Region Legal Service Office Hawaii
Legal Assistance Department
850 Willamette Street
Pearl Harbor, HI 96860

Estate Planning

Estate Planning. A well-coordinated estate plan should permit the client to use and enjoy his property during his lifetime and then pass the property to his chosen beneficiaries in the manner he wishes, with the least shrinkage in value. A crucial part of estate planning is also ensuring that the client's loved ones are taken care of and that he has properly planned for potential incapacity or disability. Estate planning is just as important as planning for retirement and should be factored into the individual's overall financial plan.

To create an appropriate plan, the attorney has to consider the client's wishes; state law of the client's likely domicile at death; state law where her real property is located; type of ownership of both personal and real property; and federal and state taxes (including federal estate and gift taxes, federal income tax and state estate, inheritance, and income taxes), among other considerations.

As a basic matter, a person's estate consists of all their property including their home and other real estate, tangible personal property (e.g., cars, furniture, coin collection), and intangible personal property such as insurance, bank accounts, retirement accounts, investments, and certain government benefits.

Every Client Has an Estate Plan. When a person fails to make arrangements for the disposition of property, she still has an estate plan, but it is one written by the state. When a person dies without a will, ownership of property that is not distributed via will substitutes (e.g., a life insurance policy, property deeded as joint tenants with right of survivorship) will be determined by the laws of descent and distribution ("intestate succession") of the state of the testator's domicile at death. Additionally, if the testator has real property located outside his domicile, the intestate law of the property's location will control distribution of that property. Unless the estate is minimal and all property is owned with survivorship language or has named beneficiaries, probate will be required to pass title and clear creditor claims on such property.

The primary objective of drafting a will and coordinating ownership of nonprobate assets is for the client to control the disposition of property at their death. When an individual does not create an estate plan, property owned outright by the individual will be passed according to the state's intestacy statute. Relying on intestate distribution is usually not the best plan for a client, nor is it likely to fully effectuate their intent.

Purpose of Wills. A will is a legal document that takes effect when you die. The main purpose of a will is to dispose of property according to the testator's desires and make arrangements for family members. A will allows the testator to make many important decisions including:

- To whom his property will be distributed;
- How his estate will be shared among beneficiaries;

- Who will serve as the executor of his estate;
- Who will serve as guardian(s) of any minor children or persons under a disability;
- Who will control the property left to any minor children; and
- How the estate plans for federal and state taxes.

A will is often one of the most important parts of the estate plan, although there are a number of other ways to dispose of property outside of probate. Will substitutes (i.e, nonprobate assets) are often used to supplement the will, take advantage of tax laws, and ensure liquidity at the testator's death. Examples of nonprobate transfers include property passing by beneficiary designation such as insurance, property owned jointly with the right of survivorship, gifts, and living trusts.

Advantages to Avoiding Intestacy. As stated above, a state's intestacy statute rarely coincides with a decedent's actual intent. It is also subject to change by the legislature so there is no guarantee that a scheme of distribution will remain the same from year to year in a state. In addition, if a testator owns property in more than one state different parts of the estate may be subject to different intestate schemes. Avoiding intestacy is crucial for military families as well as single servicemembers due to the transient nature of military service. A servicemember may travel through many states during the servicemember's career. In the absence of a will or other arrangements, the testator can have no certainty regarding the potential distribution of their property at her death.

Importance of Periodically Reviewing the Will. At the very least, a will should be reviewed and potentially updated at the following times:

- Upon the marriage, divorce, or separation of the testator or anyone named in the will;
- At the birth, adoption, or death of a child;
- Every time there is a major change in tax law;
- When the testator moves to a new state or duty station;
- When there are significant changes in the wealth or income of the testator or any beneficiary; and
- When there is a significant change in the needs, circumstances, or objectives of the testator or the beneficiaries.

Coordinating with Other Important Documents. At the same time the client is considering whether to do a will, the attorney should also assess the client's need for other documents such as:

- A durable power of attorney;
- Advance medical directives (living will and/or health care power of attorney); and
- Other appropriate documents (e.g., a new deed to coordinate with the estate tax plan).

Updating Beneficiary Designations. The attorney should always remind the client to review and update the beneficiaries listed on insurance and other documents to reflect changes in the estate plan. Updating the will, but failing to update all other paperwork, results in an ineffective estate plan.

