POST-MORTEM PLANNING

A Second Chance at Estate Planning

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1. **<u>INTRODUCTION</u>:** The first rule of estate planning is a modified version of "Murphy's Law". If anything can go wrong, it usually does, and most often at a time when it is too late to correct. The lack of planning (or the lack of proper planning) may not become apparent until a person becomes incompetent or dies. Then the lament becomes "Would-a, could-a, should-a." The purpose of this memo is to outline some of the options that the surviving family members may have to remedy some of the unexpected and undesired consequences of no planning or even bad planning.

2. **<u>ESTATE ADMINISTRATION OVERVIEW</u>:** Before going into detail as to some of the post-mortem planning techniques, let us review some of the key steps to estate administration.

2.1 **<u>Asset Inventory</u>:** The first step in estate administration is to identify the decedent's property.1 All interests that the decedent held just prior to death should be identified.

2.2 **<u>Property Title</u>:** The second step in estate administration is to verify the ownership of assets. The key to the disposition of a decedent's assets is legal ownership. Assets pass from a deceased person to one or more other persons at death either by nonprobate transfers or through probate.

(a) <u>Nonprobate Transfers</u>. Nonprobate transfers fall into two categories: assets that are transferred by operation of law and assets that are transferred by operation of a contract.

(1) *By Operation of Law*. The common law and statutory law endow certain forms of asset ownership with a built-in determination of the succession of title at death. This includes joint tenancy (which includes a right of survivorship), and pay-on-death designations (also known as "Totten trust arrangements"). In many states, title is deemed to pass the instant of death.

(2) *By Operation of Contract*. The law permits property interests to pass under certain contracts, including life insurance, employment contracts, and trusts.

(b) <u>Through Probate Administration</u>. In most states, assets owned in a decedent's name alone are subject to administration in the decedent's probate estate, and the disposition of those assets is governed by a will executed by the decedent or by the state-written "will" known as the laws of intestate succession. The assets that are subject to probate — which include all assets except assets subject to nonprobate transfers — are referred to as the "probate estate". State law determines the legal procedure necessary to transfer assets, which include a full court-supervised probate administration, an independent administration with little or not court supervision, a single-hearing proceeding to "set aside" assets without formal administration, and the collection of low-value assets by affidavit. The procedures applicable in Nevada are outlined in a memo titled "Probate in Nevada"

2.3 **Interest Parties:** The next step is to identify all the "interested parties"[2] and their respective interests. "Interested parties" include claimants and beneficiaries. Before a distribution is made to any party, it is important to make sure that the distribution does not infringe on someone else that has a superior right. Rightful claimants are always paid before any distribution is made to any beneficiary.

(a) The creditors of the decedent and of the decedent's estate are clearly "interested" in the estate. "Creditors" may include the Internal Revenue Service, employees, credit-card companies, the funeral home and the cemetery, judgment creditors, former spouses, and minor children.

(b) The "beneficiaries" of a will or trust are those designated to receive property, the use of property, or income from property. Not only is it important to identify each party's right to the decedent's estate, it is also appropriate to identify each party's duty to share in the decedent's obligations, the expenses of maintaining, administering, and distributing the decedent's property.

(c) The interested parties may include individuals and legal entities, such as corporations, partnerships, limited-liability companies, and trusts. It is important to identify those in control of any legal entity and to ascertain the terms of the law and relevant governing documents.

2.4 **Official Appointment of Successors:** Where the decedent had a role in legal entities (such as the trustee of a trust or the president of a corporation), it is important to see that each of the decedent's successors is legally replaced. As to the decedent individually, he or she will be succeeded usually by a court-appointed personal representative (also known as executor, executrix, administrator, administratrix, and the plural variations of those titles)[3]. As to the decedent's other capacities, the successor(s) will be determined under the appropriate governing instrument (such as a trust agreement or corporate bylaws).

2.5 **Estate Administration:** The trustee of a trust and the personal representative of a decedent's probate estate should:

(a) Collect all assets[4] belonging to the trust or estate;

(b) Manage and invest assets;

(c) Pay debts and taxes as required by law and under the trust document or will; and

(d) Distribute the assets to the designated beneficiaries, as provided in the trust or will.

3. **POST-MORTEM PLANNING:** Ideally, estate planning should be done *inter vivos* (during life), but more often than not there are things that were not planned, things that were planned poorly, and things that could not be anticipated. "Post-mortem estate planning" consists of techniques and tools that can help save taxes and other expenses where the inter vivos planning was inadequate. Some of the more common post-mortem planning tools include the following:

3.1 Discretionary Provisions: The greatest flexibility in wills and trusts come from the provisions that grant discretion to one or more persons. As you read the documents, look for the discretionary provisions and consider these questions:

(a) Tax Elections. Are they mandatory or discretionary? If discretionary, who has the authority to make the appropriate tax elections?

