketing tool extensively in the 1980's. Projections of vanishing premiums (typically in six to eight years) were based on high interest rates in effect at that time. Many policy owners did not understand that a continuation of high interest rate was necessary to fulfill illustrated projections. When interest rates fell, policy owners charged that no one explained the fact that the illustrated "vanish" was not guaranteed. This disappointment can be avoided with proper disclosure of illustrated concepts and the effect of changing interest rates. Good ethics and business practice dictates that illustrations show both guaranteed and non-guaranteed values with the difference clearly explained to the policy owner. Any illustrations showing non-guaranteed values may be incorrect after the first year. The agent should be thoroughly informed about "assumptions" and "hypothetical" and the effect of fluctuating interest rates and mortality charges. This additional risk should be communicated to the policy owner in written as well as verbal form.

There are many types of new generation policies which require due care and full disclosure. These include Blended Policies (permanent and term), Adjustable Policies, First-to-Die Policies, and Second-to-Die Policies. When two or more lives are insured under the same contract, particular care should be taken to explain to the policy owners that the death benefit is paid on the death of only one of the insureds.

Falling interest can create a climate where actual performance falls short of illustrated projections. Very often, policy owners do not understand the difference between hypothetical projections and contractual guarantees. This can lead to policy owner dissatisfaction, complaints and potential litigation. Increased policy owner complaints lead to adverse insurance department rulings, state regulations, fines and lawsuits against companies and agents. This affects the public perception of ethical conduct of the entire insurance industry. The solution lies in ethical business practices, particularly concerning policy owner understanding of illustrations. Self-policing through education, discretion and common sense will lead to field practices of a high ethical standard. It is important to remember that the policy owner will retain that information they see as most beneficial. As a professional community, our watch words are, tell the policy owner the truth.

Replacement of a contract of life insurance means any transaction which includes a:

- Rescinded, lapsed or surrendered policy.
- Charge to paid-up insurance, continued as extended term insurance or placed under automatic premium loan.
- Change in any manner to effect a reduction of benefits.
- Change so that cash values in excess of 50% are released.
- Policy subjected to substantial borrowing of cash value, but does not include the purchase of an additional life insurance contract.

The agent should not, when it could be detrimental to the interest of the policy owner, replace an existing contract of life, health, disability and annuity contracts with a new insurance contract. Every reasonable effort should be made to maintain the existing contract in force.

Where it appears that, due to a change in circumstances, an existing contract of insurance should be amended or changed; the agent should ensure that the policy owner is fully informed of any values, credits, or privileges in the existing contract which can be transferred to an amended or changed contract of insurance.

Services

One study indicated that the average insured purchases insurance seven times during their lifetime -- from six different agents. Is part of the reason because of poor or lackluster service?

The insurance industry employs and contracts nearly two million people. It is quite evident that insurance is an intricate and essential service in our society. It is a field upon which our society depends more and more for financial protection. Life and health insurance purchases continue to increase each year. Property and casualty insurance is a part of every mortgage contract, auto ownership, and business coverage. Life insurance in force at the end of 1993 was nearly $11 trillion. On a daily basis a large group of people will die, enter retirement, experience a cash emergency, or have a physical asset damaged or destroyed. This is the real world -- it affects everyone! These are critical times. The agent’s insurance company, the agent, and the policy sold, stand between the client and financial disaster.

Value Added

The insurance agent must be the "value added" benefit for the insured as well as the insurance company. In the decade of high tech mega information highway, the agent has to be the interpreting guide and the analyst for the general public to solve financial problems with an insurance purchase. The agent must also become the motivator, leading a prospect to action.

People like to do business with people they trust. Trust is built on ethical behavior. When potential prospects and existing policy owners find an agent with high ethical standards, they tend to do more business with the agent -- therefore becoming a client. In perhaps no other industry is the element of trust more important.

Charging fees for service is common practice in most occupational groups; however, Texas has an exception for insurance agents. Group I licensed agents are not allowed to charge fees for service unless they are properly licensed as a Certified Insurance Counselor (CIC). Property and casualty licensed agents are also allowed to charge fees for certain services.

Service Essentials

The service to a policy owner/client is not only qualitative, but also quantitative. Periodic contact is essential, but can take various forms:

Daily phone contact with the same policy owner would not only be extremely expensive and cumbersome, but also non productive and obnoxious. Most policy owners tend to accept three to six months intervals as a good basis for agent contact. This could be in the form of telephone calls, letters, informative announcements, as well as birthday and Christmas cards. Many agents use Thanksgiving cards as an alternative to the more commonplace Christmas card mailing.

Annual reviews are extremely important with many policy owners, simply because their needs change. This is particularly obvious with business clients.
It is definitely recommended that the agent staff her/his office with people able to handle day to day service needs, such as change of beneficiary designations, bank draft changes, policy amendments or endorsements, etc. If the agent elects to refer all of these tasks to the respective insurance company home office, it would significantly reduce the "value added" benefit that serve the policy owner. It would also enhance the likelihood of future replacement from another insurance agent -- who specializes in service.