Counseling clients regarding Servicemembers' Group Life Insurance (SGLI) designations is one of the single most important things a legal assistance attorney can do. This asset alone can account for up to $400,000 of the servicemember's estate. For many military families these proceeds will be the largest asset in the estate and may be the only property in the estate besides personal property. It is crucial that the servicemember update the beneficiary designations when her family circumstances change because the language on the designation form controls.

Probate. The probating of a will permits a court to supervise the transfer of assets from the decedent to her heirs. Not all property a decedent owns will be part of the probate estate. Only property that the decedent holds in her name alone at her death with no named beneficiaries or survivor language becomes property in the probate estate. The probate process transfers title in property from the decedent to his or her heirs and beneficiaries. Besides transferring the title to property, the probate process is also used to notify creditors of the death of the decedent and require them to submit claims against the estate within a certain period of time; provide for the filing of final tax returns, and to qualify guardians and fiduciaries.

In some states a summary (simple) probate proceeding may be available if the decedent’s estate is at or below a certain value at the time of death. Probate will also be necessary when the testator dies intestate or has assets that were not properly transferred via the will or will substitutes.

PROVIDING FOR MINOR CHILDREN

Minor children who survive the testator will require not only a guardian of their person, but also someone to control their property until they reach the age of majority (or older if a trust or custodian account is established). Depending on the family situation, the testator may want these to be two different people.

Property Ownership. Minors cannot legally own property outright, free of adult supervision, beyond a minimal amount established by the state. This amount is usually restricted to several thousand dollars. For amounts above the state limit there are basically four alternatives for transferring property to a minor child: (1) testamentary trust; (2) custodianship under a state’s Uniform Transfers/Gifts to Minors Act (UTMA/UGMA), (3) guardianship; or (4) living trust. The first three can be provided for by will. UGMA/UTMA accounts can also be set up during the testator’s lifetime and funded by the will.

Guardian of the Person. Naming guardians in the will is probably the most crucial part of estate planning for a client with minor children. This is a very personal decision that should not be left to an intestate proceeding. Although the guardian still has to be approved as part of the probate process, the client’s expression of intent will be given great, if not conclusive, weight. This decision is particularly important in blended families where there are children from different relationships. When clients are considering who to name as guardians in blended family situations they may need to be reminded that when a natural parent of a child survives the testator the natural parent normally will be approved as guardian absent some showing that they are unfit. The testator can still choose to name a different guardian, but that provision of the will may not be honored by the court.

NONPROBATE PROPERTY

Property Ownership and Nonprobate Vehicles for Property Transfer. Attorney's fees, executor's commissions, other fiduciary fees, court filing fees, appraisal costs, and the time and delay (can be from six months to one year) of probating an estate are sometimes cited as reasons to avoid probate. However, these costs can vary greatly by state. In fact, probate administration may better serve the client's interests relative to the benefits and costs associated with forms of property ownership and methods of wealth transfer that avoid probate by operation of law.

A decedent may not wish to avoid probate if there are significant advantages to requiring creditors and putative heirs to voice their issues in court. Heirs and beneficiaries are often advantaged by the clear title distribution provided by a probate court. In addition, the estate plan for a decedent may require that a probate estate be forced in order to properly take advantage of federal and state estate tax laws. Estate planning techniques such as credit shelter disclaimer trusts, require an estate to be probated so that appropriate testamentary trusts will be established. One of the popular alternatives to a will is an inter vivos trust. Inter vivos trusts will not necessarily avoid probate. If there is property remaining at death that needs to pass to the existing trust and will not pass automatically, a will is necessary to pass the remaining property. The inter vivos trust will also need to be managed after the testator's death and will continue to incur trustee and other management expenses.

In many instances, a combination of both probate administration and nonprobate asset transfers is required to fully implement a client's objectives. As such, each client's estate must be examined on its own merits.

