BASIC PROBLEMS TO AVOID IN ESTATE PLANNING AND ADMINISTRATION AND A BRIEF ESTATE TAX UPDATE

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by

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1. ESTATE PLANNING 101. When a young man found out that he was going to inherit a fortune when his sickly father died, he decided he needed a woman to help him enjoy it. So one evening he went to a singles bar where he spotted the most beautiful woman he had ever seen. Her natural beauty took his breath away. "I may look like just an ordinary man," he said as he walked up to her, "but in just a week or two, my father will die, and I will inherit twenty million dollars." Impressed, the woman went home with him that evening and three days later she became his stepmother.

2. ESTATE PLANNING 102. Estate planning is the process of (1) getting a person's affairs in order so that when a person becomes incapacitated or disabled, a designated agent can make health care decisions and handle business matters for that person while he or she is incapacitated or disabled, and (2) preparing documents to ensure that when a person dies, the property he or she owned passes to the desired beneficiaries in a manner that results as little taxation as possible.

3. FAILURE TO HAVE A WILL. Most people die without a will. Why should a person have a will? Everyone should have a will to make sure the persons you want to receive property upon your death actually get it. Failure to have a will can produce undesirable results. Consider the following examples:

a. Jerry is sixty [60] years old and dies survived by his wife and mother. Jerry and his wife never had children. Jerry owned an investment account worth $500,000 and a piece of commercial real estate worth $100,000 at the time of his death. Both the investment account and the commercial real estate were titled in Jerry's individual name. Who takes the property? Under the Intestate Succession Act, Jerry's wife gets $275,000 of the investment account and a one-half [1/2] undivided interest in the commercial real estate. Jerry's mother gets $225,000 of the investment account and a one-half [1/2] undivided interest in the commercial real estate.

b. Jerry is sixty [60] years old and dies survived by a wife and two children. The two children are drug addicts who have not held steady employment in ten [10] years. Jerry owned an investment account worth $330,000 and a piece of commercial real estate worth $100,000 at the time of his death. Both were titled in Jerry's individual name. Who takes Jerry's property? Jerry's wife gets $130,000 of the investment account and a one-third [1/3] undivided interest in the commercial real estate. Each of Jerry's children gets $100,000 of the investment account and a one-third [1/3] undivided interest in the investment account.

4. FAILURE TO RECOGNIZE DIFFERENT FORMS OF PROPERTY OWNERSHIP. This is perhaps the most common error in estate planning and can prevent an otherwise perfect estate plan from working properly. It is crucial that you ensure that property ownership dovetails with the estate planning documents. A person can own property in essentially three [3] different ways and leave property to beneficiaries yet another way:

a. Individual ownership. This is the situation where only one person's name appears on the deed or account. When the person passes away, the disposition of the asset the individual owned passes in accordance with the terms of the individual's will.

b. Jointly with rights of survivorship. This is the common but not universal form of ownership between husband and wife and can exist among persons not husband and wife as well. If property is held jointly with rights of survivorship between husband and wife, it is often referred to as a tenancy by the entirety. If two persons own property jointly with rights of survivorship, the person who lives the longest gets the property, regardless of what the will of the first person to pass away says.

c. Jointly as tenants in common. This is a more unusual method of property ownership but often very useful in estate planning. If two persons own property jointly as equal tenants in common, that means that each is considered to own a one-half [1/2] undivided interest in the property. Upon the death of one of them, the disposition of the deceased person's interest passes in accordance with his will rather than passing automatically to the survivor.

d. Beneficiary designation. Life insurance proceeds, retirement plan benefits, annuities and certain other assets pass to named beneficiaries by beneficiary designation. Investment accounts can now pass by beneficiary designation too. A person's will has absolutely no effect on the disposition of assets passing by beneficiary designation.

e. Effect. If your client has a will with a credit shelter trust but everything he and his wife own is titled jointly with rights of survivorship, everything passes to the wife outside the will and the carefully drafted trust sits empty and useless. The wife will have to disclaim assets to fund the trust. Make sure assets are titled so the estate plan works.

f. Problem Area. One common problem that arises is the mistaken retitling of accounts. Older parents for convenience often want to put a child's name on an account with the intent to grant the child signature authority over the account to pay bills. These accounts frequently are retitled in the names of the parent and the child as joint tenants with right of survivorship. Upon the death of the parent, the proceeds are the property of the child as the surviving joint tenant. Unless the child wants to do the right thing and split the account with his siblings, a lawsuit will likely arise.

5. FAILURE TO HAVE A POWER OF ATTORNEY OR GIVING THE WRONG PERSON THE POWER OF ATTORNEY. Most people do not have a power of attorney. While this is not as critical as failure to have a will, it is still important. Consider the following fact patterns:

a. Mrs. Patterson is ninety [90] years old and enters the nursing home essentially brain dead. Her physician indicates her condition is stable and that she may live several months and perhaps years in that condition. She has no power of attorney. Who pays her bills, files her income tax returns and handles other business matters while she is in the nursing home? The clerk of court will have to appoint a guardian to handle Mrs. Patterson's affairs. The guardian will likely have to post bond and file extensive reports with the clerk of court. This result could have been avoided if Mrs. Patterson had signed a valid power of attorney prior to her disability.

b. Mrs. Jackson has three children. Two live in New York. One lives next door. Mrs. Jackson appoints the one next door as her attorney-in-fact. Mrs. Jackson dies, and the two children from New York come home to claim their share of the estate. The child next door has used the power of attorney to transfer everything into her name and refuses to relinquish any property to her siblings. The other two children will have to pursue a lawsuit to get their share of the estate. Mrs. Jackson made a poor choice in naming the child next door to serve as her attorney-in-fact.

