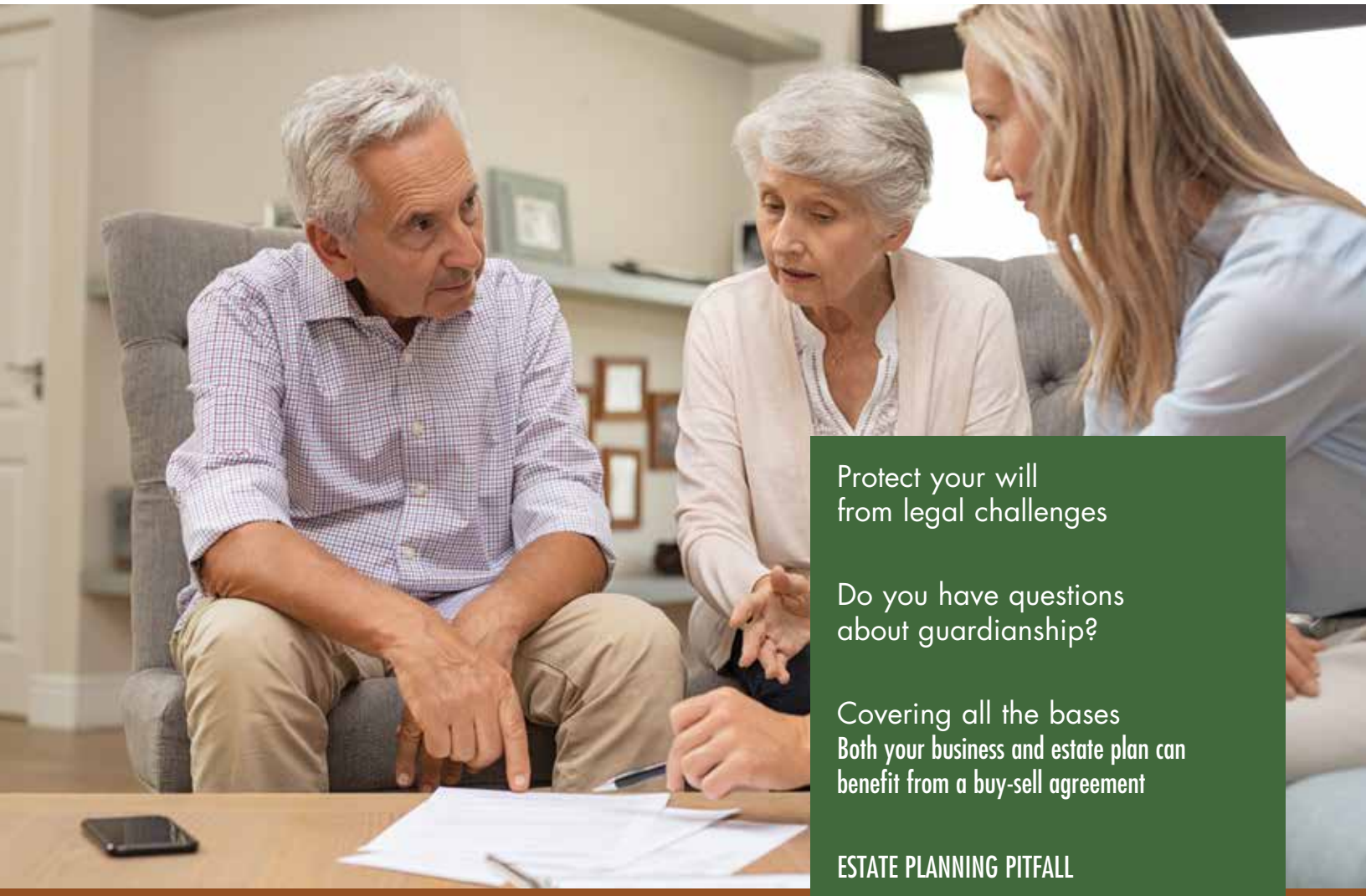
INSIGHT ON ESTATE PLANNING



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ESTATE PLANNING PITFALL
You're setting up trusts in your home state

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Protect your will from legal challenges

You've probably seen it in the movies or on TV hundreds of times: A close-knit family gathers for the reading of the will of a wealthy patriarch or matriarch. When the terms are revealed, someone benefits at the expense of someone else, causing a ruckus. It may even come to blows. This "bad blood" continues to boil between estranged family members, who won't even speak to one another.

Unfortunately, a comparable scenario can play out in real life as well if you don't make proper provisions. However, with some planning, you can avoid disputes, or at least minimize the chances of your will being contested by your loved ones.