If done correctly, the following forms of property ownership do not require probate administration to transfer property ownership at the testator's death:

- **Contractual arrangements with designated beneficiaries**. These assets pass by operation of law upon the death of the testator according to the terms of the contract or the beneficiary designation. Beneficiary designations are usually revocable. One example of a contractual arrangement is life insurance. The proceeds of life insurance pass to the beneficiary listed on the insurance company's paperwork and not by probate. The named beneficiary will usually be an individual or some legal entity other than the estate such as a trust. Life insurance proceeds are rarely subject to probate administration, unless the insured's estate or a trust is the named beneficiary. Leaving insurance benefits to the estate can result in those assets being tied up in the administration of the estate. Other examples are payment on death (POD) or transfer on death (TOD) accounts. Any money or property left in these accounts upon the death of the individual are paid to the named beneficiaries. Included in these types of accounts are Individual Retirement Accounts with a named beneficiary and Totten Trust Accounts.

- **Joint ownership with right of survivorship** (e.g., Joint Tenancy and Tenancy by the Entireties). This form of title arrangement, often between spouses, allows title to pass automatically to the surviving joint tenant without passing through probate. Jointly owned property with a right of survivorship can include bank accounts, realty, stocks, bonds, securities, etc. The ability to title assets in this way is completely dependent on state law. When property is titled to two or more individuals the presumption in most states is that a tenancy in common has been created. This presumption can only be overcome by express language that specifically refers to the right of survivorship. Titling the property to "A and B jointly" or to "A and B as joint tenants" (in some jurisdictions) may only create a tenancy in common. An example of a clear designation is "to A and B as joint tenants with right of survivorship, and not as tenants in common." In a few states, when you transfer property to a husband and wife together the presumption will be that you have created a tenancy by the entirety. If this is the couple's intent the instrument should make clear that they are creating a tenancy by the entirety and use express language to indicate this intent. Again, knowledge of state law is crucial.
- **Lifetime gifts**. A testator can make a gift of property during her lifetime to attempt to reduce the size of her estate on death and to save on taxes. A gift is broadly defined for gift tax purposes. It can be a sale, exchange, or other transfer of property without adequate and full consideration. Gifts can take forms other than outright transfers. For example, the donor could forgive a debt owed him by the donee, assign the donee the benefits of an insurance policy, or purchase property as a joint tenancy with the right of survivorship. Even gifts made shortly before death can avoid probate. However, such gifts may be brought back in to the estate for estate tax purposes if the decedent retained some level of ownership rights. In addition, if the deceased made deathbed gifts and as a result of that gift there is not enough money in the estate to pay creditors, the gifts may be ordered back into the estate to become probate property. Gifts carry the donor's tax basis to the donee (carryover basis), which is different than the basis they would receive if they inherited the property. Assets passed through the decedent's estate will generally get a new or stepped-up basis. Both gift tax and tax basis will be discussed below.
- **Living trusts**. An inter vivos trust is a trust established by the decedent during his or her lifetime. A living trust can be established either as a revocable or irrevocable trust depending on the type of estate planning needed by the client. Trusts are often governed by the Uniform Probate Code of the state or by common law. Some states will allow inter vivos trusts to exist unfunded until the death of the grantor. Living trusts are sometimes used to own life insurance.

LIMITS ON PROPERTY DISPOSITION

Many states impose some limitations on the disposition of property at death. It is essential that legal assistance attorneys be familiar with these concepts.

Community Property. Clients need to be made aware of the limitations community property places on their ability to transfer property at their death. The ten community property states are Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. As a general matter, each spouse owns a one-half interest in property that is acquired during marriage in a community property state unless they conclude an alternate agreement regarding the property such as a prenuptial agreement. Normally the other spouse has to consent to the transfer of community property while both spouses are alive. At death, the spouse is free to transfer their one-half interest in the property. Each state has variations on what is considered community property and what is considered separate property.

Property that is not considered community property is typically defined as property that was acquired before marriage, gifts or inheritance received by one spouse, and property acquired before or after moving to a community property state. For such property to retain its character as noncommunity property, it must be kept separate and not be used for the benefit of the marriage. These concepts are important even when a couple leaves a community property state. Community property does not lose its status as community property once the couple moves. It is still subject to the same rules of devise, i.e., the spouse can only devise their one-half share. It is likely that many couples are unfamiliar with this concept.

