

## ISSUES IN DRAFTING WILLS AND TRUST AGREEMENTS

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### A. PRINCIPLES IN WILL DRAFTING

Precision and clarity are crucial when an attorney drafts a will. A will speaks at the death of the testator, and any ambiguities or mistakes in the will are often difficult to handle at that time.

In North Carolina, the guiding principle of will construction is to honor the intent of the testator. In drafting a will or revocable trust, it is your job to make sure that the testator's intent is accurately expressed in the document. It is your job to chase down potential ambiguities and ensure that you have made provision for the testator's estate to be handled in such a way that the testator's intent will be carried out.

An important piece of the estate planning puzzle is the "executive" piece. That is, who will carry out the testator's intent? Do not give this piece short shrift. Although fiduciaries have a well established legal duty to act appropriately, it is important to appoint a capable, honest fiduciary who will be able to carry out his or her duties to the beneficiaries without causing problems for himself or herself.

#### 1. FIDUCIARIES

The term "fiduciary" is a general term used to describe a person in whom another person has placed special faith, confidence and trust. Because of the trust and confidence placed in him by another person, a fiduciary is required to act honestly, in good faith and in the best interests of that person.<sup>1</sup> When wills and trusts are being drafted, the selection of fiduciaries is one of the most important decisions the client makes. The fiduciaries selected by the client will be tasked with carrying out the client's wishes at a time when the client is unable to do so. In addition, fiduciaries must often navigate tricky family

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<sup>1</sup> *Moore v. Bryson*, 11 N.C. App. 260 (1971).

situations while carrying out what can be complex duties. There are several kinds of fiduciaries which may be appointed by a client in his or her will or trust.

a. Executor.

An executor's duties are set out in Article 13 of Chapter 28A of the North Carolina General Statutes. The executor's duties commence upon the executor's appointment by the clerk of superior court, which is memorialized by the issuance of letters testamentary.<sup>2</sup> Section 28A-13-2 sets out a general statement of the executor's duties:

A personal representative is a fiduciary who, in addition to the specific duties stated in this Chapter, is under a general duty to settle the estate of his decedent as expeditiously and with as little sacrifice of value as is reasonable under all of the circumstances. He shall use the authority and powers conferred upon him by this Chapter, by the terms of the will under which he is acting, by any order applicable to fiduciaries, for the best interests of all persons interested in the estate and with due regard for their respective rights.

The statute refers to a "personal representative," which includes an administrator - a person appointed to handle an intestate estate - as well as an administrator C/T/A - a person other than the named executor who is appointed to administer an estate where there is a will.

A testator has the right to name in his or her will a person who shall administer his estate after his death, provided that the person designated is not disqualified by law.<sup>3</sup> The person named in a testator's will is the executor of the estate. The person the testator names as executor has the right to administer the estate and can only be deprived of that right by his refusal or neglect to probate the will or take out letters, or his inability or unsuitableness to execute the will or trust.<sup>4</sup> Courts will give deference to the person appointed by the testator<sup>5</sup>, but in some circumstances the person named by the testator may not be appointed as executor.

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<sup>2</sup> N.C. Gen. Stat. § 28A-13-1.

<sup>3</sup> *Matter of Moore's Estate*, 292 N.C. 58, 65, 231 S.E.2d 849, 853 (1977).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* At 65, 231 S.E.2d at 854.

North Carolina General Statutes Section 28A-4-1 states that “Letters testamentary shall be granted to the executor or executors designated in the will . . . [but] if the clerk of superior court upon hearing finds that none of the foregoing persons is qualified in accordance with G.S. 28A-4-2, the clerk shall grant letters of administration in accordance with subsection (b).” The statute then provides a list of persons who may serve as administrator in the order they are preferred: (1) surviving spouse of decedent; (2) devisee of testator; (3) heir of decedent; (4) next of kin, with a person who is of closer kinship having priority; (5) any creditor to whom the decedent became obligated prior to his death; (6) any person of good character residing in the county; and (7) any other person of good character not disqualified under G. S. 28A-4-2.

A person may be disqualified from acting as executor if: he is under 18 years of age; he has been adjudged incompetent and remains under such disability; he is a convicted felon and his citizenship has not been restored; he is a nonresident of this state and has not appointed an in-state agent to accept service of process; he was a resident of North Carolina at the time of appointment but then moved from the state without appointing an in-state agent; it is a corporation not authorized to act as an executor/personal representative in North Carolina; he has lost the right to serve as executor as provided by Chapter 31A (this includes a spouse who is divorced from the decedent, who abandoned the decedent, who is separated from the decedent and is living in un-condoned adultery, etc.); he is a person whom the clerk finds otherwise unsuitable; or he is a person who has renounced.<sup>6</sup>

Some of the reasons for which a person can be disqualified from being executor are obvious - an incompetent person cannot serve as executor. The general exception that a person may not serve as executor if “the clerk of superior court finds [such person] otherwise unsuitable” is more of a gray area. This reason for disqualification is often used and examined in situations in which there is an argument over who should be the executor. One of the most common reasons that is covered in this catch-all exception is a conflict of interest. Where an executor has a conflict of interest that will prevent him from impartially performing his fiduciary duties, he may be disqualified.<sup>7</sup> For example,

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<sup>6</sup> N.C. Gen. Stat. § 28A-4-2.

