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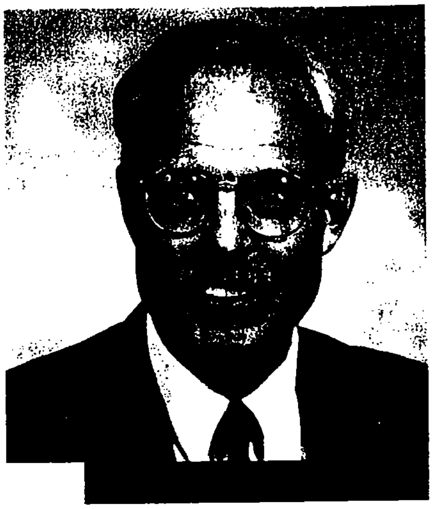
ARE YOU AND YOUR CLIENTS ON THE SAME ESTATE PLANNING PATH?

by David W. Kirch

Estate planners routinely use certain planning documents and techniques for their clients, in part because of cost, but also in part because the choices reflect the planner's philosophy, not the client's needs. Too often these routine documents and techniques are unnecessarily complex and restrictive for the client. This article reviews some of the more commonly chosen documents and techniques in estate planning, and suggests alternatives that may be more suitable in light of the client's wishes and needs. Topics of discussion include irrevocable life insurance trusts, lifetime gifting, Medicaid planning, disclaimers, living trusts, qualified terminable interest property trusts, and gradual distribution provisions.



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Too often in drafting estate planning documents, the planner routinely makes choices colored by the planner's own view of the universe, not by the client's true wishes and needs. Undoubtedly, the economics of an estate planning practice contribute to this routineness. Usually the client would not want to pay for the time necessary to do the kind of probing that might be required to match the client's needs, family situation, and personal philosophy to the type of estate planning documents best suited for them.

The problem with this approach is that too often these choices result in creating complications for clients that their circumstances do not warrant and depriving clients and their families of control of their own lives. There also is a danger of the estate planner being overly protective and not gearing the documents to a level of sophistication appropriate for a particular client.

Most estate planners are entrenched in the premise that we must, in every case, advocate estate planning choices that produce the lowest possible taxes for the client and the maximum protection against a client's and beneficiaries' disability. Advising the client to take such actions, however, can produce results that are inconsistent with the client's other needs and that ignore some of the important trade-offs that result when those actions are taken.

Planners need to listen more carefully to clients, and to be more sensitive to their needs for simplicity. Clients need to understand the documents we prepare for them. The planner cannot assume that clients have the same view as the planner as to what protections are necessary.

Tax Planning

For example, when advising clients to make gifts in order to use the $10,000 annual gift-tax exclusion, it is important to ascertain their level of comfort with their own financial security, as well as their children's level of financial responsibility. It is always good to point out to clients that by making lifetime charitable gifts, rather than charitable gifts in their wills, they can produce income-tax as well as estate-tax savings. However, many clients, particularly elderly clients and those with substantial assets, may feel significant financial insecurity with outright lifetime charitable gifts. Perhaps some kind of split-gift charitable giving would be more appropriate in some cases.

The availability of liquid assets is always important to elderly clients who, through retirement, have lost the security of a regular income flow from full-time employment. Further, elderly clients faced with potentially enormous nursing-home expenses are often uneasy about the idea of reducing their net worth, even though it can produce substantial estate-tax savings. Because of the increase in the income-tax basis of assets at death, appreciated assets may not be suited to non-charitable gifting. However, because appreciated assets are often the least liquid assets, a client can often more easily give them away without feeling deprived of needed financial resources. Furthermore, while making cash gifts avoids the loss of an increase in basis at death, they also may have a greater impact on the client's own sense of financial security than a gift of illiquid appreciated assets.

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Giving cash to the children in order to purchase assets from their parents may be a more comfortable method for the client. However, if the gift and purchase are close in time, the Internal Revenue Service (IRS) could argue that a step transaction occurred in order to defeat the claim of an increase in basis.

Trust Complications

Many tax-savings techniques are tied to the use of trusts. However, trusts—whether revocable or irrevocable—can create complications and inflexibilities in the client's financial and personal affairs, which a fully informed client may not want.

The use of individual trustees appears to be increasing. But individual trustees often do not properly or fully administer trusts and do not always get competent professional assistance in doing so. Consequently, many trust formalities are frequently ignored, endangering the intended tax benefits of the trust arrangement. Planners need to avoid being overly idealistic about how well a trust will be managed in the real world by clients and their families who may lack either the true desire or necessary sophistication.

