

Estate Planning, Wills and Trusts

University of Illinois at Chicago
Retirement Planning Conference

April 24, 2010

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I. Types of Property.

- A. Property titled in a person's own name is held in *sole ownership*.
- B. Joint ownership.
 - 1. Property held in *joint tenancy with right of survivorship* will pass to the survivor (or survivors) upon the death of any joint tenant. If all joint tenants die simultaneously, it is treated as tenancy in common.
 - 2. *Tenancy by the entirety* is the same as joint tenancy with right of survivorship, but is used only by spouses and only for residential property. It protects the property from the claims of creditors.
 - 3. Property held in *tenancy in common* means each tenant owns a separate undivided share that passes at death in accordance with his or her will.
- C. *Probate property* is any property held in sole ownership or in tenancy in common. Such property must go through probate upon death or disability.
- D. *Non-probate property* is any property that can pass at death without being subject to probate. Examples of such property are:
 - 1. Joint tenancy with right of survivorship.
 - 2. Tenancy by the entirety.
 - 3. Life insurance.
 - 4. Retirement plans.
 - 5. Totten Trusts (*e.g.*, a bank account in the name of "Jane Doe, for James Doe.")
 - 6. Property "payable on death" ("POD"), such as U. S. savings bonds.
 - 7. Property held in trust.

II. Probate.

- A. *Post-death probate* is a judicial forum in which:
1. The rights of the estate's beneficiaries are protected by the court.
 2. Claims against the decedent's estate are barred if not timely filed.
 3. The right to contest the decedent's will is barred if a will contest is not timely filed.
 4. The court supervises the administration of the affairs of a deceased person, the discharge of his or her debts, the payment of all estate and inheritance taxes, and the distribution of all remaining property to the intended beneficiaries.
- B. Is probate time-consuming or costly?
1. Probate can take as little as six months to complete. It is the federal and Illinois death tax returns that usually delay the process.
 2. A lawyer may no longer charge his fee in accordance with a fee schedule established by a Bar Association. His fee must be reasonable in time and rate for the work performed.
 3. *Independent administration* is a very simple process for estates. In non-contested estates, probate can be a reasonably efficient way to handle your affairs.
- C. Should probate be avoided? In general, the answer is yes:
1. Probate still adds at least \$2,000 - \$4,000 to the cost of administration,
 2. If a probate avoidance technique is used, such as a *living trust*, an estate not required to file a federal estate tax return can be administered in a matter of months.
 3. A living trust has the additional—and significant—advantage of avoiding pre-death probate, discussed later in this outline.
- D. Probate can be avoided through the use of a *small estate affidavit* if the probate assets total less than \$100,000.
- E. Why is having a *will* important?
1. It permits you, rather than the probate court, to name your *executor*.

2. It permits you to waive the cost of the executor's bond, which would otherwise run about 1%-2%.
 3. It gives you the right to indicate your preference as to who shall be *guardian* of your minor children.
 4. It allows you to establish trusts for minor children, thereby avoiding costly and annoying guardianship proceedings.
 5. It permits avoidance of the Illinois *intestacy* statute, summarized as follows:
 - (a) If there is a surviving spouse and no children, all to spouse.
 - (b) If there are children, but no spouse, all to children in equal shares.
 - (c) If there are both, spouse receives one half and children share one half.
 - (d) If no spouse or children, the estate is distributed in equal shares to surviving parents and siblings, with a sole surviving parent taking a double share.
 6. It is a method of implementing effective tax planning.
- F. *Pre-death probate.* The probate courts also have jurisdiction of solely-owned property in the event of incompetency. This is an expensive and time-consuming process, involving annual accountings to the court, applying for the court's permission for many transactions, and the employment of legal counsel. One advantage of having a guardian is that, under Illinois' substituted judgment law, a guardian may, with a proper order of the court:
1. Make gifts.
 2. Create or amend trusts.
 3. Modify an existing will.
 4. Change *beneficiary designations*.
 5. Execute *disclaimers*.
 6. Exercise *powers of appointment*.

III. **Doesn't Joint Tenancy Avoid Probate?**

- A. Yes—on the death of the first joint tenant, the property passes automatically to the surviving joint tenant, without regard to the provisions of decedent's will.
- B. However, if both joint tenants die simultaneously, it is a probate asset in each of their estates.