(b) Income and Principal Allocations. Who pays the expenses? Who benefits from the income? Does the Uniform Principal and Income Act apply, or has the applicable will or trust instrument changed the applicability of the statute's default provisions? Are there gifts or distributions that are expressly to be undiminished by taxes and/or by expenses? Is some of this allocation subject to the discretion of the trustee or a special trustee?

(c) Equitable Apportionment. If an expense is deducted on the estate tax return, is there a need to make some sort of equitable adjustment to favor the income beneficiary who has been deprived of the benefit that an income tax deduction would have afforded?

(d) Subtrusts. If the trust is an A/B Trust or an A/B/QTIP Trust,[5] is each subtrust that is to be set up properly documented? In addition to the subtrust allocation, is there a GST exemption[6] that requires the creation of another separate fractional subtrust?

(e) Power of Appointment. Does someone have the discretion to direct distributions?

(f) Trustee's Discretion. What discretion does the trustee have to make distributions of income? of principal? Can there be unequal distributions?

(g) Change of Trustee. Who has the right to remove and/or replace a trustee?

3.2 Post-Mortem Elections: There are a number of special elections that can reduce the estate tax on a decedent's estate. Although these are not the focus of this memo, they include the following:

(a) Qualified Terminable Interest Property (QTIP) Trust[7]: The allocation of assets to a QTIP trust can qualify for the marital deduction for estate tax purposes if the trust is designed to provide the survivor with a qualified income interest, to exclude beneficiaries other than the surviving spouse from trust distributions during the surviving spouse's lifetime, and to otherwise comply with the statutory requirements.[8]

(b) Special Use Valuation: Farm land and other closely-held business interests can qualify for a lower special use valuation if the business constitutes the requisite percentage of the estate and the estate passes to qualified heirs.9

(c) Deferral of Estate Tax Payments: An election can be made to defer estate tax payments over a 15-year period starting with the decedent's death if the decedent's estate consists of the requisite percentage of one or more businesses.10

(d) Deductions: Certain deductions can be applied against the income tax or the estate tax.

(e) Partnership Basis Adjustments: If a decedent own a partnership interest, the partnership itself can make an election to favorably adjust the basis of assets.11

(f) Alternate Valuation Date: Estate tax values can be based on their date-of-death value or their value as of an alternate valuation date.12 That date is six months from the date of death or the date of any disposition of an asset, whichever occurs first.

(g) Section 303 Redemption: Favorable tax treatment is given if stock is redeemed to help pay funeral bills and death taxes.13

(h) Fiscal Year: The probate estate can elect a fiscal year, and the timing of expenses and income can be orchestrated to minimize income.14

(i) Combination of Trust and Estate: Traditionally a revocable trust and probate estate were treated as separate entities with separate tax rules, An election can now be made to treat a trust as part of a decedent's estate.15

3.3 Qualified Disclaimer: A "disclaimer" is a document under which the person making the disclaimer (referred to as the "disclaimant") irrevocably refuses to accept the receipt of property. A disclaimer is given when the disclaimant determines that it is better for the alternate recipient(s) to receive the disclaimed property. The disclaimant has no authority to direct the distribution; the disclaimed property passes as though the disclaimant had predeceased the decedent. A "qualified disclaimer" is a disclaimer that is recognized for federal transfer tax purposes.16 If a disclaimer is not a qualified disclaimer, it is treated as if the disclaimant accepted the property and then made a gift to the alternate recipient(s).

(a) H and W, who are married, establish a revocable living trust. The trust provides that upon the death of the first spouse to die, the trust divides into a Survivor's Trust, an Exemption Trust, and a Marital Trust.

(1) PROBLEM: When H dies, all assets are owned in joint tenancy, leaving W owning 100% of all assets, and H's "applicable exclusion"17 for estate tax purposes is wasted, possibly pushing W's estate into a higher estate tax bracket.

(2) SOLUTION: If W disclaims the right of survivorship and H has a "pour-over will", H's property interests can pass via probate to the

Exemption Trust and Marital Trust.

(b) A and B have a $10 million combined estate, and they have created a trust that leaves everything to the survivor, with distributions to their families when both are deceased. A dies in 2012, and B is concerned that Congress could reduce the applicable exclusion below $5 million.

(1) PROBLEM: If Congress does not change the law, the estate tax exclusion amount will be $1,000,000. Some political leaders are advocating a $3,500,000 exclusion. If either occurs, there will be an estate tax upon B's death.

(2) SOLUTION: B disclaims a portion or specific assets — up to $5 million — to allow the residuary trust beneficiaries to take early without a tax.

3.4 <u>Renunciation of Powers</u>: Similar to a disclaimer, a renunciation of powers is a refusal to accept one or more powers. This can be exercised by a fiduciary (such as a trustee or personal representative) or by a beneficiary who has a power of appointment (the power to direct distributions from a trust).