The use of a by-pass trust to take advantage of the $600,000 exemption of the first spouse to die is probably the most commonly used technique for saving estate taxes. Irrevocable life insurance trusts are another commonly used technique, with the trust being funded with gifts up to the client's annual $10,000 gift-tax exclusion ($20,000 for both spouses). However, alternatives to the irrevocable life insurance trust should always be explored. An outright gift of the policy into the names of children as joint tenants with right of survivorship may make more sense than a trust. The increased scrutiny given to such trusts by the IRS has increased the yearly administrative paperwork and expenses, as well as the risk that the life insurance proceeds may not avoid estate taxation because of some technical defect in the provisions of the trust or its funding and administration.

For example, the trust will require a separate bank account, which may not have sufficient funds in it to justify the monthly charges. Also, sending "Crummey" notices to persons with withdrawal powers of contributions is frequently overlooked, as well as the need to file fiduciary income-tax returns and prepare, if applicable, annual gift-tax returns to use the $1-million generation-skipping transfer-tax exemption.

All these details of administration must be taken into consideration and be appreciated by the client before committing to the cost and maintenance responsibilities of an irrevocable life insurance trust. If a policy is relatively small, the client may not feel the need to keep the proceeds in a trust for the benefit of the surviving spouse. For example, it may be equally suitable, and much less expensive and complicated to accomplish, for the client to adjust other gifts to the children of a predeceased child, making an outright gift of the policy to the children as joint tenants with right of survivorship.

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Environmental Liability

The potential liability of trustees for environmental cleanup costs has created new wrinkles in the use of trusts to hold real estate. The author recently encountered a Chicago trust department that refused to distribute over $100,000 in trust assets upon termination of the trust. The trustee held $10,000 in stock, which was about 5 percent of the total stock owned by the trust, in a corporation faced with potential liability for a contamination cleanup. As trustee of various trusts, the trustee held, in total, 28 percent of this corporation's stock. The trustee was concerned that the *City of Phoenix*[1] case, which held a trustee responsible out of its own assets for such liability because the trustee directly owned and managed the contaminated property and had distributed the trust assets, might be extended to trustee ownership of a minority interest in a corporation.

While this concern may seem remote, its possible ramifications are enormous. Trustees would have to investigate not only every piece of real property funding a trust, but also the real property held by every corporation whose stock is used to fund a trust (at least corporations whose stock is not publicly traded) if there is a risk the Environmental Protection Agency would seek to "pierce the corporate veil."

We practice in a brave new world when it comes to assessing the efficacy of trusts to administer property. Provisions are now routinely being included in trust documents allowing a trustee to designate a co-trustee who might hold property liable for environmental cleanup. The costs associated with the "due diligence" necessary to avoid liability in such instances can make placement of such property into a trust uneconomical. Property known to be contaminated should probably be placed into a separate trust. The planner should ask the client about the possibility of contamination to each piece of real property owned by the client.

Needlessly Taking Away Control

More and more often, estate planners are using planning devices associated with purposes other than tax savings. These devices frequently result in taking control and resources away from clients and their families.

Planning for Medicaid eligibility in elderly clients is one such area. The enormous growth of attention given to Medicaid planning is likely to continue, despite the restrictions placed on such planning by the Omnibus Budget Reconciliation Act of 1993 (OBRA '93). Encouraging the use of gifts, irrevocable annuities, and life estate and joint tenancy ownership of residences is often based on the assumption that many clients would rather be impoverished (or have other family members impoverished) than to bear the expense of nursing homes. Further legal restrictions of the available options seem inevitable. Planners must question the use of these devices for clients who have sufficient resources to pay their likely nursing home expenses, or for whom institutionalization is not likely to occur in the near future. For instance, long-term-care insurance to cover this risk should be considered as an alternative.

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Another common technique is to use joint ownership arrangements regarding a residence in order to avoid estate recovery programs seeking reimbursements of Medicaid benefits. However, these arrangements should not be undertaken unless the residence is likely to be sold during the client's lifetime. Such transfers of an interest in a residence can deny an elderly individual of the full benefit of the exclusion up to $125,000 in gain on the sale of a residence under Internal Revenue Code Section 121 or the ability to roll over the gain upon purchase of a new residence under Section 1034. (See the article in this issue, "Home Sweet Home: Timing the One-Time Tax Exclusion.")

The use of nonsupport, or "supplemental needs," trusts for a client's disabled child assumes it is better for the beneficiary's basic support needs to be provided for by public assistance, rather than by the beneficiary or the family. But if other children can be trusted to take care of the needs of a disabled child, making gifts to those other children, rather than establishing a trust for the disabled child, may make more sense. Obviously, before undertaking such an arrangement, the possibility that such gifts will expose the assets to the creditors of the other children or to claims or objections of their spouses (in the event of a dissolution of marriage or death) must be explored with the client.

