Insight on Estate Planning

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Estate Planning Pitfall

You haven't named backup beneficiaries

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Estate planning for personal property

Why you should sweat the small stuff

When planning their estates, most people focus on major assets, such as business interests, real estate, investments and retirement plans. But it's also important to "sweat the small stuff" — tangible personal property. Examples include automobiles, jewelry, clothing, antiques, furniture, artwork, photographs, music collections, personal papers, collectibles (such as stamps, coins or baseball cards) and mementos.

Ironically, these personal items — which often have modest monetary value but significant sentimental value — may be more difficult to deal with, and more likely to result in disputes, than big-ticket items. Distributing $4 million in stock or other liquid assets among your children is relatively straightforward. But dividing a few thousand dollars worth of personal items accumulated over a lifetime is another story. Squabbling over these items can lead to emotionally charged disputes and even litigation. In some cases, the legal fees and court costs can eclipse the monetary value of the property itself.

Create a dialogue

There's no reason to guess which personal items mean the most to your children and other family members. Create a dialogue to find out who wants what and to express your feelings about how you'd like to share your prized possessions.

Having these conversations can help you identify potential conflicts. After learning of any ongoing issues, work out acceptable compromises during your lifetime so your loved ones don't end up fighting over your property after your death.

Make specific bequests whenever possible

Some people have their beneficiaries choose the items they want or authorize their executors to distribute personal property as they see fit. For some families, this approach may work. But more often than not, it invites conflict.

Generally, the most effective strategy for avoiding costly disputes and litigation over personal property is to make specific bequests — in your will or revocable trust — to specific beneficiaries. For example, your will might leave your art collection to your son and your jewelry to your daughter.

Appraisal required?

Often, the value of personal property is purely sentimental, but some items have a substantial market value as well. For more valuable objects, executors or administrators are well advised to obtain a professional appraisal. An appraisal can help stave off challenges on grounds that property was undervalued in dividing the estate among its beneficiaries. This is particularly important when the executor or administrator is also a beneficiary.

An appraisal may also be required under federal tax law. For example, if an art or collectible item — or collection of similar items — is worth more than $5,000, a written appraisal by a qualified appraiser must accompany the estate tax return. And gifts or bequests of art valued at $50,000 or more must be referred to the IRS Art Advisory Panel if the return is examined by the IRS. Qualified appraisals may also be required to support certain charitable deductions.

Specific bequests are particularly important if you wish to leave personal property to a nonfamily member, such as a caregiver. The best way to avoid a challenge from family members on grounds of undue influence or lack of testamentary capacity is to express your wishes in a valid will executed when you're "of sound mind."

If you use a revocable trust (sometimes referred to as a "living" trust), you must transfer ownership of personal property to the trust to ensure that the property is distributed according to the trust's terms. The trust controls only the property you put into it. It's also a good idea to have a "pour-over" will, which provides that any property you own at your death is transferred to your trust. Keep in mind, however, that property that passes through your will and pours into your trust generally must go through probate.

Prepare a personal property memorandum

Spelling out every gift of personal property in your will or trust can be cumbersome. Perhaps you want to leave your son a painting he's always enjoyed and give your daughter your prized first-edition copy of your favorite book. You may want to leave your coin collection, which has never interested your children, to an old friend. And so on.

Specific bequests are particularly important if you wish to leave personal property to a nonfamily member, such as a caregiver.

If you wish to make many small gifts like these, your will or trust can get long in a hurry. Plus, any time you change your mind or decide to add another gift, you'll have to amend your documents. Often, a more convenient solution is to prepare a personal property memorandum to provide instructions on the distribution of tangible personal property not listed in your will or trust.

In many states, a personal property memorandum is legally binding, provided it's specifically referred to in your will and meets certain other requirements. You can change it or add to it at any time without the need to formally amend your will. Even if it's not legally binding in your state, however, a personal property memorandum can be an effective tool for expressing your wishes and explaining the reasons for your gifts, which can go a long way toward avoiding disputes.

If you use a personal property memorandum, it's advisable to include certain property in your will or trust, such as high-value items, gifts to nonfamily members or other gifts that are susceptible to challenge.

Little things mean a lot

As you plan your estate, don't overlook tangible personal property. The dollar value of these items may be relatively low, but their emotional value demands careful planning to avoid hurt feelings, misunderstandings and disputes. Your estate planning advisor can help you include these items in your estate plan. ■

How flexible is your estate plan?