<sup>7</sup> *In re Moore's Estate*, 25 N.C. App. 36, 212 S.E.2d 184 (1975).

where the person appointed executor performed services as an accountant for a company, and one of the assets of the estate was a potential claim against the company, the person appointed had a conflict of interest such that he was properly disqualified from serving as executor. The court determined that “[e]specially when a decision to bring suit might endanger [the accountant’s] chances of future employment by the firm, the possibility that his decision to bring suit will be influenced by his own personal interests is great. One cannot represent his own interest and at the same time represent those of another which are in conflict with his own with fairness and impartiality to either.”<sup>8</sup>

When the person who has qualified as executor fails in his duties or has a conflict of interest, the clerk may upon his or her own motion remove the executor. Upon a verified complaint for removal filed by an interested party, the clerk may initiate a procedure to determine whether the executor should be removed. The clerk may remove the executor if he or she finds that the person appointed was originally disqualified or has become disqualified; if letters were obtained by false representation or mistake, if the person appointed has violated his or her fiduciary duty through default or misconduct; or if the person has a private interest that “might tend to hinder or be adverse to a fair and proper administration. The relationship upon which the appointment was predicated shall not, in and of itself, constitute such an interest.”<sup>9</sup> If an executor is removed because of bad acts, then the executor may not receive a commission for his or her services.<sup>10</sup>

In will drafting, it is important to help your client ensure that he or she chooses an executor who will be able to handle executor duties. In a fractious family, for example, it may be best to choose an independent third party to serve as executor.

When a will is being drafted, it is wise for the testator to name successor or alternative executors, to cover the possibility that the testator’s first choice for executor cannot serve. This allows the testator to remain in control of who will serve to administer the will. If no successor is named, the decision of who will administer the estate is left to the persons interested in the estate or the clerk of superior court. If, for example, the named executor renounces his right to serve as executor, he may name a person and ask

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<sup>8</sup> *Id.* At 40, 212 S.E.2d at 187.

<sup>9</sup> N.C. Gen. Stat. § 28A-9-1 (which also includes a description of the procedure for removal of an executor).

<sup>10</sup> N.C. Gen. Stat. § 28A-23-3.

that the clerk appoint that person, but those wishes are not binding upon the clerk of court.<sup>11</sup>

Sometimes, testators may want to appoint more than one person to serve jointly as executors. If a client wishes to appoint joint executors, it is important that the will set out how they will work together - the provisions of the will govern, but if the will is silent, then North Carolina General Statutes Section 28A-13-6 will determine how co-executors will function. The general rule is that acts and duties must be performed by both joint executors, if there are two, and if there are more than two, by a majority of the executors. One way to address the situation of co-executors is to provide for them to have joint and several powers, so that a single one of the executors may act on behalf of the estate without having to obtain the signature or joint action of the other executor(s). If the will does not provide for a division of powers, the executors may, by written agreement signed by all of the executors and approved by the clerk of court, provide that certain powers exercised by one executor can bind all executors.<sup>12</sup>

Sometimes, a testator may appoint a person who is not a resident of North Carolina to be executor. Generally an out-of-state resident may serve as executor of a North Carolina estate, but the person appointed must submit himself or herself to the jurisdiction of the North Carolina courts and appoint a person to serve as his or her agent for service of process within North Carolina.

A good practice in drafting wills is to waive the bond for an executor. If there is no express waiver of the bond, an executor must be bonded. Bonding can be difficult (depending on the person who is named as executor) and expensive. If the testator trusts the person being named as executor, then often it eases the administration process to also waive the bond.

b. Trustees

If a person's will establishes any trusts, then the will should also appoint a trustee for the trust. The trustee's fundamental duty is to "administer the trust in good faith, in accordance with its terms and purposes and the interests of the beneficiaries and in

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<sup>11</sup> See AOC form E-200.

<sup>12</sup> N.C. Gen. Stat. § 28A-13-6.

accordance with [Chapter 36C of the North Carolina General Statutes].”<sup>13</sup> North Carolina has adopted a Uniform Trust Code, which is contained in Chapter 36C, and which presents a code governing the creation and administration of trusts, including testamentary trusts. Generally speaking, the Trust Code sets out default settings for a trust. The terms which are set forth in the document establishing a trust (whether it is a will or trust declaration or agreement) can override most of the provisions of the Trust Code.

Again, the decision of who is appointed as a trustee is an important one which should be carefully considered by the client.

In a trust established for minor children, for example, it is a good idea to choose a trustee who is someone other than the guardian named for the children. This can provide a system of checks and balances that can stem the risk of abuse of a trust by a guardian. Often in a situation where clients are in a second marriage, a marital trust is used to provide for the surviving spouse during his or her lifetime, with the remainder to the children of a prior marriage. In second marriage circumstances, an independent trustee can be quite valuable. The independent trustee can protect the interests of the surviving spouse and the children, while appointment of a family member has a high likelihood of leading to family conflict and even litigation.

In some circumstances, a corporate trustee will be the best choice, while in others an individual trustee will be a better choice. Often, corporate trustees require that a trust have assets of a certain threshold value before they will serve, whereas individual trustees are generally more flexible regarding the asset value of a trust.

A testator or settlor of a trust may appoint more than one person to serve as trustee. In this circumstance, the default rule is that if there are two trustees, trustee action must be unanimous. If there are more than two trustees, trustee action must be taken by a majority of the trustees.<sup>14</sup> If more than one trustee is appointed, it may be desirable for the general rule not to apply. For example, in some circumstances, it makes sense to appoint a family trustee and an independent trustee. The family trustee may have more personal contact with the beneficiary, while the independent trustee may be in

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<sup>13</sup> N.C. Gen. Stat. § 36C-8-801.