Start at the beginning

Before you (and your spouse, if married) set the table for your will, which is the centerpiece of any comprehensive estate plan, discuss estate matters with close family members who likely will be affected. This may include children, siblings, adult grandchildren and possibly others. Present an outline regarding the disposition of your assets and other important aspects.

This doesn't mean you should be specific, but doing so will provide a basic overview of your estate. Consider the input of other family members; don't just pay lip service to their feedback. In fact, they may raise issues that you hadn't taken into account.

This meeting — which may require several sessions — may head off potential problems and better prepare your heirs. It certainly avoids the kind of "shockers" often depicted on screen.

While it's usually best to bring issues out into the open, you don't have to provide all of the specifics. For instance, there's no need to publicize restrictions that may be placed on a spendthrift son or daughter. That benefits no one.

Means of protection

Although there are no absolute guarantees, consider the following methods for bulletproofing your will from a legal challenge:

Draft a no-contest clause. Also called an "in terrorem clause," this language provides that, if any person in your will challenges it, he or she is excluded from your estate. It's the definitive way of thwarting contests to a will.

This puts the onus squarely on the beneficiary. If he or she asserts that the estate isn't divided equitably, the beneficiary risks receiving nothing. Be aware that, in some states, this clause may be subject to certain exceptions. Contact your estate planning advisor for specifics.

Invite witnesses. Usually, little thought is given concerning witnesses to the will. It's often just whoever happens to be around. It might even be staffers at the attorney's office where the will is being drawn up.

But it's far better to use witnesses who know you well, such as close friends or business associates. They can convincingly state that you were of sound mind when you made out the will. Also, choose witnesses who are in good health, preferably younger than you are and easily traceable. Finally, you may add extra witnesses for greater protection.

Obtain a physician's note. A note from a physician about health status is recommended for someone extremely ill or elderly. For instance, it can state that you have the requisite mental capacity to make estate planning decisions and thus will be useful in negating legal challenges.

It's important to obtain the physician's note close to the time that the will is signed. A note from several years ago will carry little weight in court.

Draft a revocable living trust. This trust type is often viewed as a vehicle that discourages will contests. The assets transferred to the trust are governed by the terms of the trust, not your will, giving you more flexibility.

For starters, assets in a living trust are exempted from the probate process. The trust is the owner of the assets — not you. Conversely, a will is subject to public inspection and must go through probate. In most states, the disposition of a living trust cannot be contested.

Furthermore, you retain some control over the assets during your lifetime, since you can change beneficiaries or even revoke the trust entirely. Generally, a living trust is adopted to complement your will.

Let's go to the videotape

Thanks to technology, there's yet another way to shield a will from legal challenges: Record it. Depending on the situation, a video recording may serve as the sole will or a supplement to a written one.

Videotape offers the obvious benefit of showing the mental condition of the testator. Demeanor, tone, inflection and other traits are accurately reflected. Also, the beneficiaries might benefit emotionally by having this final message viewed, while the testator can be more confident that his or her intentions will be met.

But a video recording isn't foolproof. The strategy could backfire if the testator shows signs of being incompetent or unduly influenced by others. Plus, the video may be tampered or altered if it's not carefully stored. Finally, state laws may have an impact, so consult with your attorney.

Last but not least

After your will is drafted, don't make the mistake of putting it in a drawer or safe where you may forget about it. Review it periodically with your attorney. By fine-tuning the will, you improve the likelihood that it'll deter a legal challenge and, if necessary, prevail in court. •

Do you have questions about guardianship?

If you're the parent of a newborn or toddler, you may be thinking about naming a guardian for your child. This can be a difficult decision, especially if you have a plethora of choices or, on the other hand, no one you can trust. Or perhaps you plan on petitioning the court for guardianship of a child. In either event, you must adhere to the legal principles under state and local law.

Questions & answers

The following are answers to several common questions about guardianships:

Q. How do I choose the guardian for my child?

A. In most cases involving a parenting couple, you designate the guardian in a legally valid will. This means that the guardian will raise your children if you should die unexpectedly. A similar provision may address incapacitation issues.

Choose the best person for the job and designate an alternate if that person can't fulfill the duties. Frequently, parents will name a married couple who are relatives or close friends. If you take this approach, ensure that both spouses have legal authority to act on the child's behalf.

Also, select someone who has the necessary time and resources for this immense responsibility. Although it's usually not recommended, you can have different guardians for different children.

Consider, also, the living arrangements and the geographic area where your child would reside if the guardian assumes the legal responsibilities. Do you really want to uproot your child and send him or her to live somewhere far away from familiar surroundings? Don't ignore these factors, or the myriad others that impact your decision.

Q. Do I have to justify my decision?

A. No. However, it can't hurt — and it could help — to prepare a letter of explanation for the benefit of any judge presiding over a guardianship matter for your family. The letter can provide insights into your choice of guardian.

