The Estate Planner

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Qualified disclaimers add flexibility

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No matter how carefully you plan your estate, changing circumstances can quickly derail your efforts. For example, federal or state tax laws may be amended; your net worth may go up (or down); you might get married (or divorced) or have a child; or your children's needs may change, making them less (or more) reliant on your wealth.

It's difficult, if not impossible, to design an estate plan that accommodates every possible contingency. But you can build some flexibility into your plan by preparing for the use of qualified disclaimers.

Setting the stage

How do disclaimers provide flexibility? They allow your beneficiaries to reject an inheritance, when appropriate, allowing your wealth to pass in a manner that's more tax-efficient or that better achieves your goals.

A disclaimer can be a powerful tool, but it requires careful planning. To avoid negative gift or estate tax consequences, a disclaimer must be "qualified," meaning:

- The disclaimer is in writing,
- The disclaimer is delivered to your estate's representative within nine months after the transfer is made (or, if later, within nine months after the beneficiary turns 21),
- The person making the disclaimer (the "disclaimant") hasn't accepted the property or any of its benefits, and
- The disclaimer causes the property to pass — without any direction from the disclaimant — to the transferor's spouse or to someone other than the disclaimant.

For a disclaimer to work, your plan needs to set the stage by spelling out what happens to property in the event it's disclaimed. To ensure that the property passes without any direction from the disclaimant, the terms of your will or living trust must name a contingent beneficiary.

Many benefits

The flexibility of qualified disclaimers can benefit your estate plan in light of a variety of changes:

Tax laws. As of this writing, there's no estate or generation-skipping transfer (GST) tax for people who die in 2010, but these taxes are scheduled to return in 2011 at higher levels than in 2009. Congress may pass estate tax law changes this year, but it's not certain what specifically they'll do.

They may reinstate the estate tax regime as it existed in 2009, or they may modify tax rates, exemption amounts or other provisions. They may put changes into effect beginning in 2011, beginning at the time the new law is passed or retroactively to Jan. 1, 2010. (Check with your estate planning advisor for the latest information.)

Without an estate tax, it may be desirable to leave all of your wealth to your surviving spouse. But if you die when the estate tax is in effect — or if you believe that your spouse's estate will be large enough to make estate taxes an issue in the future — your family might be better off if your assets are divided into marital and nonmarital shares. This makes the most of your estate tax exemption amount and reduces the size of your spouse's taxable estate.

Disclaimer-based planning can make your plan more flexible. For example, you might leave all of your assets outright to your spouse, but name a nonmarital trust or your children as contingent beneficiaries so your spouse can use disclaimers to redirect a portion of those assets if you die with a taxable estate or if your spouse's estate is likely to be subject to estate taxes.

Financial circumstances. Suppose your will leaves a significant inheritance to your daughter. By the time you die, however, your daughter has built a substantial estate of her own. If she accepts the inheritance, it will ultimately be taxed as part of her estate. With proper planning, your daughter can disclaim the inheritance and allow it to pass directly to her children (or to a trust for their benefit), avoiding double taxation. Before making a disclaimer, however, she should check to ensure it won't trigger GST taxes.

For a disclaimer to work, your estate plan needs to spell out what happens to property in the event it's disclaimed.

Charitable giving plans. Suppose your son is the primary beneficiary of your IRA and the contingent beneficiary is your favorite charity. Assuming that the estate tax is revived and your estate's value exceeds the applicable exemption amount, not only will the IRA carry a significant income tax liability, but it also will be subject to estate taxes. If your son is financially secure, however, he might disclaim the IRA and allow it to pass directly to the charity. By doing so, he eliminates the income tax liability while creating a charitable deduction that reduces the size of your taxable estate.

Mapping out a strategy

To determine whether disclaimers will benefit your family, work with your estate planning advisor to create an estate plan roadmap that outlines all the potential dispositions of your assets together with the potential tax and financial implications. This will allow you to identify points on the map where you might be better off letting beneficiaries choose their own route. ✤

Avoiding disclaimer pitfalls

As you consider the benefits of disclaimer planning (see main article), keep in mind that qualified disclaimers also have some disadvantages. For one thing, they depend on a beneficiary voluntarily relinquishing the right to an inheritance.