<sup>14</sup> N.C. Gen. Stat. § 36C-7-703.

charge of investments or have the final say-so as to distribution decisions, taking some of the pressure off of the family trustee. In such a situation, careful delineation of the role of each type of trustee is important.

The Trust Code sets out the duty of loyalty which a trustee owes to the beneficiaries of the trust and says that the trustee “shall administer the trust solely in the interest of the beneficiaries.”<sup>15</sup> This provision may be overridden by the terms of the trust, so if the client wants for the trustee to be able to engage in any self-dealing, then the instrument creating the trust may so provide. Use of an investment firm related to or affiliated with a corporate trustee is generally not considered to be self-dealing, so long as the investment complies with the prudent investor rules.<sup>16</sup>

The trustee has a duty to be impartial to multiple beneficiaries of a trust.<sup>17</sup> (This is where an independent trustee can be important, as explained above.) The trustee has a duty to exercise reasonable care, skill, and caution in dealing with a trust,<sup>18</sup> but a trustee with special skill or expertise must use that special skill or expertise in administering the trust.<sup>19</sup>

The Trust Code contains many default powers for the trustee.<sup>20</sup> These are a valuable resource of trustee powers, but they are also subject to the rule that the express terms of the trust can override them.

c. Guardians

The parents of minor children can appoint another kind of fiduciary in their wills. They can name a guardian for minor children. Parents may name a guardian or guardians in a writing signed in the presence of two witnesses who are at least 18 years of age other than the guardian being named.<sup>21</sup> A written attested will complies with the requirements for the appointment of a standby guardian for a minor child. The testator can appoint alternate guardians. The appointment may waive bond for the guardian. Before a guardian officially becomes guardian of a minor child, the clerk must make findings that the guardian was properly appointed, that the best interests of the minor child will be

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<sup>15</sup> N.C. Gen. Stat. § 36C-8-802.

<sup>16</sup> N.C. Gen. Stat. § 36C-8-802(f).

<sup>17</sup> N.C. Gen. Stat. § 36C-8-803.

<sup>18</sup> N.C. Gen. Stat. § 36C-8-804.

<sup>19</sup> N.C. Gen. Stat. § 36C-8-806.

<sup>20</sup> N.C. Gen. Stat. § 36C-8-815 and 8-816.

promoted by the appointment of the person designated as guardian, and that the guardian named is fit, among other findings.<sup>22</sup>

For families with minor children, the selection of a guardian can be one of the hardest decisions in the estate planning process. In wills or trusts in which appointment of a guardian is appropriate, it can be helpful to explain what can be distributed to the guardian and why. For example, you may provide that a guardian may receive funds to renovate a home so that the minor child can live with them

## 2. FORMS

In drafting wills and trusts, there are several good sources for forms that may serve as a starting point for a particular client's estate planning. Several banks have will and trust manuals, including BB&T. It can be helpful to find forms that are North Carolina specific. Several software systems are also available. Menu forms is available, and it uses forms produced by attorneys at Robinson Bradshaw and Hinson in Charlotte.<sup>23</sup> Other national providers often document assembly programs for estate planning such as Wealth Counsel<sup>24</sup> and Jonathan Blattmachr.<sup>25</sup> In using the systems of national providers, it is very important to customize forms to include North Carolina law.

As always, if you begin drafting with a form, it is critical to carefully proofread and ensure that the document you have prepared fits the client's needs and is specifically tailored to the client. Form books are a good starting point for estate planning, but the importance of proofreading and customizing drafts to your client's needs cannot be overstated.

## 3. CLAUSES

There are certain clauses and provisions that are included in all wills, and forms give you a good beginning place to draft these. Some of the important and common clauses in wills are:

a. Introductory paragraph. This paragraph usually states the testator's name, can state the testator's county of residence, and can give family information. Providing

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<sup>21</sup> N.C. Gen. Stat. § 35A-1374.

<sup>22</sup> *Id.*

<sup>23</sup> <https://www.rbh.com/onlinestore>

<sup>24</sup> [www.wealthcounsel.com](http://www.wealthcounsel.com)



family information in the will can help with the administration process and can help eliminate ambiguity. For example, if the testator wants to include stepchildren in the will and treat them as natural children, a family information section is very important in explaining how these beneficiaries are to be treated.

b. Revocation of prior wills. All wills should include a statement that the will being executed revokes any prior will. If the person is executing a codicil that is not intended to revoke a prior will, it is smart to recite that purpose in the introductory language of the will, and it is also smart to state that terms of the will that are not addressed in the codicil are ratified and affirmed. With word processors and with the likelihood that an attorney can easily alter terms of a will, as a general rule, it is better for a client to execute a new will rather than a codicil. This is because piecemeal modification in a codicil can be susceptible to inadvertent omission and other mistakes.