Generally speaking, policy owners want convenience and immediate response. An agent, who refers policy owner service duties directly to the insurance company, is missing tremendous future sales opportunities, alienating themselves from building the trusted relationship necessary to maintain a strong business practice, and presenting themselves in less than an exemplary fashion.

Underwriting

Perhaps no other area pertaining to compliance and ethics deserves as much attention as agent underwriting. When any type of claim occurs, the insurance application becomes the basis for a claim dispute, denial or acceptance. An agent, who compromises part of the underwriting process with false or misleading information, as it pertains to the prospective insured, is creating potential wealth for litigating attorneys.

Part of the Contract

The agent must always remember that an underwritten application becomes part of any insurance contract. It is critical that all questions be answered completely and honestly. Too often it is tempting for an agent to "trim" ten or twenty pounds off a rather overweight insured or help them grow one or two inches, in order to assure a standard issue from the respective insurance company. Asking a potential policy owner to discard a lit cigarette during the application process may create non-smoker discounts, but in all likelihood would initiate a claim denial. Insurance companies have challenged fraudulent non-smoker rated policies through the court system, and won. It is also naive for the agent to believe that a two-year incontestability clause will exempt him/her or the insured from blatant, fraudulent underwriting. Insurance companies may pay a claim, but they can and do pursue legal action against the insured's estate.

The agent should make every effort to provide the insurance company with all accurate information pertaining to the prospective insured. Cover letters should be submitted with the application to provide details of unusual or extensive medical history or information; unusual business uses of insurance; foreign travel and residence; unusual financial situations; unusual beneficiary and ownership arrangements to clarify the insurable interest; unusual occupational duties; and any case discussions with an underwriter prior to the application submission.

Many insurance agents order medical examinations, attending physician statements, and financial information through third party sources, and upon receipt forward these items to the insurance company. This is not an illegal practice, but it may be against the company's practice. Since underwriting information is highly confidential, both the originals and photocopies of financial statements, attending physician statements, hospital abstracts and other confidential records that have been obtained by agency personnel require safeguarding.

Protect Confidentiality
To comply with state and federal privacy laws and to control and protect confidential information provided to the company by applicants, guidelines need to be followed to insure the strictest handling of these documents. Examples to follow are:

Access to files containing confidential material must be restricted to employees who have legitimate "need to know" in order to perform their assigned duties.
Confidential information stored in personal files, should be retained only as long as there is legitimate need. Some companies absolutely forbid the acquisition and retention of medical examinations, attending physician statements, hospital abstracts or other medical histories. It is up to the agent to know what the insurance company's practices are.

Since the application is such an integral part of the insurance contract, care should be utilized in presenting all information to the insurance company in a professional manner. One of the most consistent complaints with insurance company underwriters is illegible applications. Not only does this impair the underwriting process, but it could be grounds for significant dispute during the processing of a claim.

Generally, changes or alterations to the application must be initialed by the insured/applicant. This is specifically important in changes in plan, face amount, owner, beneficiary, medical or financial representations and dates. Some companies are more lenient and allow amendment signatures at the contract delivery.

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The National Association of Insurance Commissioners (NAIC) has a Model Privacy Act that requires any applicant/insured to be notified of any adverse action taken in regard to their application. This Act allows an insured the right to know the details of the personal information about themselves in the company files, and has the right to request an insurance company to amend, delete, and correct such information.

Litmus Test

Labeling a decision as an "ethical decision" may disguise the fact that almost every decision holds some ethical issue or impact. Perhaps a better approach would be to develop an ability to judge the ethical implications. What role do ethics play in this decision? How does one recognize an ethical situation or problem? What are the warning signs that this may be a tougher decision with deeper issues and wider impact?

Here are some guidelines. Not all apply every time, but they should raise understanding and improve the decision-making process.

- Do I put a monetary value on this decision? Would I make this decision differently if cost were not a factor? Am I putting a monetary value on my ethics?
- Do words such as right, fairness, truth, perception, values, or principles appear in my reasoning when I am making my decision?
- Do I feel as if I need to search through a standard policies and procedures or

contact a legal representative for help with my decision?
- Do questions of fair treatment arise?
- Do my personal goals or values conflict with my professional ones?
- Could this decision generate strong feelings or other controversy?
- What does my heart tell me? Do I ponder this decision on the way home?
- Do I offer myself excuses such as everybody does it, or no one will find out, or I did it for “The Company”?
- Does this decision really need to be made by someone else? Did I inherit it because someone else doesn't want to make it?
- How am I going to feel tomorrow if I do this?

If an individual faces a tough decision and feels as if some guidance is needed, sometimes there is no place else to turn. One must have an internal compass, a value system for guidance. That is why an ethical standard is important for everyone in the insurance industry.