- C. In the case of a married couple, the use of joint tenancy does not necessarily avoid probate. Because the surviving spouse now owns the property in his or her own name, it will be a probate asset at the survivor's death.
- D. In the case of joint tenancy with others, such as a child, giving a child an ownership interest in your property creates the following possible problems:
 - 1. The asset is now potentially subject to the child's creditors during your lifetime.
 - 2. The property may become embroiled in a child's divorce proceeding.
 - 3. The asset will be taxable in the child's estate, if he or she predeceases you, unless you can prove to the government that you provided all the consideration for the asset's purchase.
 - 4. In the case of real estate, if you want to sell the property, you must obtain the child's consent.
- E. Joint tenancy may be very costly in larger estates (*i.e.*, estates over \$2,000,000) because joint tenancy precludes the ability to establish trusts which can save taxes.

IV. **Other Ways to Avoid Probate.**

- A. Life insurance policy proceeds and retirement plan death benefits are paid pursuant to a written beneficiary designation. They are not, therefore, subject to probate unless made payable to your estate.
- B. Gifts transferred and received before death.
- C. A transfer of your assets before your death to a trust can avoid probate and guardianship proceedings.

V. **What is a Trust?**

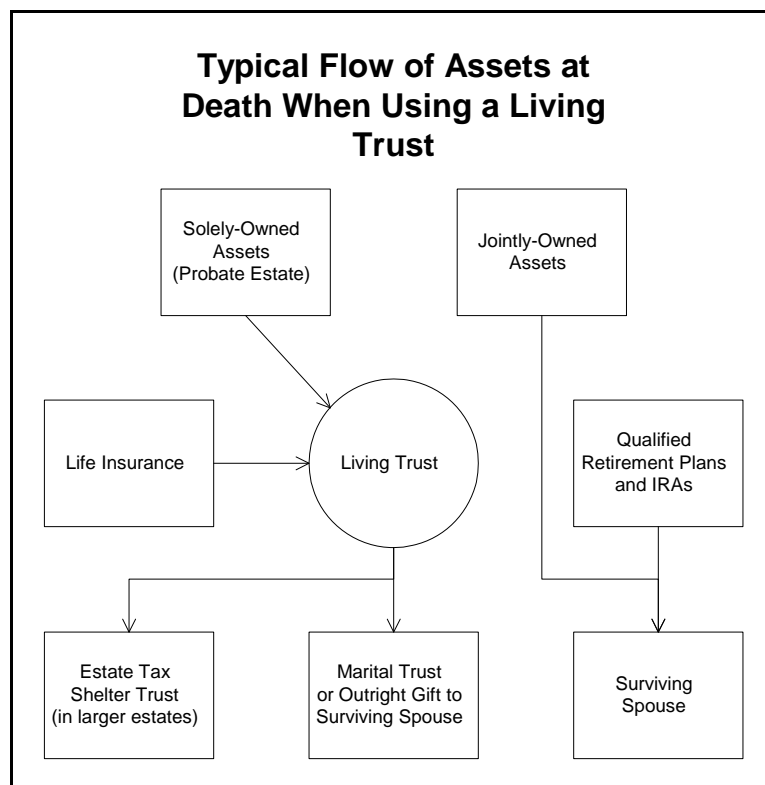
- A. A *trust* is established by a written instrument, usually called a *trust agreement*.
- B. The trust agreement names a *trustee*, and should either identify one or more successor trustees or contain some mechanism for appointing successor trustees.
- C. The trust consists of property that is titled in the name of the trust or that becomes payable to the trust, such as life insurance proceeds.
- D. The trust agreement instructs the trustee as to how to administer and distribute the trust property during the trust term and upon the trust's termination.

- E. Trusts serve three purposes:
 - 1. They provide management of property for a beneficiary who by reason of age, training or inclination is unable or unsuited to manage the funds himself.
 - 2. They can be a means of avoiding the imposition of estate, inheritance and income taxes.
 - 3. They permit probate avoidance.