c. Tangible personal property. Tangible personal property can be lumped in with the residue of the estate or it can be treated separately. Tangible personal property includes items such as a testator's furniture, clothing, jewelry and automobiles, but does not include money or other intangibles, such as stocks and bonds. In some states, a memorandum or other writing may be incorporated in the will that directs that tangible personal property be distributed in a certain way. In those states, the memorandum approach to dealing with tangible personal property is useful, because it allows the testator to make provision for specific items of tangible personal property to be distributed to specific individuals without making a number of specific bequests in the will. In those states, the memorandum may be revised without having to go through the formalities of re-executing a will, and the memorandum is binding upon the executor. North Carolina does not have this rule, however. If a memorandum is incorporated by reference in a North Carolina will, it cannot be revised after the will has been executed unless it constitutes a codicil to the will. An option in North Carolina is to devise the tangible personal property to the executor of the estate, and include precatory language that states that the testator expects and trusts that the executor will follow the testator's directions as set forth in a memorandum or written note in distributing the tangible personal property.

d. Specific bequests/devisees. Wills may contain bequests or devisees of specific property. When specific devisees are used, it is important to be careful in describing the property devised and describing the beneficiary. The will should also provide what happens to the property if the devisee is deceased. North Carolina does have an anti-lapse statute that may apply, depending on the relationship of the devisee to the testator, but it is better practice to state what happens to specific devisees in the event that the devisee is deceased (because the anti-lapse statute will not apply to every specific devise, and because it is a lot easier to explain language you have drafted to a client than it is to explain the anti-lapse statute to a client! A specific devise may be made to a class of beneficiaries. For example, a testator may devise a sum to all of his or her grandchildren living at the time of his or her death.

e. Residuary estate. Every will should contain a clause that deals with the testator's residuary estate to avoid a situation of partial intestacy. Even if the testator is sure that in his specific bequests, he has devised every interest in any property that he owns, a residuary clause is necessary to deal with lapsed gifts and forgotten or unexpected property interests.

f. Fiduciary appointments. In this section, the testator should name an executor and possible successors to the executor. Again, the reason why it is desirable to name successors is so that the testator can control who is administering the estate rather than relying upon the clerk to name someone. If the testator establishes any trusts or if there is a possibility that any trusts may be established under the will (for example, under a catch-all "holdback" trust provision), the testator should name trustees in this section. If the testator has any minor children, then the testator can name guardians for minors in this section.

g. Debts and Expenses. The will should provide for the payment of the testator's debts and administration expenses. If the testator desires, he or she may include a provision that the testator's charitable pledges are to be paid, regardless of whether such pledges would be considered "enforceable" obligations of the testator's estate. In addition, it is smart to provide that the decedent's funeral expenses are to be paid, regardless of whether the costs of a funeral or cremation and suitable marker or memorial exceed the amount allowed by statute. Currently, funeral expenses that are authorized -

absent a specific provision in the will - are limited to \$2,500<sup>26</sup>, and the amount allowed for a gravestone is \$800 (if the estate exceeded \$25,000; if not, the amount allowed is \$400).<sup>27</sup> These amounts are not sufficient to pay for the costs of a funeral or often even a cremation, so it is important that the will itself authorize expenses in excess of these statutory amounts.

Generally, when property devised to a person is encumbered, the devisee takes the property subject to the encumbrance.<sup>28</sup> If the testator wishes for the secured obligation to be paid and for the property to pass free of encumbrances, there must be an express provision in the will which exonerates the devised property from the encumbrance.

h. Taxes. The testator should provide for how death taxes are to be paid. Tax allocation clauses are generally included in wills even if the estate will most likely not be a taxable estate. There are a few ways to address this. Sometimes, the testator may provide that death taxes are to be paid from the residuary estate. This means that no part of the tax burden on the estate will be expected to be paid from any specific devise or bequests. Sometimes, if the specific bequests and devises are a substantial portion of the estate, the testator may provide that every devise shall bear its *pro rata* share of the taxes. Carefully describing how taxes are to be paid has become even more important as non-probate assets such as IRAs, retirement plans and life insurance constitute larger portions of decedent's estates. For example, if the beneficiary of an IRA is different than the residuary beneficiary of the estate, it may be unfair to force the residuary beneficiary to foot the estate tax bill for the IRA.

Also, if part of an estate qualifies for the estate tax marital deduction or charitable deduction, a testator may want any taxes to be borne by the non-marital or non-charitable deduction, because the payment of taxes out of a marital or charitable share will cause a reduction of the marital or charitable deduction, which in turn would cause circular reductions to be calculated.

i. Executor's powers. It is wise to recite the powers given to the executor in the will. Often, the statutory powers given to an executor are incorporated by reference (N.C. General Statutes § 32-27, § 32-26). The section which recites the executor's

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<sup>26</sup> N.C. Gen. Stat. § 28A-19-6.

<sup>27</sup> N.C. Gen. Stat. § 28A-19-9.

powers can be a good place to describe how joint executors are to exercise their powers (for example, giving joint executors joint and several powers). Beware: a personal representative in North Carolina has the powers set forth in N.C. Gen. Stat. § 28A-13-3 except as qualified by the express provisions of a will. The power to sell real property in § 28A-13-3(1) requires a personal representative to follow the procedures set out in subsection G.S. 28A-13-3(c) in selling real property, which requires a special proceeding in order to sell real property. If a testator wishes for real property to be sold following death, the personal representative can authorize the executor to sell the property at public or private sale in his discretion, with or without court order, but to be effective, such a direction should spell out which specific real property the executor may sell. Often property is devised to the executor, with instruction for the executor to sell. Most will forms contain a general authorization for an executor to handle (sell, lease) the real property of a testator, but these clauses, without more, are held to be ineffective and if such a clause is the only authorization for the sale or lease of real estate, then the clerk will require that the executor file a petition to take control and custody of the real property in order to sell it. In this section, the testator may waive the executor's bond as well.