For many years, a primary reason for estate plan flexibility was because of the uncertainty surrounding the federal gift and estate tax laws. Today, however, those laws have a great deal more certainty. But that doesn't mean estate plan flexibility is any less important.

The fact is your family's circumstances will change in the years after your death. Let's take a look at a few postmortem estate planning strategies that will help ensure your wishes are carried out as you desire.

Qualified disclaimers

A disclaimer is an irrevocable, unqualified refusal by a beneficiary to accept a bequest, allowing the property to pass to another beneficiary. Normally, using a disclaimer to direct property to someone else would be considered a taxable gift. But there's an exception for "qualified" disclaimers.

To qualify, a disclaimer must be in writing, be delivered to the estate's representative within nine months after the transfer is made (or, if the disclaimant is a minor, within nine months after the disclaimant turns 21), be delivered before the disclaimant accepts the property or any of its benefits, and cause the property to pass to the deceased's surviving spouse or to someone other than the disclaimant, without any direction from the disclaimant.

This last point is critical and requires some planning on your part. To ensure that the disclaimant doesn't direct the property's disposition, the property must pass automatically to a contingent beneficiary according to the terms of your will or trust.

Spousal right of election

Another strategy for redistributing your wealth after you're gone is the spousal right of election. In most states, a surviving spouse has the right to circumvent your will and take an elective share (one-half or one-third, for instance) of certain property. So, for example, if you leave all of your assets to your children or other beneficiaries, your spouse might exercise his or her right of election if it would produce a more favorable tax outcome. Check with your estate planning advisor to see if this strategy is applicable in your state.

Keep in mind, however, that exercise of the election with respect to property held in charitable remainder trusts may disqualify those trusts.

QTIP trust

Qualified terminable interest property (QTIP) trusts are often used to take advantage of the marital deduction while ensuring that assets are preserved for the children (particularly children from a previous marriage). They also receive some creditor protection.

Ordinarily, to qualify for the marital deduction, you must transfer assets to your spouse with no strings attached. The QTIP trust is an exception to this rule. So long as your spouse receives all of the trust income for life and certain other requirements are met, your estate can enjoy the benefits of the marital deduction while still preserving assets for your children or other beneficiaries. When your spouse dies, any remaining trust assets pass to your beneficiaries but are taxed as part of your spouse's estate.

Even if you don't need a QTIP trust to protect your children or preserve your assets, it may still be a good strategy. Why? Because it creates opportunities for postmortem estate planning.

To claim the marital deduction for amounts transferred to a QTIP trust, your executor or personal representative must make an election on your estate tax return. A properly designed QTIP trust gives your representative the flexibility to make the election, not make the election, or even make a partial election, depending on which strategy would produce the optimal results.

A disclaimer is an irrevocable, unqualified refusal by a beneficiary to accept a bequest, allowing the property to pass to another beneficiary.

Seek professional advice

To stay on top of changing tax laws and family circumstances, periodically review your estate plan and revise as necessary. Discuss with your advisor how postmortem planning strategies can add flexibility to your plan. ▮

Avoid state income taxes with an incomplete nongrantor trust

Now that the federal gift and estate tax exemption has reached an inflation-adjusted $5.43 million, many people are shifting their estate planning focus to income tax reduction. One potentially attractive strategy for high-income taxpayers, particularly those who live in high-income-tax states, is an incomplete nongrantor trust.

These trusts — established in favorable tax jurisdictions, such as Delaware, Florida or Nevada — make it possible to reduce or even eliminate state taxes on trust income. And, as an added benefit, they offer asset protection against creditors' claims.

How it works

Trusts generally are classified either as grantor trusts or nongrantor trusts. With a grantor trust, the person who establishes the trust (the "grantor") retains certain powers over the trust and, therefore, is treated as the trust's owner for income tax purposes. The grantor continues to pay taxes on income generated by the trust assets.

With a nongrantor trust, the grantor relinquishes certain controls over the trust so that he or she isn't considered the owner for income tax purposes. Instead, the trust becomes a separate legal entity and income tax responsibility is shifted to the trust itself. By setting up the trust

in a no-income-tax state (typically by having it administered by a trust company located in that state), it's possible to avoid state income taxes. The grantor is entitled to receive distributions from the trust, usually at the discretion of a distribution committee.