VI. **What is a Living Trust?**

- A. A *living trust* is simply a trust created during a person's lifetime into which the person places all of his or her assets.
- B. A living trust is almost always revocable.
- C. Usually, the person who creates the trust—the *grantor*—names himself or herself as the trustee, in which case the trust is called a *self-declaration of trust*.
- D. The primary advantage of the living trust is that it avoids probate proceedings:
 - 1. Most importantly, the living trust avoids the guardianship proceeding in the probate court in the event of incompetence.
 - 2. Secondly, the living trust avoids post-death probate.
- E. Other advantages:
 - 1. Privacy as to the disposition of one's estate.
 - 2. Ease of execution.
 - 3. Lower fees.
 - 4. Typically, there are fewer law suits to set aside trusts than wills and fewer claims against trusts than estates.
 - 5. If desired, a trust can be used to circumvent the surviving spouse's mandatory share of any estate.
- F. Disadvantage: The cost and time to fund.

- G. Frequent misconceptions about trusts:
1. A trust is not supervised by any court or state agency. The court only takes action if a party to the trust requests it.
 2. A trust does not have to be located at or administered by a bank. Banks do frequently act as trustee, but it is not required. Most trusts have an individual as trustee.
 3. The trust assets do not have to be maintained at any one place. A trust consists of a collection of assets that you are free to have at a variety of different places, just as your own assets are.
 4. A trust can be created either in a trust agreement or in a will.
 5. Many trusts can be created in a single instrument.
- H. One method that is appropriate for most couples is the use of a joint living trust. All of the couple's assets are placed in a single trust, which, by its terms, divides ownership of the trust property 50-50. Such trusts are very easy to fund and I find my clients are often much more comfortable with this concept..
- I. When a living trust is used, a *pourover will* is used in conjunction with it. This causes any property not funded into the trust during lifetime to be placed in the trust after death.



II. Power of Attorney for Property.

- A. A *power of attorney for property* permits management of assets without court appointed guardian.
- B. Because Illinois permits *durable* powers of attorney, a property power of attorney can function as an alternative to a living trust.
- C. A better strategy is to use a property power of attorney to supplement a living trust, for any assets not yet funded into trust.
- D. Illinois has a statutory form of power of attorney for property which is more acceptable to financial institutions than one which does not follow the statutory format. This form is available at stationery stores or through an attorney.

VIII. Power of Attorney for Health Care (an *Advance Health Care Directive*).

- A. You should also execute a *power of attorney for health care*, which permits you to (1) name the persons responsible for making health care decisions on your behalf and (2) set forth your wishes in the event of a terminal illness.
- B. A health care power of attorney is preferable to a *living will*, which is the document that permits you to express your wishes as to the type of care you should be provided in the event of a terminal illness, but it does not name anyone to carry out those wishes nor does it have the options available in the power of attorney form.

IX. The Transfer Tax System.

- A. Our federal government has imposed, and probably will again impose, *transfer taxes* (estate, gift and generation-skipping taxes) on the passage of wealth from one generation to another.
 - 1. The *estate tax* is imposed on transfers at death:
 - (a) Last year an *exemption* of \$3,500,000 was available. At present, the exemption is essentially infinite, as there is no estate tax during 2010, although this may change, and that change may be retroactive to the first of this year. In the absence of legislation from Congress, the exemption is scheduled to be \$1,000,000 in 2011 and beyond.
 - (b) The excess over the exemption was taxed last year at a flat rate of 45% (and when combined with the Illinois Estate Tax, the effective rate was 54%). This year the tax rate is effectively zero. Next year, the rate is scheduled to be 55%.

(c) At present, there is no Illinois estate or inheritance tax, either now or in the future, and it will take the passage of a new statute to reimpose this tax. Last year Illinois taxed estates over \$2,000,000 at an effective top rate of 9%.

2. The *gift tax* is imposed on lifetime transfers:

(a) Even though there is not an estate tax in 2010, there is still gift tax, which is imposed on gifts in excess of a lifetime gift tax exemption of \$1,000,000, with tax rates reaching 45% this year, and 55% next year.

(b) There is a \$13,000 per donee annual exclusion, indexed for inflation.

3. The *generation-skipping tax* is imposed on transfers to grandchildren or more remote descendants, whether outright or as a result of the termination of an ancestor's trust:

(a) Last year there was a \$3,500,000 exemption, this year the tax is repealed, and next year the exemption will be only \$1,000,000, all assuming no change in the law as it presently stands..

(b) Last year the tax rate was 45%, next year the top rate is scheduled to increase to 55%.