Notably, the judge will apply a standard based on the "best interests" of the child, so you should explain why the guardian you've named is the optimal choice. Focus on aspects such as the child's preferences, who can best meet the child's needs, the moral and ethical character of the potential guardian, and the guardian's relationship to the child.

Q. How do I establish guardianship of a child who isn't mine?

A. This situation is more tenuous, and the rules can vary widely depending on the location. Be sure to seek legal counsel who can help guide the process, which likely involves requesting the right of guardianship. To the extent possible, you'll also want to obtain a letter of consent from the child's parents, and file the letter with the court.

Next steps typically involve the court scheduling interviews with all the relevant

parties, including those who have a vested interest in the proceedings. Most likely this will involve home visits to inspect the premises, along with a criminal background check of the proposed guardian. Then the court will make its decision.

Q. How does the court determine guardianship of the child?

A. As previously stated, the court will use the standard of the best interests of the child. If the court agrees that the child's best interests is for you to become guardian — considering all the facts and circumstances — it will approve the arrangement. Most states require guardians to sign an oath before they can assume responsibilities.

In addition, the court will generally require documentation of the guardianship. Your attorney can assist you in providing the proper documentation.

Q. What happens if the child's parents object?

A. This is where things can get tricky. If you don't obtain consent, guardianship is usually granted only in cases where a child has been abandoned or the judge decides that the child should be removed from the parents' custody. Frequently, you'll have to prove in court that the parents are unfit.

Furthermore, other relatives, such as grandparents, have certain legal rights and must be notified about guardianship hearings. Although you won't generally need formal consent from all parties, any objections they raise could adversely affect your case — not to mention the tension it will likely create. If emotions spill over, consult your attorney immediately.

A major decision

Whether you're naming a guardian for a child in your will or attempting to become a legal guardian yourself, the implications are enormous. Don't take these matters lightly. Fortunately, your estate planning advisor can provide the guidance needed under the prevailing laws. •

Covering all the bases

Both your business and estate plan can benefit from a buy-sell agreement

A buy-sell agreement provides for the disposition of each owner's business interest after a "triggering event," such as death, disability, divorce, termination of employment or withdrawal from the business. However, to be effective, the agreement must include the appropriate provisions.

It also should be part of your estate plan if you have an interest in a family-owned or other closely held business.

What are the benefits?

A well-crafted buy-sell agreement provides many benefits, including:

- Keeping ownership of the business within the family or another select group (for example, people actively involved in the enterprise),
- Preventing an owner's former spouse from acquiring a business interest in the event of a divorce,
- Providing owners and their heirs with liquidity to pay estate taxes and other expenses in the event of death or disability,
- Establishing the value of the business for gift and estate tax purposes (if certain requirements are met), and
- Minimizing disputes over ownership succession issues.

Typically, buy-sell agreements achieve these objectives by requiring or permitting the company or the remaining owners to purchase the interest of an owner who dies, becomes disabled or leaves the business. They may also provide the company or the remaining owners with a right of first refusal in the event an owner wishes to sell his or her interest.

Are there tax implications?

Generally, buy-sell agreements are structured in one of two ways: "redemption" or "cross-purchase" agreements. Either of these will permit or require the *company* to purchase a departing owner's shares, while the latter confers that right or obligation on the remaining owners.

From a tax perspective, cross-purchase agreements are generally preferable. The remaining owners receive the equivalent of a "stepped-up basis" in the purchased shares, in that their basis for those shares will be determined by the price paid, which is the current fair market value. Having the higher basis will reduce their capital gains if they sell their interests down the road. Also, if the remaining owners fund the purchase with life insurance, the insurance proceeds are generally tax-free.

Redemption agreements, on the other hand, may trigger a variety of unwanted tax consequences, including corporate alternative minimum tax, accumulated earnings tax or treatment of the purchase price as a taxable dividend.

The disadvantage of a cross-purchase agreement is that the owners, rather than the company, are responsible for funding the purchase of a departing owner's interest. And if they use life insurance as a funding source, each owner will need to maintain insurance policies on the life of each of the other shareholders, a potentially cumbersome and expensive arrangement.

What's a fair selling price?

A buy-sell agreement's valuation provision is critical to avoiding unpleasant surprises or conflicts. Generally, the fairest and most effective method of setting the purchase price is to conduct periodic independent business valuations and to base the price on fair market value.

Many agreements set the price using a formula tied to earnings, cash flow, book value or some other objective measure. Although formulas offer simplicity and lower costs, they can't account for subjective characteristics or other factors that drive business value. As a result, they often underestimate or overestimate business value, which can lead to disputes when the buy-sell agreement is invoked.