Homestead. In some states "homestead" property is treated differently than other property in a number of areas including bankruptcy, creditor claims, taxes, property transfer and probate. In Florida, for example, the homestead is not subject to devise if the owner is survived by a spouse or minor child. Florida defines a homestead according to its location. If it is located within a municipality it only consists of the actual residence of the owner or the owner’s family. The residence cannot cover more than onehalf acre of land. If located outside a municipality, it consists of 160 contiguous acres of land and all improvements thereon. Homestead property in Florida does not include property owned by spouses as tenants by the entireties. The spouse can waive their rights to the homestead. In addition, if there are no minor children the owner can devise the home outright to his or her spouse. In the absence of a spouse or child, the owner can devise the property to whomever they wish. In a case where the owner attempts to leave homestead property in contravention of Florida Law, the probate code provides that the surviving spouse will take a life estate with a vested remainder in any lineal descendents alive at the time of the owner’s death.

Effect of divorce and annulment in some jurisdictions. There are a few jurisdictions where, by statute, divorce has the effect of automatically revoking beneficiary designations that named the spouse as the beneficiary or appointed the spouse as a fiduciary. This is generally the case unless a divorce decree or specific agreement between the spouses states otherwise. In such cases, the asset is distributed as if the former spouse predeceased the decedent. These jurisdictions may allow for the beneficiary designation to continue if the property was put into a trust or the designation was irrevocable at the time it was made. Such laws have no effect on SGLI designations because the servicemember always has an absolute right to maintain or change their beneficiaries according to federal statute. Divorce may also have the effect of destroying a tenancy by the entireties and making it a tenancy in common. Check local law for the effect on joint tenancy with right of survivorship.

Statutory share/forced share. Some states provide for a minimum share of the estate for a surviving spouse or pretermitted children. The ability to force this share may be dependent on whether the testator/trix specifically intended to disinherit such persons.

ESTATE PLANNING FOR LARGER ESTATES GENERALLY

For the purpose of effective estate planning, larger estates are those over $750,000. An attorney should not draft a will or provide estate planning advice for estates over $750,000 without considering Federal Estate and Gift Tax (FE&GT) implications. A servicemember who has full SGLI, owns a home and regularly saves can quickly accumulate an estate in excess of $750,000. Servicemembers who have $400,000 of SGLI and other property of significant value should be made aware of the FE&GT implications for their estate.

"UNIFIED" TAX SYSTEM

The Federal Estate and Gift Tax (FE&GT) system is a unified tax system aimed at the transfer of wealth at death and gratuitous transfers during life. Due to various credits and exclusions under the Internal Revenue Code (IRC), most gifts are not subject to gift tax, nor are most estates ultimately subject to estate tax. According to the Internal Revenue Service, only about 2% of estates end up having to pay federal estate tax.

A federal estate tax return must generally be filed for the estate of every U.S. citizen or resident whose gross estate plus taxable lifetime gifts minus allowable deductions exceeds the applicable exclusion amount for the year the decedent dies.

	For Gift Tax Purposes		For Estate Tax Purposes	
Year	**Unified Credit**	**Applicable Exclusion Amount**	**Unified Credit**	**Applicable Exclusion Amount**
2009	**$345,800**	**$1,000,000**	**$1,455,800**	**$3,500,000**
2010	**$330,800**	**$1,000,000**	**Estate tax repealed**	**Estate tax repealed**
2011 & beyond	**$345,800**	**$1,000,000**	**$345,800**	**$1,000,000**

The tax rates for transfers not "sheltered" by the unified credits are progressive and quite large, in the forty and fifty percent range. Currently, an estate does not pay any federal estate or gift tax unless a decedent has given away lifetime taxable gifts and an estate in excess of $2,000,000 in value. The value of all taxable gifts given during life and the value of property transferred at death are added together.

The federal estate tax provisions of the EGTRRA expire after December 31, 2010. On January 1, 2011, the estate tax provisions in effect prior to signing of the EGTRRA will be reinstated, meaning that the applicable exclusion amount for estate tax will go back to $1,000,000, absent action by Congress. The tax on lifetime gifts will remain the same. Estate plans should therefore be reviewed every time there is a change in the tax law.

STATE TAXES AT DEATH

Clients also need to be aware of their potential state tax liability. Each state has a different taxation system. Many had an estate tax, which typically consisted of a pick-up or sop-up tax. The pick-up tax was a tax that was equivalent to the state death tax credit provided by the IRC. Estate tax was taxed to the estate on transfers of property that were attributable to the decedent. The tax was taken out of the estate before it was distributed to the beneficiaries. Some states have state inheritance taxes. This tax is a tax on the value of the property inherited and is paid by the beneficiary. The amount of the tax is often dependent on the beneficiary's degree of kinship to the decedent.