B. The primary methods used to avoid transfer taxes are:

1. The personal exemption:

The Estate Tax Exemption	
Year	Exemption
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	Tax repealed
2011 and after	\$1,000,000

2. The *unlimited marital deduction*.

3. The *estate tax shelter trust*.
4. A plan utilizing an estate tax shelter trust is appropriate for couples with total combined assets in excess of the federal estate tax exemption amount (\$3,500,000, \$1,000,000, or \$?).
5. Implementation:
 - (a) A well-drafted will or will substitute (living trust)
 - (b) Avoidance of joint tenancy.
 - (c) Proper *beneficiary designations* for insurance and retirement plans. When an estate tax shelter trust is used:
 - (1) Insurance, non-qualified benefit plans and Roth IRAs should — generally — be paid to the trustee, either:

"The trustee named or to be named in the insured's (participant's) last will and testament."

or

"John A. Doe, as trustee of the James E. Smith Trust dated _____."
 - (2) Only the surviving spouse can take the death proceeds from a qualified plan and roll them, tax-free, into an IRA. Therefore, that spouse should—generally—be the primary beneficiary of any qualified plan and the designations shown above can be used for the secondary (or contingent) beneficiary, although direct bequests to children is an alternative if the beneficiary designation is properly worded.
 - (3) N.B.: This is an extremely complicated area of the law, and the correct beneficiary designation depends upon a number of factors, including age, marital status, ages of children, etc. It is particularly important to consult an advisor prior to the attainment of age 70½.
6. It is possible to qualify that portion of the estate which is in excess of the estate tax exemption for the marital deduction, yet have the deceased spouse retain substantial control. On the other hand, through the use of a so-called QTIP trust, the deceased spouse may restrict the surviving spouse's use of the funds and may determine the ultimate recipients.
7. It is critical, if Congress passes new legislation, or if 2011 arrives without such legislation, that couples whose total combined assets exceed the

federal estate tax exemption amount seek assistance from their estate planning professional to make sure that their estate plan avoids or minimizes the federal and Illinois estate taxes.

X. Tax Avoidance Through Gifts.

A. Using the \$13,000 *annual exclusion*.

1. Gifts made under this exclusion effect a dollar-for-dollar reduction of taxable estate. Gifts made under this exclusion must be made outright, rather than in trust, unless a special gift trust is used.

B. Using the \$1,000,000 lifetime exemption. (This exemption is not currently scheduled to increase, but some of the legislative proposals would increase it to be equal to the estate tax exemption, probably \$3,500,000 or above.)

1. Gifts made under this exemption do not reduce taxable estate, but remove future earnings and appreciation from taxable estate, and may shift income and capital gains to a lower tax bracket.

2. Gifts made under this exemption need not be outright, but can be made in trust, postponing indefinitely the donee's use and/or control of the property. Gifts of closely-held stock are often made in trust, for preservation of control. Unfortunately, that control cannot be retained by the donor, but must be given to someone else.

3. A large, one-time gift also solves the problem of removing future appreciation in an appreciating asset from the donor's estate, a problem which the \$13,000 annual exclusion is often unable to solve because the asset is growing at a far faster rate than the rate at which it can be gifted.

C. A gift program is an excellent method of avoiding estate taxation, but only if there are sufficient assets and/or control remaining for economic and emotional security. Don't let the "tax tail" wag the dog!

XI. Generation-skipping Transfers. People often believe that *generation-skipping transfers* skip over a generation. In fact, they are a method of allowing each generation the use of property without having to pay an estate taxes upon the death of each generation.