j. Trustee powers. If the will establishes any trusts, it is important to set out the powers given to the trustee. N.C. Gen. Stat. § 36C-8-816 gives a trustee certain specific powers, but those powers may be modified by the terms of the trust, and the statutory powers of N.C. Gen. Stat. § 32-27 may be incorporated by reference, but additional powers may also be included. For example, if a trust will hold an ownership interest in a business, it would be wise to include powers allowing the trustee to deal with the stock or other ownership interest. If a family farm or business is included, and if the testator wants it to remain in trust, it would be smart to include a provision that the trustee does not have to diversify the trust's assets.

k. Custodianship/stand-by or holdback trusts. The will may include a provision for what happens if any property is to be distributed to a minor child or incompetent adult under the will. There are several options in making provision for this circumstance. A simple reference to the Uniform Transfers to Minors act may suffice, or

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<sup>28</sup> N.C. Gen. Stat. § 28A-15-3.

the testator may want to add provisions for a trust to be established for any distribution to a person under a certain age. A testator may give the executor the authority to determine how a devise is distributed. For example, a testator may provide that if a property is to be distributed to a minor child, the executor may decide whether to distribute the property to the child's guardian, a custodian of a UTMA account, or to hold the property in trust for the child. A provision like this one can give the executor flexibility to deal with varying circumstances, such as the size of the devise, the age of the beneficiary, and other relevant factors. Likewise, for incompetent or disabled individuals, a testator may want to establish a discretionary trust or simply have the funds held by a custodian or paid to a community trust.

1. Definitions and construction. Many wills contain a definitions and construction section. A common provision is that masculine and feminine pronouns may include each other as the context of the will requires. Many wills define the terms "children" and "issue." Many wills address how adopted persons are treated. The detail of the definition section often depends on the complexity of the will. For example, if the will contains generation-skipping transfer trust provisions, then "available exemption" may be a defined term.

m. Attestation clause. In written attested wills, it is usual to have a clause in which the testator acknowledges that the foregoing document is the testator's will, that the testator executes it freely and of his or her own will, that he or she is of sound mind, that he or she is 18 years of age or older, and that he or she executes the will free of undue influence and under no undue constraint. Likewise, there is a clause that the witnesses to the will sign. A sample attestation clause is:

We, \_\_\_\_\_, \_\_\_\_\_ and  
\_\_\_\_\_, the witnesses, sign our names to this instrument, being first duly sworn, and do hereby declare to the undersigned authority that the testator signs and executes this instrument as his/her last will and that he/she signs it willingly, and that each of us, in the presence and hearing of the testator, hereby signs this will as witness to the testator's signing, and to the best of our knowledge the testator is

eighteen years of age or older, of sound mind, and under no constraint or undue influence.

Some practitioners use two witnesses, because that is the number of witnesses required in North Carolina for a valid written attested will. Some practitioners use three witnesses, because some states still require three witnesses, and by using three witnesses, the will is more likely to be valid in such a state, if circumstances arise in which the will is probated in such a state. Also, there would be an additional witness who could testify as to the proper execution of the will, in the event of a will caveat.

n. Notarization. The will should be notarized so that it is a self-proving will. The Notary Public confirms that the testator and the witnesses all duly signed the will. If the will is not self-proven, then for the will to be probated, you must find the witnesses at the time the will is presented to the court for probate, to prove that the will was properly executed.

o. Identification of Drafting Attorney. Drafting attorneys must identify themselves and their business addresses in all written, attested wills in North Carolina executed January 1, 2010 or later. N.C. Gen. Stat. § 31-4.2. It is unclear whether the failure to identify the drafting attorney would invalidate the will.

## B. REVOCABLE AND IRREVOCABLE TRUSTS

A trust is a fiduciary relationship with respect to property in which the trustee holds legal title to the trust property pursuant to agreement with the trust's grantor or settlor, subject to enforceable equitable rights in the beneficiary.

### 1. FUNDING THE TRUSTS

Revocable trusts are commonly used as will substitutes. A typical revocable trust (or "living trust") provides that during the settlor's lifetime, he or she may withdraw or direct the use of trust assets. The trust agreement may provide for how trust assets are to be used during the settlor's incapacity and therefore can be helpful in planning for a client's incapacity. Using a trust to plan for incapacity can have benefits over using a durable power of attorney. Generally, a trustee has an easier time dealing with financial institutions, because institutions are more familiar with trust arrangements and the law that applies to them. In some instances, financial institutions will give an attorney-in-fact a hard time. North Carolina has a statute to address difficulties in getting institutions to accept a durable power of attorney - N.C. Gen. Stat. § 32A-41. Even armed with this statute, this practitioner has had trouble with some out-of-state financial firms accepting a valid power of attorney. The settlor of a revocable trust usually retains sufficient power over the trust assets that the trust is disregarded for income tax purposes, and all of the trust's assets are deemed to belong to the settlor for income tax purposes, even if title is technically in a trustee. If one of the powers retained by the settlor is listed in IRC §§ 671-677, then the trust will be considered a "Grantor" trust and will be disregarded for estate tax purposes.

If a revocable trust is used, the dispositive provisions of a client's estate plan can be kept private - a revocable trust is not filed with the clerk of court like a will is. The desire for privacy is a reason that many clients choose a revocable trust for estate planning. As public records become more and more accessible online, the likelihood of information in a will being viewed is higher.