Until recently, state inheritance and estate taxes ("death taxes") had been of much less importance in estate tax planning than the federal tax system for two reasons: (1) state rates were usually much lower than the federal rates; and (2) many states used the pick-up tax described above (they charged the estate whatever the maximum amount was that could be subtracted from the federal tax bill meaning there was no extra tax liability for the decedent's estate). In recent years, state governments became concerned by the gradual reduction in the state death tax credit allowed by the federal government and its scheduled elimination in 2005. Due to uncertainty about the future of this specific credit and the FE&GT system as whole, there is great speculation about what will happen with state estate and inheritance taxes. This area is very much in flux as state governments decide whether they will sacrifice revenue by not charging a tax, or restructure their tax systems to ensure they receive money from these transfers.

TAX RETURNS

There are a number of different taxing systems that may apply when an individual dies. An individual's estate will be required to pay personal income taxes for the last year of life. A standard Form 1040 can be filed by the executor. Additionally, if the decedent's estate exists for any period of time and generates income, the estate, as a legal entity, may need to pay income taxes as well. Form 1041 is used.5

FEDERAL GIFT TAX

The FE&GT is considered a unified tax system because all transfers, those given during life and at death, are taxed under the same system. Therefore, it is incumbent on an estate planner to understand how the FE&GT works as a unified system. Gift or estate taxes are payable only on gifts or transfers of a certain value.7

ESTATE PLANNING TO REDUCE A CLIENT'S ESTATE

Many techniques can be used to reduce a client's estate so that he or she pays little or no estate taxes. Inter vivos transfers can be used to move property out of a client's estate. However, many clients do not like to relinquish control of property during their life. Retention of control over property will cause it to be included in the client's estate at his or her death. Clients owning life insurance that pushes them over the estate tax limit may be able to establish an irrevocable lifetime insurance trust to hold and own the life insurance on the client. This cannot be done with SGLI but can be accomplished with other commercial insurance. The servicemember will always have an incident of ownership in SGLI because he always has the right to change his beneficiaries. If set up correctly, the client will not have the right to change the beneficiary on commercial insurance placed in an irrevocable insurance trust.

Living Trusts. Other clients may want to use a lifetime revocable trust to own their property during their lifetime with a named beneficiary receiving the benefits of the trust upon the death of the decedent. The trust becomes irrevocable upon the death of the grantor. During the grantor's lifetime the trust is taxed as though it is the grantor's property. If the trust is revocable during the grantor's lifetime, the grantor retains some level of control over it. This means that the property held by the trust is included in the grantor's gross estate at his death and does not result in tax savings. The revocable living trust, if funded properly, is effective for transferring the grantor's property outside of probate but is not effective for avoiding federal estate and gift taxes.

An irrevocable trust can be created to take advantage of tax savings however it will still be subject to income tax returns and administration costs which may or may not be cheaper than probate. Only an irrevocable living trust over which the grantor has no control will be effective for transferring property outside the grantor's gross estate. Once property is owned by the trust it becomes property over which the grantor no longer owns or has control. A continuing problem with inter vivos trusts is that grantors typically forget to transfer all of their property into the trust or use transfer instruments that are ineffective. The failure to properly transfer property can render part or even all of the tax plan useless.

Testamentary Trusts. Another option for a client is to establish a testamentary trust to which the federal estate tax credit can be applied. This is a trust provided for by the terms of the will. The trust is actually established upon probate of the decedent's will. A testamentary trust can be established for the benefit of whatever beneficiary the client desires. If the client desires to provide for his or her grandchildren or another beneficiary of an age group similar to grandchildren, the client must be concerned about the implications of the Generation-Skipping Transfer tax. The Generation-Skipping Transfer tax will not be discussed in this chapter but for clients desiring to establish gifts to grandchildren that skip their children they need to understand the possible tax implications.

Credit Shelter or Bypass Trusts. The purpose of this testamentary trust is to maximize the unified credits of both spouses. The attorney has to plan not only for what will happen on the death of the first spouse, but also for the death of the second spouse. Since the first spouse to die can pass property tax free to the surviving spouse pursuant to the unlimited marital deduction, the attorney is really planning for the death of the second spouse. It is the second estate that will be subject to taxes.