A. A generation-skipping trust is typically created by parents for the benefit of their children.

B. A generation-skipping trust is not considered to be part of the child's estate for federal estate tax purposes.

- C. A properly established generation-skipping trust is not subject to the federal generation-skipping tax at the child's death, which is imposed upon the transfer of a decedent's property to grandchildren or other beneficiaries two generations or more removed from the decedent. The generation-skipping tax is imposed at a flat rate equal to highest estate tax rate (*i.e.*, 45%).
- D. Illinois has recently joined a few other states in passing legislation so that it is now possible to create a generation-skipping trust that will pass tax free from generation to generation in perpetuity.
- E. The generation-skipping trust is very similar to the estate tax shelter trust that provides such significant tax savings in the estate plan of a married couple:
 - 1. The child (or other beneficiary) can be the sole trustee of the trust.
 - 2. As trustee, the child can have full control over all investment decisions.
 - 3. The child can receive all of the trust income.
 - 4. As trustee, the child can have the right to distribute to himself or herself so much of the principal of the trust as the child determines to be required for his or her support, health care, and education. The IRS defines "support" as support in accustomed manner of living.
 - 5. The child can use the trust property to buy a home or invest in a business.
 - 6. As trustee, the child can be given the right to distribute income and principal to his or her spouse and descendants.
 - 7. The child can be given a power of appointment over the trust property, which allows the child to determine the ultimate beneficiaries of the trust property. If the child wants his or her children to receive the property outright, instead of in a tax-exempt trust, the child has the power to do this.
- F. Advantages of a generation-skipping trust:
 - 1. Most states, including Illinois, prevent a creditor from claiming a beneficiary's interest in a trust to satisfy a judgment (except in certain special circumstances, such as child support).
 - 2. Under the law of most states, including Illinois, property inherited in trust is not available to a divorcing spouse when the couple's property is

divided. When one out of every two marriages ends in divorce, this is an important protection for your descendants.

3. The trust beneficiary will have an emergency source of support in the event of a financial or medical catastrophe. Because of this, he or she can more readily shift personal assets to younger generation members through direct gifts or trusts, thereby lowering estate taxes on his or her own estate.
4. If a child's personal assets, outside of the trust, are sufficient to create a taxable estate, the inclusion of the trust assets in the child's estate will cause those assets to be taxed at an assumed 45% rate.

G. Disadvantages of a generation-skipping trust:

1. Maintaining a trust means that an income tax return will need to be prepared and filed for the trust each year. However, the fact that the trust is a separate taxpayer provides some tax savings opportunities.
2. While the beneficiary/trustee has essentially full control over the trust, withdrawals must be based on a standard related to support, health care, and education, as previously noted. If the trustee makes distributions for non-support items (*e.g.*, round-the-world cruises, expensive jewelry, and furs, etc.), the trustee could be sued for breach of trust by the trust remaindermen, *i.e.*, the beneficiary's descendants. While such suits are unlikely, they do occur.

H. There was a limit on how many dollars can be allocated to generation-skipping trusts. That limit—called the *generation-skipping tax exemption*—was, as of 2009, \$3,500,000 per person creating the trusts, or \$7,000,000 per married couple. The number of children is irrelevant. A couple with one child could together create a \$7,000,000 generation-skipping trust for that child; a couple with ten children could create ten \$700,000 generation-skipping trusts. Also, be aware that you can establish generation-skipping trusts for some children and not for others. As previously noted, the generation-skipping tax exemption is currently scheduled to decrease to \$1,000,000 per person, \$2,000,000 per couple, next year.

XII. The Irrevocable Life Insurance Trust.

- A. Individuals whose estates are in excess of the federal estate tax exemption amount, and married couples whose combined estates are in excess of twice that exemption amount — counting life insurance as part of the estates — need to consider implementing an *irrevocable life insurance trust*.
- B. An irrevocable life insurance trust — or ILIT — is a method of excluding life insurance from a person's taxable estate. This is accomplished by the ILIT becoming the owner of the life insurance policy.

- C. The insured makes contributions to the ILIT each year so that the trust can pay the insurance premiums. These contributions are gifts, but can qualify for the \$13,000 annual gift tax exclusion if the trust agreement gives the trust beneficiaries (spouse, children, grandchildren, etc.) the right to withdraw a portion of these contributions. While this sounds dangerous, the author has implemented many such trusts in the last 30 years and has never seen a case of an unwanted withdrawal.
- D. The insurance proceeds can be used to pay estate taxes by loaning the money to or purchasing assets from the decedent's estate or living trust. Otherwise, the proceeds are held in—usually—exactly the same way as the estate tax shelter trust discussed earlier.
- E. The insured must survive for three years after transferring the policy to the trust for the technique to work. A way around the three-year rule is to have the trust be the original applicant and first owner of a new life insurance policy.

XIII. Summary.

In summary, the cornerstones of a good estate plan consist of:

- A living trust, and companion pour-over will, in most cases.
- A power of attorney for property.
- A power of attorney for health care.
- Appropriate ownership of assets.
- Appropriate beneficiary designations.
- A gift program, if the estate is large enough.
- Generation-skipping trusts in many estate plans.
- An irrevocable life insurance trust, if the estate is large enough.

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