One of the main benefits of a revocable trust is that, if it is properly funded, it can help a settlor avoid the probate process. If a person's assets are all held in a revocable trust at the time of that person's death, then none of those assets would be held in the person's individual name, so there would be no assets subject to probate. The key to

having a revocable trust help minimize probate is to have the trust be properly funded. Clients need detailed guidance in funding revocable trusts, and it is best if clients will allow their attorney to oversee the funding process.

*Certification of Trust.* A certification of trust sets out important information about a trust without disclosing the dispositive terms of the trust. Some financial institutions have their own certification of trust form, but preparation of a certification of trust form for clients is useful, because it allows them to provide the information that financial institutions require about a trust without having to turn over the entire trust agreement.

North Carolina allows for certifications of trust in N.C. Gen. Stat. § 36C-10-1013. That statute provides that “Instead of furnishing a copy of the trust instrument to a person other than a beneficiary, the trustee may furnish to the person a certification of trust. . .” The certification includes: the existence and date of the trust, the identity of the settlor (unless withheld under a specific provision in the trust), the identity and address of the current trustee, the powers of the trustee, the revocability or irrevocability of the trust, disclosure of who has power to revoke the trust, the authority of co-trustees to execute documents, the trust’s taxpayer identification number, and the manner of taking title to trust property.

Use of a certificate of trust can be helpful, especially for clients who are concerned about privacy. An institution may require copies of excerpts from the trust containing the information described in the trust, but the statute gives protection to institutions that rely upon certifications of trust.

*Identifying the Trust.* To put assets into a trust, the trust must be adequately identified. For example, the title of trust assets may be held in this form:

Haris Pilton, Trustee of the Haris Pilton Revocable Trust U/A dated  
September 22, 2007.

This title lists the trustee’s name, the name of the trust, and the date of the trust agreement. It supplies sufficient identifying information for the trust. Remember that title to assets is held by the trustee; the trust is a relationship, not an entity.

*Cash Accounts.* A client’s bank accounts should be re-titled in the name of the trust. A client may not wish to use small joint accounts to fund the trust. In fact, some



clients prefer to retain a small joint account to be used primarily for household expenses. An alternative would be to have a revocable trust as owner of an account but to have the checks printed in the client's name, instead of disclosing the trust relationship.

When changing bank accounts to fund the trust, remember that the client's social security number is the identification number for the account. The account withholding and reporting will essentially remain the same.

Before clients re-title certificates of deposit, they should consult with a bank officer to make sure that the bank will not consider the change in account name to be an early withdrawal that incurs a penalty.

If a trust has joint trustees, when re-titling bank accounts, be careful to give each trustee signature power over the account. New signature cards should be signed by the trustee(s) in his or her capacity as trustee.

*Investment Accounts.* If a client has a brokerage or investment account, a broker or custodian can help change the title of the account so that the account will belong to the trust. The procedure for changing the title of investment accounts is the same as it is for re-titling cash accounts.

*Stocks and Bonds Not Held in Investment Accounts.* There are two ways to deal with stock or bond certificates: A client can open a brokerage or investment account in the name of the trust and deposit the certificates in the account or the client can work with the transfer agent for the stock or bond and direct the agent to reissue the stock with the trustee as the new owner. Working with transfer agents generally takes longer than working with brokers.

*Tangible Personal Property.* If any tangible personal property has separate title documents, those should be used to transfer the property to the trust. Most tangible personal property does not have a "title," however. A declaration that the trust is the owner of the tangible personal property is often used. This is simply a signed statement by the settlor that he or she is transferring his or her tangible personal property to the trust. A declaration that the tangible personal property has been transferred can even be included in the terms of the trust agreement.

Vehicles are included in tangible personal property, but they frequently are not transferred to revocable trusts. Owning a vehicle in trust can give automobile insurance

companies pause, and sometimes can cause the insurance company to apply a business rating to the vehicle. In addition, title to a vehicle after the owner's death can often be transferred without formal probate proceedings.

*Retirement Plans.* This topic is included only to emphasize that a client should **NEVER** transfer the ownership of a qualified retirement or pension plan or individual retirement account to a living trust during the client's lifetime. Instead, the client should examine beneficiary designations to ensure that the beneficiary designations, in combination with the trust (or will, for that matter) will accomplish the client's goals in regard to the plan after the client's death. In dealing with beneficiary designation forms, it is wise to get a confirmation that the beneficiary change has been accepted from the plan administrator. More and more frequently, a large portion of clients' assets are held in qualified retirement plans. These assets require very careful planning, because of the income tax issues that apply to them. You must consider who will end up paying the income tax associated with these assets, when it will be payable, and at what rates. If a client wants to leave retirement plan assets in trust for a beneficiary, it is critical to review the Code and to draft the trust so that the tax-preferred status of the account will not be jeopardized.<sup>29</sup>

*Promissory Notes and Other Receivables.* Clients may assign interests in promissory notes and other receivables to their revocable trusts by endorsement or by a written document. The client should also notify the debtor of the assignment.

*Partnership Interest.* Partnership agreements often contain restrictions on the transferability of partnership interest. Attorneys may need to work with the partners in a partnership to allow for a transfer of partnership interest. If a transfer is permitted, partnership interests may be transferred through a written assignment of interest signed by the owners of the partnership interest and acknowledged by the other partners.