Ultimately, an effective plan should at least provide that on the death of the first spouse an amount up to the estate tax exclusion for that year will be put into trust. The trust can be set up so the surviving spouse receives income from it during his or her lifetime, or the income can be accumulated or paid to other persons. Although the spouse can be an income beneficiary and may even be given a limited right to invade the principal, she should not be the remainderman. Leaving this trust property to the spouse as the ultimate beneficiary defeats the tax plan since it doesn't maximize use of both spouses' unified credits.

The estate of the first spouse to die will normally pass an amount up the exclusion amount in trust. The executor will then apply the unified credit to the trust. If the testator died in 2006, for example, the trust would be funded with up to $2,000,000 in property to take advantage of the 2006 unified credit. Property in the trust up to the exclusion amount will pass to the beneficiary tax free because the Federal estate tax credit of $780,800 will be applied. All property in excess of the exclusion will be passed outright to the surviving spouse. The first estate will pay no tax on this outright transfer due to the marital deduction that the executor will get to apply. When the second spouse dies, her executor will apply her unified credit to her taxable estate. Her taxable estate will not include the principal in the credit shelter trust because she did not have control or ownership rights over it. The total amount that can be protected if both spouses die in 2006 is thus $4,000,0000. To take advantage of the credit shelter trust, the decedent's estate must be probated since the trust is established and funded through the decedent's will. The property placed in this trust should not be left to a non-citizen spouse.

Funding the trust. There are several ways to fund the trust. The testator could specify a fixed dollar amount in the will, fund it according to a formula that is designed to coordinate with the maximum federal exclusion available at the decedent's death, or leave it unfunded and allow the spouse to choose what goes into the trust via the exercise of disclaimers.

- **Fixed amount**. Specifying a fixed dollar amount in the will is generally an ineffective way to fund the trust. Unless you have a crystal ball, there is no way to predict what year the testator will die and thus what the applicable estate tax exclusion amount will be. For example, if a testator with $4,000,000 provides in his will that only $1,000,000 should go into the trust and he dies in 2006, he has wasted $100,000 of his exclusion amount. Although his estate will not feel the effects, the beneficiaries of his spouse's estate will.
- **Formula**. Using a formula that takes into account the current federal estate tax exclusion amounts and unified credit is a more effective way to fund a trust than the fixed dollar method. In the will, the executor can be directed to put property in the trust equal to the exclusion amount in effect at the date of death. The potential drawback with this manner of funding the trust is that the formula may not effectively interact with state death taxes.
- **Disclaimer**. Another estate planning technique that may be used is to establish the trust in the will but leave it unfunded. The testator's spouse will inherit the entire estate and then must disclaim property to fund the trust. A disclaimer is a refusal of an interest in property. The trust will only be funded up to the amount that the spouse actually disclaims. This technique offers the most flexibility and allows the surviving spouse to more fully coordinate between federal and state taxes. The spouse can keep what he or needs and pass the remaining property into the trust up to the value of the federal exclusion, $2,000,000 for 2006, 2007 and 2008. This flexibility can be a drawback if the spouse is elderly or fiscally challenged and is not willing to get help from an attorney or

other professional when the trust is stood up. If the client knows that the spouse will likely refuse to give up any control over the property, the disclaimer will not be a good choice for the couple. For a disclaimer of property to be effective it normally must be done within nine months of the death of the testator and the survivor cannot exercise any control over the property. For example, if the survivor receives a check from the insurance company they should not cash it. Even with assets for which ownership transfers automatically on death such as a joint tenancy, the spouse should normally be able to validly disclaim the property. However, any usage of the property after the decedent's death can often defeat the surviving spouse's disclaimer. The federal rules are little bit more liberal than some of the state rules regarding disclaimer. Most survivors will need to hire a professional on the death of the first spouse to assist them with the disclaimers.

- **Property in excess of the exclusion**. Any remaining property in the estate is often passed to the spouse or a charity to take advantage of the marital and charitable deductions available. If the testator does not have a spouse or designate a charity beneficiary to take advantage of the deduction, then some estate tax may be due on the remainder of the estate passed to other beneficiaries.

For more information, please contact your local Region Legal Service Office.