Can a buy-sell agreement benefit you?

If you own interests in a family or closely held business, a buy-sell agreement may be right for you. However, it's important to carefully define the terms and to consider the potential implications of the agreement's language. Your estate planning advisor can give you more details. •

ESTATE PLANNING PITFALL

You're setting up trusts in your home state

Suppose you've decided to include one or more trusts in your estate plan. It's only natural that you should create the trust in the state where you live, right? Wrong. Don't assume that this is the best approach. For a variety of reasons, you may be better off establishing the trust in a different jurisdiction.

For example, certain trust-friendly states may permit perpetual "dynasty trusts" that benefit many generations to come. Others may allow "silent trusts," where the beneficiaries don't have to be notified about their interests. Still others might offer greater flexibility relating to a trustee's duties and powers than your home state. But the reason most often cited for going out of state is taxes.

In particular, residents of high-income-tax states such as California, New York and New Jersey are flocking to states where there's no income tax at all. By doing so, you can take advantage of "self-settled trusts" where the grantor and the beneficiary are one and the same. If structured properly, the trust avoids being characterized

as a grantor trust in which the income is taxable to the grantor by the state where he or she resides. And you don't have to move out of state for this tax benefit.

Nevada, Wyoming and Delaware have become known as tax havens for these types of trusts. The applicable trusts are often referred to by the monikers of NINGs (Nevada Incomplete-gift Nongrantor Gift trusts), WINGs (Wyoming Incomplete-gift Nongrantor Gift trusts) and DINGs (Delaware Incomplete-gift Nongrantor Gift trusts), respectively.

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I'm a Trustee, Now What?

Serving as a Trustee of a trust comes with many responsibilities. If you've been named as a Trustee, understanding these responsibilities early on will make your life easier and help you avoid legal liability. The following is a brief guide detailing some of the important things you will need to know when taking on the role of Trustee.

Set-up and Maintenance

If the trust is newly formed, a Trustee likely will need to open a trust bank account. Unless the trust is a grantor trust, a Trustee is also responsible for acquiring a tax identification number from the IRS. Similarly, unless the trust is a grantor trust, a Trustee is responsible for filing a Form 1041 (trust and estates income tax return) annually.

After the initial set-up is accomplished, a Trustee's ongoing duties include managing and investing trust assets prudently, making distributions according to the trust's terms, and complying with notice and accounting requirements as set forth in the trust instrument and state law. In certain cases, the Trustee must provide annual accounting reports to the beneficiaries.

Distributions

Broadly, a Trustee's job is to manage the trust in accordance with its terms while adhering to his or her fiduciary duties. While this may entail a variety of different jobs, one of the most difficult jobs is the Trustee's role in making distributions to beneficiaries.

A trust instrument usually will give a Trustee some direction on how and when to make distributions to beneficiaries. One common direction is that distributions may be made for "health, education, maintenance, and support" in the beneficiary's "accustomed standard of living." Essentially, this standard directs a Trustee to cover medical and educational expenses and to provide enough funds to the beneficiary to maintain the lifestyle the beneficiary had at the time of trust creation. Even with guidance like this, a Trustee's role in deciding the amount and timing of distributions can be challenging.

Fiduciary Duties

At all times, a Trustee's actions in respect to a trust must comply with the overarching legal standards associated with the duties of a fiduciary. If a Trustee breaches a fiduciary duty, the Trustee can be personally liable. A trust document may waive some of the fiduciary duties, but the following generally apply:

- The duty of loyalty directs that a Trustee cannot put his or her interests above the interests of the trust beneficiaries. Therefore, a Trustee generally cannot engage in self-dealing activities or use trust property for the Trustee's own benefit.
- The duty of care requires the Trustee to carefully manage the trust property and assets. This duty includes a duty to act prudently, particularly with regard to the prudent investment of trust assets.
- The duty of care also encompasses the duty to identify, secure and safeguard trust property, the duty to pay taxes, and the duty to organize and account for trust property. A Trustee may delegate his or her duties (such as delegating accounting responsibilities to a CPA), but must do so wisely.
- Generally, a Trustee has a duty to treat beneficiaries impartially. This can be difficult when beneficiaries have competing interests.
- A Trustee has a duty to act in good faith.

A Trustee has many complicated responsibilities, only some of which are discussed here. To ensure proper administration of a trust, a Trustee may employ advisors such as accountants, bookkeepers or attorneys. If you have accepted the role of Trustee and could use guidance, we at Stokes Lawrence would be happy to assist. Please contact a member of the Stokes Lawrence Estate Planning Group at (509) 853-3000 in Yakima or (206) 626-6000 in Seattle.