(a) H & W, settlors18, leave their estate in trust for their children, C1, C2, and C3. The settlors' GST exemption has been allocated to the trust, and it is totally exempt for generation-skipping transfer tax (GSTT) purposes.

(1) PROBLEM: C1 is the trustee, but as trustee, she has certain powers that might cause estate tax inclusion in her estate.

(2) SOLUTION: C1 can irrevocably renounce those powers, refusing to accept them or exercise them at any time.

(b) Grandpa and Grandma give their grandson Ralph a general power of attorney, with full authority to establish trusts, make lifetime gifts, and direct the distribution of their assets so long as the distributions are made to any of their descendants. Grandpa and Grandma have given Ralph a general power of attorney that constitutes a general power of appointment under federal transfer tax law.19

(1) PROBLEM: The broad powers under the power of attorney could cause estate tax inclusion in Ralph's estate upon his death, and it may expose Grandpa's and Grandma's property to Ralph's creditors because he has the right to exercise the power in his own favor.

(2) SOLUTION: Ralph can irrevocably renounce the power to benefit himself.

(c) H & W have an A/B/QTIP trust. H dies, and W discovers that the QTIP trust gives her the right to direct principal distributions to her husband's descendants at any time during her lifetime or upon her death.

(1) PROBLEM: The survivor's power of appointment would disqualify

the allocation of assets to the QTIP trust from qualifying for the marital deduction since no principal distributions can be made from a QTIP to anyone other than the surviving spouse.

(2) SOLUTION: The survivor should immediately and irrevocably renounce the right to direct distributions during life.

3.5 <u>Judicial Reformation/Construction</u>: If the planning in a will or trust is unintentionally deficient, some errors can be corrected by a court decree that reforms the document to its original intent. If a document uses words or phrases that can be interpreted with different meanings, a court decree can be sought to clear up the ambiguity.

(a) H and W establish a trust, intended to be a standard A/B/QTIP trust.

(1) PROBLEM: The attorney drafting the trust neglected to include the provisions relating to the division of property into the various subtrusts after the first death. This is not discovered until after H dies, and their CPA is preparing the federal estate tax return (IRS Form 706) for H's estate.

(2) SOLUTION: Ask the court to insert the missing language that should have been there but for the "scrivener's error". Because the trust contains language stating that the Exemption Trust and QTIP Trust are irrevocable, the settlors' intent is clear, and the attorney can provide the court the missing language as part of an affidavit stating what should have been included.

(b) H and W establish an A/B/QTIP trust. W dies. Trust B is intended to be excluded from the surviving spouse's estate. Trust B makes the surviving spouse the sole trustee with the power to distribute the principal of Trust B as the trustee deems appropriate for his support, health, welfare, and comfort.

(1) PROBLEM: H's service as trustee with the power to distribute principal for his own "welfare" and "comfort" might constitute a power of appointment because it is not limited by an ascertainable standard related to his "health, education, support, or maintenance".[20] This problem is not discovered until after H has been serving as sole trustee for years.

(2) SOLUTION: Petition the court to construe the terms "welfare and comfort" to be consistent with "health, support, and maintenance".[21]

(c) H and W establish an A/B/QTIP trust.

(1) PROBLEM: H dies, but W does nothing to divide the trust into the various subtrusts. Assets are not re-titled, no fiduciary tax returns (IRS Form 1041) are filed for the irrevocable trusts, and no records are kept with respect to the assets or interests in each trust.

(2) SOLUTION: If W dies without anything being done, reconstruct the accounting, tracing the assets as they would have gone if the trust had been

administered correctly, then petition the court for an approval of the accounting.

(3) SOLUTION: If this is discovered during W's life, the children could file a motion in court to compel W to provide an accounting of the various subtrusts and to bring everything up to date. This would establish the children's clear rights to protect their interest in seeing that the tax-exempt trust is preserved and that the other trusts are properly accounted for.

3.6 "Decanting": When a trust gives the trustee discretion to make distributions to beneficiaries, that distribution can be used to "pour" or "decant" part of the trust into a second trust.

(a) This can be appropriate in a number of scenarios:

(1) There are different beneficiaries for different assets, and it is better to allocate the assets into separate trusts.

(2) Some of the administrative provisions of the trust are deficient, and a new trust that contains improved provisions will benefit the beneficiaries.

(A) If trust does not permit the holding of S corporation stock, then the S corporation stock can be decanted into a similar trust that does qualify to hold such stock.

(B) If a trust requires the application of a certain state's laws that are unfavorable to the management of certain assets or trigger unfavorable tax treatment to certain beneficiaries, it may be appropriate to move some assets into a trust that is governed by another state's laws.