*Corporate Business or Professional Interests.* Corporate counsel should help with this transfer. Corporations will have to cancel certificates held in the settlor's name and issue new certificates in the name of the trust. If the business is a limited liability

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<sup>29</sup> A great resource for dealing with retirement plan assets is [Life and Death Planning for Retirement Benefits](#) by Natalie Choate. It is available at [www.ataxplan.com](http://www.ataxplan.com).

company, the way a transfer may be effected will depend on the terms of the company's operating agreement.

*Real Property.* A deed is required to transfer an interest in real property. It is important to remember that the title will be held by the trustee of the trust, not by the trust itself (because a trust is not an entity).

Helping clients to fully fund their revocable trusts is crucial to accomplishing the goals of most revocable trusts. If properly funded, revocable trusts are very useful in allowing for a way to help a client manage property if he or she is incapacitated, to ease administration following death, and to protect a client's privacy.

## 2. USING IRREVOCABLE TRUSTS TO PURCHASE LIFE INSURANCE

Irrevocable trusts have different purposes. Some common uses of irrevocable trusts include life insurance trusts, gifting ("*Crummey*") trusts, charitable remainder trusts, and retained interest trusts. A useful tax-planning tool is the use of an irrevocable trust to purchase life insurance.

Life insurance has a useful place in estate planning. In exchange for the payment of a fixed premium, usually in periodic payments, an insurance company agrees to pay a death benefit in a certain amount at the insured's death. There are many kinds of life insurance products, and it takes expertise to select the appropriate product for an individual. If a life insurance policy is owned by the insured on the date of his death or if it is payable to his estate, the insurance will be part of the insured's taxable estate. If owned by and payable to someone other than the insured, it is generally not subject to estate tax, unless the insured owned the policy and gave it away less than three years prior to the date of death.

It is not necessary to have an irrevocable life insurance trust in order to keep life insurance from being part of a decedent's taxable estate, but irrevocable trusts offer many advantages. An insurance policy may be owned by individuals or, sometimes, even business entities. Insurance policies owned by revocable trusts are deemed to belong to the grantor of the trust. Please note that an insurance policy has both an owner and a beneficiary, who are not necessarily the same. If someone wants to give away a life insurance policy in order to get the policy out of the insured's taxable estate, he should change both the owner and the beneficiary designation; a change of beneficiary without

an accompanying change of owner will not suffice to remove the policy out of the taxable estate. When an existing policy is transferred, the three-year rule discussed above is applicable.

The proceeds of a life insurance policy are included in a decedent's estate for estate tax purposes if the proceeds are receivable by the executor of the estate<sup>30</sup> or if the decedent died having "incidents of ownership" in the insurance policy.<sup>31</sup> Some examples of incidents of ownership include: (i) The rights to the economic benefits of the policy; (ii) The power to change the beneficiary of the policy; (iii) The power to cancel the policy; (iv) The power to assign the policy or revoke an assignment; (v) The power to pledge the policy as collateral for a loan; (vi) The right to borrow against the cash surrender value of the policy; (vii) The retention of a reversionary interest that exceeds 5% of the value of the policy immediately before the death of the decedent; (viii) The right to convert a policy from a whole life policy to a limited payment life policy or endowment life policy; (ix) The right to withdraw accumulated dividends or surrender paid up additions for their cash value; (x) The right to substitute a policy of equal value for the policy; or (xi) if the proceeds are payable to the creditors of the insured in satisfaction of the insured's debts.

Making a gift of a life insurance policy can be an effective estate planning tool, because life insurance has a lower present value than the death benefit. To make an effective gift of the life insurance, the donor cannot retain any incidents of ownership over the policy. Often, the donor wants to make the gift in trust, so that he or she can set parameters as to how the proceeds will be used, while giving the policy away and having the value of the policy's proceeds not be included in the donor's estate.

An irrevocable life insurance trust cannot be altered, amended, revoked, or terminated by the settlor of the trust once it is created and funded.<sup>32</sup> The settlor of the trust funds the trust either with cash, which is then used to purchase life insurance, or with an existing policy. If done properly, the irrevocable life insurance trust will not be

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<sup>30</sup> Internal Revenue Code §2042(1).

<sup>31</sup> Internal Revenue Code § 2042(2).

<sup>32</sup> Although the Uniform Trust Code does allow for the modification or termination of irrevocable trusts in certain circumstances.

included in the decedent's estate,<sup>33</sup> but the proceeds will be paid to the trust established by the decedent. The life insurance trust can then make loans to the decedent's estate or use the proceeds to purchase assets from the estate, which is a good way for the life insurance policy proceeds to supply liquidity for payment of estate taxes and debts. Or, the life insurance trust may provide a source of income for future generations of a decedent's family.

When the life insurance trust is set up, the funding of the trust is a gift to the beneficiaries of the trust. The trust itself can purchase a policy, or an existing policy can be transferred to the trust. If an existing policy is transferred to the trust, the value of the gift can be difficult to determine. If the policy is a paid-up policy or single premium, the value of the gift is the amount the insurance company would charge for a single premium contract of the same specified amount on the life of a person of the age and health of the insured. The measuring policy for determining the value of the gift must be identical to the original policy, including the same surrender value. If the policy is not new or is not paid up, then the value of the gift is the policy's interpolated terminal reserve, plus the policy's unearned premium.<sup>34</sup> This amount may be slightly different than the cash surrender value of the policy and the insurance company should furnish those values.