With a nongrantor trust, the grantor relinquishes certain controls over the trust so that he or she isn't considered the owner for income tax purposes.

Ordinarily, when you contribute assets to a nongrantor trust, you make a taxable gift to the trust beneficiaries. To avoid triggering gift taxes, or using your gift and estate tax exemption, it's important to structure the trust as an *incomplete* nongrantor trust. In other words, you should relinquish just enough control to ensure nongrantor status, while retaining enough control so that transfers to the trust aren't considered completed gifts for gift-tax purposes.

One important caveat: This strategy won't work if your home state imposes its income tax on out-of-state trusts based on the *grantor's* state of residence.

An example

Suppose you live in a state that imposes a 10% income tax and you have a $5 million investment portfolio that earns a 7% annual return, or $350,000 per year. By using the incomplete nongrantor trust strategy described above, you can save $35,000 per year in taxes (10% of $350,000), assuming your state doesn't extend its income tax to out-of-state trusts established by state residents.

Assume further that you reinvest your tax savings in order to grow your portfolio more quickly. Over a 20-year period, an incomplete nongrantor trust would produce a total benefit (state income tax savings plus earnings on reinvested tax savings, presuming half of the earnings are attributable to growth and thus not currently taxed, with the other half taxed at the highest marginal rate) of more than $1.3 million.

Consider a cost-benefit analysis

Incomplete nongrantor trusts aren't right for everyone. It depends on your particular circumstances and the tax laws in your home state. Also, while this strategy produces significant state income tax savings, it could also increase federal estate and income taxes. Why? Because

incomplete gifts remain in your estate for federal estate tax purposes. And nongrantor trusts pay federal income taxes at the highest marginal rate (currently, 39.6%) once income reaches $12,300 (for 2015).

To determine whether this strategy is right for you, ask your advisor to conduct a cost-benefit analysis that weighs the potential state income tax savings against the potential federal estate and income tax costs. ∎

Estate Planning Pitfall

You haven't named backup beneficiaries

To ensure that your wealth is distributed according to your wishes, it's important to designate both primary and secondary (or "contingent") beneficiaries for your will, trusts, retirement plans and life insurance policies. A 2012 federal court case demonstrates what can happen if you name a single beneficiary without a backup.

In *Herring v. Campbell*, the Fifth U.S. Circuit Court of Appeals held that a pension plan administrator didn't abuse her discretion in denying benefits to a deceased participant's stepsons. The retired employee had participated in a company pension plan that allowed him to designate a primary and secondary beneficiary. In 1990, and again in 2001, he designated his wife as primary beneficiary but didn't designate a secondary beneficiary. His wife died in 2004 and he died the following year without having designated a new beneficiary.

In the absence of a valid beneficiary, the plan called for benefits to be distributed in the following order of priority:

- Surviving spouse,
- Surviving children,
- Surviving parents,
- Surviving brothers and sisters, and
- Estate's executor or administrator.

After the employee died, the plan administrator denied benefits to his stepsons, even though he'd left his estate to them and referred to them in his will as his "beloved sons." Because he had no surviving spouse, parents or children, his six siblings received the benefits, totaling more than $300,000.

The court upheld the administrator's decision, rejecting the stepsons' claim that they should be treated as the employee's children under the doctrine of "equitable adoption." The administrator interpreted "children" to mean biological or legally adopted children, finding that to include equitably adopted children would create uncertainty and invite disputes over whether individuals have been equitably adopted. This, the court said, was a fair reading of the plan. Had the employee named his stepsons as secondary beneficiaries of the pension plan, this dispute could have been avoided.

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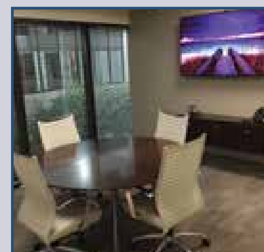
(David Siddall and Bill McQueen)



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Just six blocks to the east of our previous location on 2nd Avenue South, our new office is located in the City Center (Northern Trust Bank) building at:

100 – 2nd Avenue South, Suite 200N, St. Petersburg, Florida 33701

We appreciate all of your support in the success of our firm and look forward to serving you in our new office!

If you're ever in the area, we would love for you to stop by for a cup of coffee and a biscotti in our client café!

We welcome the opportunity to serve as your Guide, Counselor and Advocate as you commence on this important journey of your lifetime!

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