(C) Spendthrift trust provisions might be appropriately added to protect trust assets against the claim of beneficiaries' creditors.

(D) A large trust might be providing limited payments to a child, and payments to grandchildren and other beneficiaries may be held up waiting for the child's death. In some circumstances, the trust for the child can be decanted into a separate trust without prejudicing the child's benefit, allowing distributions to the grandchildren to be made from the original trust.

(b) The rules on decanting trusts are determined under state law. Nevada's decanting statute is NRS 163.556, and it does not permit decanting to reduce a beneficiary's share or to add beneficiaries.

4. **<u>CONCLUSION</u>:** When a person dies, make a list of the desired consequences, and compare that with the actual documents, facts, and circumstances of the interested parties. A combination of post-mortem planning tools can be brought together to make up the deficiencies of pre-mortem planning.

NOTE: This memo provides general information only and does not contain legal, accounting, or tax advice. For brevity, this memo is oversimplified and should not be relied on for any particular situation. Although this memo may discuss tax issues, this is not a "covered opinion" as defined in Circular 230 issued by the U. S. Treasury Department, and nothing in this memo can be relied upon to avoid any tax penalties.

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NOTES

1. Except as modified with other adjectives, the words "property", "assets", and "estate" are used interchangeably.

2. "Interested parties" does not refer to someone having an "interest" in the sense of "curiosity". The term refers to those persons or entities that have an ownership interest in or claim against the property involved.

3. The personal representative is "court appointed" because the official appointment is made by the probate court. The designation of the personal representative in a decedent's will be honored by the court unless that personal representative declines to act, is unable to act, or is disqualified by a felony conviction.

4. In legal terminology, the words "property" and "assets" are used interchangeably.

5. In this memo, the phrase "A/B Trust" refers to a trust that divides into a Survivor's Trust and an Exemption (Credit-Shelter or Bypass Trust). In that scenario, Trust B is the Exemption Trust, which receives the maximum amount of the deceased spouse's property that can pass free of estate tax because of available deductions and credits, and Trust A is the Survivor's Trust, to which all other assets of the deceased spouse and of the survivor are allocated. The phrase "A/B/QTIP Trust" refers to a trust that divides into a Survivor's Trust, an Exemption (Credit-Shelter or Bypass) Trust, and a QTIP Marital Deduction Trust upon the death of the first spouse to die. Trust A is the Survivor's Trust (consisting of the surviving spouse's assets), Trust B is the Bypass Trust (consisting of the maximum amount of the deceased spouse's assets that can pass tax free because of available deductions and credits), and the QTIP Trust is the trust that qualifies for the marital deduction, to which the balance of the deceased spouse's property interests are allocated.

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6. The federal generation-skipping transfer tax (GSTT) is imposed on transfers to grandchildren and lower generations ("skip persons"). Each transferor has a "GST Exemption", which is currently $1,010,000 and which can be applied to generation-skipping transfers. For transfers into trusts, whether made during life or at death, the GST exemption is most efficiently allocated to an entire trust (or to a portion of a trust called a "subtrust") so that the entire trust (or subtrust) will be GSTT-exempt.

7. The QTIP trust is recognized in the code under IRC § 2056(b)(7). There are other trusts that can qualify for the marital deduction, including a income/general power of appointment trust that is recognized under IRC § 2056(b)(5). These materials focus on the QTIP trust because that type of marital-deduction trust has become most common.

8. IRC § 2056(b)(7).

9. IRC § 2032A.

10. IRC § 6166.

11. IRC §§ 754 and 743(b).

12. IRC § 2032.

13. IRC § 303.

14. Reg § 1.441-1T(b)(2) does not restrict estates to the calendar year.

15. IRC § 645

16. IRC §§ 2518 and 2046.

17. Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. For ESTATE TAX purposes, the applicable exclusion has been, is and will be: $600,000 in 1997, $625,000 in 1998; $650,000 in 1999; $675,000 in 2000 and 2001; $1,000,000 in 2002 and 2003; $1,500,000 in 2004 and 2005; $2,000,000 in 2006, 2007, and 2008, $3,500,000 in 2009; unlimited in 2010; $5,000,000 in 2011; $5,120,000 in 2012; and $1,000,000 in 2013 and beyond. The applicable exclusion for GIFT TAX purposes is the same as that for estate tax purposes from 1997 to 2004 and for 2011 and 2012. For 2005 through 2010 and for 2013 and beyond, the applicable exclusion for GIFT TAX purposes is fixed at $1,000,000.

18. A "settlor" is a creator of a trust. Trustor and grantor are frequently used as synonyms.

19. IRC § 2514(c).

20. IRC § 2514(c)(1).

21. If this problem were discovered early, H's resignation or a renunciation of the power to distribute for "comfort and welfare" might suffice.