The use of medical powers of attorney, authorizing third parties to make medical decisions for a client, has substantially increased since the *Cruzan* case was decided by the U.S. Supreme Court.[2] Many times these documents are structured as "standing powers," meaning the power can be exercised even during times when the principal retains the power to make decisions for himself or herself. The use of "standing powers" is frequently based on a concern that the principal may not exercise good judgment or that the existence of capacity to make decisions may not be clear. Yet many clients feel that such powers infringe on their freedom of choice. They would prefer for the provider of medical services to assume that their decisions were to be honored, rather than that they would give up this power to a third party.

Choosing Appropriate Documents

Estate planners may unconsciously steer their clients to use particular forms or documents, and provisions in those documents, based on the advisor's view of what is best for the client, without sufficient attention to the client's wishes. We should realize that these choices may reflect our own priorities in the conflict that can exist between "advisor paternalism" and "client autonomy."

Revocable Trusts vs. Wills

A controversial area in estate planning in recent years has been the use of wills with testamentary trusts versus the use of revocable or living trusts. Many clients have the false impression that a living trust provides greater opportunities for estate-tax savings than does a will. Many clients are asking estate planners to prepare trusts, rather than wills, based on the prevalent but not necessarily correct assumption that the avoidance of probate is always preferable. Clients seek this avoidance even if it results in using a device that the client frequently does not understand and which can be more costly and complex than a will to establish. Because of the simplicity and flexibility of informal probate, which is now available in most states, establishing a living trust can cost the client more money, and which is paid at an earlier time, than would probate of a client's will.

Although the delay associated with probate is frequently a client concern, a recent study conducted by the American Association of Retired Persons (AARP) revealed that estate administration usually takes from 6 to 12 months, approximately one half the time required before the enactment by many states of the Uniform Probate Code in the 1970's. If an estate has to file a Form 706 Federal Estate Tax Return, administration of the estate with a revocable trust will probably not be quicker than with a will. If there are probate assets that have not been transferred to the trust that are in excess of a state's small estate procedure limits, there will probably be no probate avoidance. A revocable trust probably will not afford the same protection from the claims of creditors of the decedent than is available in a probate estate administration, if there is no statutory procedure for giving notice to such creditors by the trustee and a statutory time limit which is applicable to protect the trustee. In most states, only the decedent's probate estate has such statutory protections.

Revocable trusts can provide substantial benefits in the event of a client's disability, as well as avoid the complexity and costs of probate in multiple jurisdictions if the client owns real estate in states other than his or her domicile. However, for a client who does not have these concerns, the use of revocable trusts can result in a structure of ownership of assets during the client's lifetime that is difficult to work with and not understandable to the client. Titling of assets in a trustee's name during a client's life can be more complicated than a later transfer of assets through probate administration. In some states, the proper method for titling property in a trustee's name is cumbersome or uncertain. It is necessary to inquire for each asset how titling can best be accomplished. Without a sufficient power of attorney given to the successor trustee, and an exercise of that power to transfer the client's assets prior to death, there will probably be no probate avoidance if the settlor acts as trustee. Most clients do not realize that assets titled in the decedent's name as sole trustee will, in most states, still require probate administration.

If the spouse or children of the client are selected as trustees, special limitations on the trustee's powers during the settlor's lifetime may have to be incorporated into the trust to avoid the trustee having a taxable general power of appointment under IRC Section 2041. Such restrictions can cause the distribution powers of the spouse, where minor children are beneficiaries of the trust during the settlor's lifetime, to be unduly restrictive.

Disclaimers

Another major choice for every will or trust of a client whose estate is potentially taxable is determination of whether to use a formula marital deduction clause or a disclaimer approach is best for funding the by-pass trust to use the $600,000 exemption of the first spouse to die. Using a formula for married couples whose estates are under $1.2 million assumes it is better to put more assets in trust than is necessary to save taxes.

Some planners shy away from the use of disclaimers because of lack of confidence in the surviving spouse to retain an attorney who is knowledgeable in the proper use of the disclaimer approach, and because disclaimers can be more complicated to administer. It is true that using a disclaimer to fund the family trust places on the surviving spouse the burden of making decisions to save estate taxes at a time when he or she is certainly more susceptible to financial and psychological insecurity, making the decision to disclaim assets more difficult. The planner should not overlook the fact that a surviving spouse can take advantage of the annual $10,000 gift-tax exclusions to reduce his or her taxable estate below $600,000, even if a family trust is not used for this purpose. However, there is always the risk that the surviving spouse will not live long enough to accomplish the desired estate-tax savings by relying on use of the annual gift-tax exclusion.