6. FAILURE TO ADEQUATELY PROVIDE FINANCIALLY FOR SURVIVING FAMILY. Many people live an extravagant lifestyle but save almost nothing and have no life insurance. When the person passes away, the income stream ends and there are often no assets to take care of the family. Think about what would happen if your client passes away. Will your client's family have enough assets to maintain their standard of living? Recommend some sort of life insurance to your clients as income

protection for the family.

7. FAILURE TO CONSIDER TAX PLANNING. Here are the basics:

a. Estate Tax Exemption - The estate tax exemption amount is now graduated. The amount of tax a decedent's estate has to pay will depend largely on the date the client dies. For instance, the tax result for a person who dies with $3,500,000 in 2008 differs greatly from a person who dies with the same size estate in 2009, 2010 or 2011. The following schedule summarizes the graduated changes:

(NOTE: LIKELY TO CHANGE IN 2009)

YEAR	EXEMPTION IN DOLLARS
2001	675,000
2002	1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000
2010	Unlimited Exemption
2011	Exemption goes back to $1,000,000

The client with $3,500,000 would pay approximately $675,000 in estate taxes if he died in 2008, no estate taxes if he died in 2009 or 2010 and $1,125,000 in estate taxes if he died in 2010. Is this good tax policy?

b. Obama's Proposals: **SEE ATTACHED HANDOUT**

c. Failure to Fully Utilize Exemptions of Both Spouses. Consider the following comparison of a couple who planned and a couple who did not plan. Is it worth a few thousand dollars to realize these tax savings?

HOW TO SAVE OVER HALF A MILLION DOLLARS USING BASIC DEATH TAX PLANNING
Hypothetical Assumptions:

Married couple with children.
Husband dies first in 2008. Wife later dies in 2009.
Husband owned the following assets when he died:

House Equity	$ 300,000
Personal Property	50,000
Investments	2,050,000
Real Property	2,000,000
Retirement Plans	150,000
Life Insurance	450,000
Total	$5,000,000

Example 1: Simple Wills - Husband leaves everything to wife outright to wife. No strings attached.

NOTE: The important thing to understand in this example is that no estate tax is payable at the first death because of the unlimited marital deduction, but the husband wastes his personal $2,000,000 exemption (the amount available in 2008). Doing so costs the children big money at wife's later death.

Husband's Death	$5,000,000	total estate
	-5,000,000	everything to wife (marital deduction results in no estate tax)
	-0-	taxable estate
Wife's Death	$5,000,000	total estate (assets inherited from husband)
	-3,500,000	available exemption amount **for 2009**
	$1,500,000	taxable estate
	$675,000	approximate federal death taxes at marginal rate of 45%

Example 2: Tax Planned Wills & Trusts - Husband leaves first $2,000,000 (the exemption amount in 2008) in a credit shelter trust for wife and the balance of his estate outright to his wife. The trust property will be distributed to the children at the wife's death in 2009.

NOTE: The important thing to understand in this example is that both spouses utilize their respective estate tax exemptions and nearly double the amount that can pass to the children free of estate tax without tax planning. The husband utilizes his $2,000,000 exemption (the amount in effect for 2008) by leaving assets having a value equal to the exemption amount in a credit shelter trust that will not be taxed in wife's estate. The wife utilizes her personal $3,500,000 exemption (the amount available in 2009) to transfer assets having a value equal to the exemption amount at her later death in 2009.

Husband's Death	$5,000,000	total estate
	-2,000,000	available exemption amount **for 2008** put in trust for wife and children
	-3,000,000	balance outright to wife
	-0-	taxable estate
Wife's Death	$3,000,000	total estate (assets inherited from husband)
	-0-	assets put in trust by husband not included in wife's estate is trust drafted properly
	-3,500,000	available exemption amount **for 2009**
	-0-	taxable estate
	NONE	approximate federal death taxes

<u>Conclusions</u>: Children in Example 2 receive $675,000 more at death of wife. If the $2,000,000 placed in trust for wife at husband's death substantially appreciates until wife's death, tax savings may be even greater.

8. GIFTING. You can now give away $12,000 each year to any person each calendar year. The donor pays no gift tax on this amount and the donor does not pay income tax on the transfer. If you transfer more than $12,000 to any one person during a calendar year, then you must file state and federal gift tax returns. The federal gift tax exemption amount is fixed at $1,000,000. North Carolina has special gift tax rules. Gifts in excess of that amount result in federal gift tax. Total lifetime transfers over $100,000 (excluding amounts transferring utilizing annual exclusion) are taxable in North Carolina prior to December 31, 2008. North Carolina has eliminated the gift tax effective January 1, 2009.