Once the trust owns a policy, the trustee is responsible for payment of premiums. Usually, the grantor makes contributions to the trust to cover the payment of the premiums, which results in a gift to the beneficiaries of the trust. Since the gift is to the trust instead of being an outright gift to the beneficiary and is not a gift of a present interest, the grantor generally cannot use his gift tax annual exclusion for the gift. There is an exception to this rule, however. The grantor can give "*Crummey*" withdrawal powers over the contributions to the trust, which makes those contributions present gifts. A *Crummey* power is a power given to a trust beneficiary to withdraw, for a limited period of time (often 30 days), any property transferred to the trust. The beneficiary's power to withdraw creates a sufficient present interest in the beneficiary that the gift is considered a gift of a present interest to the beneficiary for gift tax purposes.

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<sup>33</sup> The proceeds are not included because the decedent is deemed to have made a completed gift of the policy, so long as the decedent does not retain incidents of ownership over the property.

<sup>34</sup> Treasury Regulation § 25.2512-6(a).

The use of a right to withdraw to create a present interest was tested in the case of *Crummey v. Commissioner*, decided in 1968, so the power of withdrawal is often referred to as a “*Crummey*” power. The Internal Revenue Service has vigorously attacked *Crummey* powers, but the courts have generally allowed *Crummey* powers to create a present interest.

Use of a *Crummey* power requires written notice of gifts from the trustee of an irrevocable life insurance trust to the beneficiaries. Making sure that notices to a beneficiary of his or her right to withdraw property is important to show that the right given was a “real” right to withdraw. The IRS has ruled that beneficiaries cannot waive their right to receive future *Crummey* notices (instead, the trust agreement can provide that the *Crummey* right of withdrawal will lapse if not exercised within a certain amount of time)<sup>35</sup>. A beneficiary should not, upon receipt of a *Crummey* notice, waive his or her right of withdrawal prior to the end of the withdrawal period. Each time a contribution is made, the trustee should give to each beneficiary who has withdrawal rights notice of the contribution and preferably will receive from each beneficiary a written acknowledgment that the beneficiary is aware of the contribution and is aware of his or her right to withdraw the contribution. If premiums are due monthly or quarterly, the grantor may make a single contribution each year and the trust may make the periodic payments. A single *Crummey* notice can be sent, covering the full amount, and then the trustee can use the funds to pay the policy premiums as they come due.

The trustee should have broad power to satisfy any withdrawal rights that are exercised, including the right to borrow funds to satisfy such a withdrawal.

To protect the “present gift” aspect of the *Crummey* power, take care in drafting distribution or termination provisions so that distributions will not defeat an existing power of withdrawal that has not lapsed but is unexercised. If the amount of the *Crummey* withdrawal right is conditioned on whether the gift will be a split gift on a gift tax return, then the condition may be considered a condition subsequent to the gift, which makes the gift unascertainable until the condition subsequent occurs, which may defeat the whole point of having a *Crummey* withdrawal right.

The grantor of a life insurance trust may not exercise *Crummey* powers on behalf of a beneficiary. Likewise, the grantor should not be the trustee of the trust. Holding these powers may be considered a retained interest in the trust or an incident of ownership of the policy, so that the value of the trust would be considered part of the grantor's estate at the time of his death, defeating the purpose of the trust.

Often, "hanging" withdrawal powers are used in irrevocable life insurance trusts. The reason for this is that if the amount subject to a beneficiary's *Crummey* power in any year is greater than \$5,000 or 5% of the value of the trust, and the power lapses, then the person holding the *Crummey* power is deemed to have made a gift of the excess amount to the other beneficiaries of the trust. The hanging power cures this problem by allowing the power to hang until a year in which it can lapse and the amount subject to the withdrawal power does not exceed the \$5,000 or 5% limit. An alternative way to deal with this gift problem is to give the power holder limited testamentary power of appointment over the property which the beneficiary would be considered the grantor.

Please note that *Crummey* withdrawal powers may result in an irrevocable trust's having several grantors for income tax purposes in determining the trust to be a grantor trust. This can be confusing and may make the preparation of fiduciary income tax returns more difficult. Consequently, it is recommended that trusts with *Crummey* withdrawal powers hold only life insurance policies and not other income-producing assets. Normally if life insurance policies are the only assets of a trust, the trust will not be required to file fiduciary income tax returns.

Care must be exercised in the drafting, funding, and administering insurance trusts, but they are a valuable estate planning tool.

### Conclusion

While wills and trusts are an important part of an estate plan, it is equally important to make sure that you have an understanding of your client's assets, priorities, and planning goals. Once you have met with your client, then you can develop a plan, keeping in mind that a will addresses probate assets, that a revocable trust can act as a

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<sup>35</sup> Internal Revenue Code § 2514(e) provides that a lapse of the power is not equivalent to an exercise of the power, whereas a waiver of the power by the beneficiary may be deemed an exercise of the power which

will substitute, but can do even more than a will by providing for how assets will be handled during incapacity and by providing privacy. Many assets may be controlled by beneficiary forms or contractual arrangements (such as pay-on-death accounts or assets held jointly with right of survivorship), and these assets must be addressed. Irrevocable trusts, like life insurance trusts, may be used to add additional layers of planning. Underlying the use of any of these documents, however, is the need to be careful and thorough in providing an estate plan.

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transfers the amount the beneficiary could have withdrawn to the trust.