Despite these factors, disclaimers can create a great deal of flexibility for estates in the $500,000 to $1.2-million range. Clients and their spouses often are more comfortable in not being locked into a trust arrangement, and they are more willing to have tax-planned wills with this flexibility.

Marital Trust vs. Outright Gift

Another key drafting decision is whether to place the gift to the spouse qualifying for the marital deduction into a trust arrangement or to make the gift to the spouse outright. Planners often justify the routine use of marital trusts on the basis that such trusts can be used to manage property if the surviving spouse becomes incapacitated. However, the surviving spouse can make arrangements for his or her own incapacity with a durable power of attorney. A power of attorney is less suitable if there are no close family members to act as agent. Where a power of attorney is appropriate, the client and surviving spouse may prefer to give the surviving spouse the ability to seek competent financial advisors on his or her own, by giving the marital share to the spouse outright, rather than dealing with a trustee with whom the surviving spouse may not be comfortable.

Routine Use of QTIPs

The routine use of qualified terminable interest property trusts (QTIPs) for the gift qualifying for the marital deduction must also be questioned. Such trusts qualify for the marital deduction, but the surviving spouse cannot control at his or her death the disposition of the property placed into the trust. QTIP trusts are frequently appropriate for clients who have children by previous marriages or have charitable objectives that may not be shared by the surviving spouse. However, in many situations both clients feel that the spouse can be trusted to treat their own children or other beneficiaries fairly and would not choose, if fully aware of the options, to restrict the surviving spouse's control over the property qualifying for the marital deduction.

If it were not for the estate-tax savings resulting from using a by-pass trust, most clients would otherwise leave everything outright to the surviving spouse, making marital trusts, including QTIP trusts, for such clients frequently inappropriate.

To the extent that the choices we advocate are based on a perceived need to protect clients and their families from themselves in all instances and at all costs, the planner is often denying the client flexibility and freedom from complexities.

Unnecessary Restrictions

To avoid the creation of a general power of appointment in a trustee who is also a beneficiary of the trust under Section 2041, a properly structured estate plan will consider the use of ascertainable standards, limiting the powers of the trustee to make distributions from a trust. Usually a catch-all provision restricting a trustee-beneficiary from exercising discretionary powers over income and principal, including discretionary powers to terminate a trust, is sufficient. It should prevent the trustee from making a distribution to himself or herself in excess of purposes limited by the accepted standard of "health, education, maintenance, and support." It also should prohibit the trustee from discharging the trustee's legal obligation of support of a beneficiary with trust distributions. However, some planners, out of what might be considered an excess of caution, also routinely included such restrictions in the distribution provisions themselves. Such an approach, because it also limits the distribution powers of disinterested trustees, may be more restrictive than necessary to protect against adverse tax consequences and can unduly limit availability of the trust for beneficiaries.

The routine use of gradual distribution provisions, providing for distribution of trusts to beneficiaries in stages as the beneficiaries attain various ages, also may be unnecessarily complicated. The assumption of such provisions is that children may need protection from themselves and that they will squander money distributed at younger ages. A legitimate question exists regarding the need to complicate documents and trust administration by requiring a trustee to make any distribution to a beneficiary until the beneficiary is able to handle it. The amount remaining in the trust after partial distributions may not be enough to justify the expense of trust administration. The trustee can always use the power to terminate the trust (assuming the document makes such a provision) or to make discretionary distributions to beneficiaries whose maturity justifies doing so.

It is not uncommon for wills and trust instruments to limit the power to remove and appoint trustees to court-appointed fiduciaries for incapacitated beneficiaries. Such provisions frequently reflect a distrust of the spouses of the client's children. Such a restriction may not be appropriate and may create unnecessary expenses in administering the trust should there be a need to remove or appoint a successor trustee.

Finally, the use of provisions expressing a preference for informal estate administration, in states providing for such probate procedures, may not be incorporated into a will by the planner because of the concern that such provisions will be abused. However, the absence of such provisions may result in more frequent use of formal probate proceedings, even when the expense is not justified, because the fiduciary will be overly concerned about its own liability in proceeding informally without specific authority in the will to do so.

Summary

To the extent that the choices we advocate are based on a perceived need to protect clients and their families from themselves in all instances and at all costs, the planner is often denying the client flexibility and freedom from complexities. This can defeat the most important objective of estate planning: giving clients the peace of mind they were looking for in the first place when they sought our professional services and the benefit of our professional judgment. ■

Footnotes

1. *City of Phoenix, Arizona v. Garbage Service Company*, 33 E.R.C. 1655 C.D. Arizona, April 5, 1991.
2. *Cruzan v. Director, Missouri Department of Health*, 58 U.S.L.W. 4916, June 25, 1990.

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