9. FAILURE TO PLAN FOR NURSING HOME CARE. This for the vast majority of people is a bigger concern than taxes. You have to reach a certain level of wealth to have an estate tax problem. The cost of extended nursing home care hits people regardless of net worth. There are several concepts even a general practitioner should know about relating to medicaid benefits for nursing home care that you should know about:

a. <u>Qualification</u>. There are two types of tests: the income test and asset test. The income test requires the disabled person's monthly nursing home costs to be greater than the person's countable monthly income to qualify. The asset test requires the disabled person to spend down all but $2,000 of nonexempt assets to qualify.

b. <u>Estate Recovery</u>. Even if an asset is exempt in determining qualification, the state may still have a claim against the person's estate for the amount of benefits paid. For example, suppose a man holds title to the family farm and goes into a nursing home, and the farm is not counted in determining medicaid eligibility because it qualifies as an exempt asset. Medicaid pays his nursing home bills while he is alive. When the man dies, the farm will be part of his probate estate. The state can and probably will file a claim on the estate to recover the medicaid benefits paid. So the planning process should address potential estate recovery not just qualification for benefits.

c. <u>Transfer Penalty</u>. If a person going into a nursing home makes gifts during a lookback period of either 3 or 5 years depending on the type of transfer, then the person is disqualified from receiving benefits for an unlimited number of months determined by dividing the total value of the gifts made by the average cost of nursing home care in North Carolina ($5,000).

d. <u>Be Careful</u>. This are of the law is extremely complicated. The rules change frequently. Do not attempt to give advice in this area unless you know the rules thoroughly.

SEE THE ATTACHED MANUSCRIPT REPRINTED WITH PERMISSION BY ROBERT A. MASON, A CERTIFIED ELDER LAW ATTORNEY. HIS PHONE NUMBER IS (336) 610-6000. HE IS AN EXPERT IN THIS AREA AND A GOOD PERSON TO WHOM YOU CAN REFER CLIENTS WHO HAVE THESE PROBLEMS.

10. FAILURE TO PLAN FOR DISABLED CHILD. Many people have disabled children with special planning needs. If so, consider a supplemental needs trust. These are designed to make sure the assets the parent leaves the disabled child are not required to be spent before the child gets governmental assistance.

11. FAILURE TO FACE ISSUES OF PROBLEM CHILDREN. This is a common issue facing parents today. Encourage your clients to face up to the problems their children have and be realistic in analyzing whether the children can handle the family business or bear any sort of financial responsibility. Consider recommending trusts if the person has problem children. The effective tax rate of leaving property to irresponsible children is one hundred percent.

12. FAILURE TO EVALUATE INSURANCE ILLUSTRATIONS PROPERLY. Large amounts of insurance have been sold on the basis of illustrations that have no basis in reality. Encourage your clients to get an illustration that projects reasonable returns. Premiums rarely vanish as fast as the insurance agent's illustration shows. Advise your client to get written guarantees of death benefits in writing from the insurance company. Do no let your client rely on the an insurance agent's verbal guarantee of the death benefit.

13. PREMATURE GIFTING PRIOR TO DEATH. Many people want to avoid probate so bad that they make gifts prior to death of low basis assets. The donee of a gift takes the donor's basis in the property and does not receive a stepped up basis that the donee would have received had the donor retained the property until death and transferred it to the donee by testamentary transfer. Probate fees in North Carolina are capped at $6,000. Don't let your client create unnecessary income taxes of several hundred thousand dollars to avoid $6,000 of probate fees.

14. FAILURE TO APPOINT HEALTH CARE AGENTS. Everyone needs to appoint someone to tell the doctor what to do if you become incapacitated and cannot do so yourself. Health care powers of attorney are simple to put in place. Many physicians and hospitals will not discuss even your spouse's medical condition with you if your spouse has not appointed you as his health care agent.

15. FAILURE TO PROVIDE INSTRUCTIONS ON ARTIFICIAL LIFE SUPPORT AND FORCE FEEDING. You can provide advance instructions on whether or not you will be hooked up to artificial life support machinery or be force fed through tubes in a number of situations. Everyone can and should have a living will in place so your family members don't have to make these difficult decisions for you.

16. BASICS OF ESTATE ADMINISTRATION. Here are the basic forms you need to know about:

a. Application for Letters of Administration or Letters Testamentary;
b. Waiver of Personal Representative's Bond;
c. Certificate of Probate;
d. Oath/Affirmation;
e. Appointment of Resident Process Agent;
f. Affidavit of Notice to Creditors;
g. Inventory for Decedent's Estate;
h. Estate Tax Certification;
i. Annual or Final Account; and
j. Order to Appear and Show Cause for Failure to File Inventory/Account

The attached "NORTH CAROLINA ESTATE PROCEDURE PAMPHLET" issued by the Administrative Office of the Courts is helpful. Review it before you engage in the administration of an estate. You should be aware that each clerk of court (there are 100 in North Carolina) has its own set of local rules that are generally unpublished and that you can learn only by making a mistake.