But your spouse or children may be reluctant to do so, even if their resources are more than sufficient to support their lifestyles. Or they might accept inherited assets without understanding the benefits of a disclaimer or recognizing that accepting the property disqualifies any future disclaimer. You can minimize these risks by communicating with your loved ones, explaining how disclaimers can benefit the family as a whole, and educating them about the requirements for qualified disclaimers.

Be particularly careful when disclaimed property will pass to a trust. Remember that, for a disclaimer to be qualified, the property must pass to someone other than the disclaimant (unless the disclaimant is a surviving spouse, in which case there are exceptions that allow him or her to have some access to the property). So, for example, if your child disclaims assets that are redirected into a trust in which he or she has a remainder interest, the disclaimer may be disqualified.

Let values be your trustee's guide

A principle trust may be a better option than an incentive trust

You want to pass your wealth on to your children after you're gone, but you also want the peace of mind that they'll manage the inheritance with responsibility and care. An incentive trust is one option, but there are drawbacks — primarily rigid distribution rules.

If you'd like more flexibility, a principle trust may be a better option. Rather than setting rules for distributions, you set the principles and values you want the trustee to follow. As long as you're at ease with your trustee having broader discretion, you may find that you can better achieve your goals with a principle trust.

Incentive trust's rigidity

An incentive trust attempts to shape your beneficiaries' behavior by conditioning distributions on specific benchmarks that are readily understandable and achievable. Examples include obtaining a college degree, maintaining gainful employment, or refraining from unacceptable behaviors such as drug or alcohol abuse.

In an effort to quantify acceptable behavior, some incentive trusts provide for matching distributions based on a beneficiary's salary or charitable donations. Unfortunately, this approach can lead to unintended consequences.

For example, if your trust conditions distributions on gainful employment or matches a beneficiary's salary dollar-for-dollar, it may discourage heirs from becoming stay-at-home parents, doing volunteer work or pursuing less lucrative but worthwhile careers, such as teaching or social work. If the benchmark is graduating from college or obtaining a graduate degree, the trust may unfairly penalize family members with disabilities or who simply lack the temperament or capacity for higher education.

One potential solution is to design a detailed trust document that attempts to cover every possible contingency or exception. Not only is this time-consuming and expensive, but, even with the most carefully drafted trust, there's a risk that you'll inadvertently disinherit a beneficiary who's leading a life that you'd be proud of. Or, the trust may reward a beneficiary who meets the conditions set forth in the trust but otherwise leads a life that's inconsistent with the principles and values you wish to promote.

Principle trust's flexibility

A principle trust guides the trustee's decisions by setting forth the principles and values you hope to instill in your beneficiaries. These principles and values may include virtually anything, from education

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and gainful employment to charitable endeavors and other "socially valuable" activities.

By providing the trustee with the discretion and flexibility to deal with each beneficiary and each situation on a case-by-case basis, it's more likely that the trust will reward behaviors that are consistent with your principles and values and discourage those that are not.

Suppose, for example, that you value a healthy lifestyle free of drug and alcohol abuse. An incentive trust might withhold distributions (beyond the bare necessities) from a beneficiary with a drug or alcohol problem, but this may do very little to change the beneficiary's behavior. The trustee of a principle trust, on the other hand, is free to distribute funds to pay for a rehabilitation program or medical care.

At the same time, the trustee of a principle trust has the flexibility to withhold funds from a beneficiary who appears to meet your requirements "on paper," but otherwise engages in behavior that violates your principles. Another advantage of a principle trust is that it gives the trustee the ability to withhold distributions from beneficiaries who neither need nor want the money, allowing the funds to continue growing and benefit future generations.

Must trust your trustee

Using a principle trust requires a great deal of trust in your trustee to properly interpret the specific conditions under which trust distributions will be made to — or withheld from — your beneficiaries. That being said, a principle trust can give you the peace of mind that, no matter what the future holds for your children, your estate plan has the flexibility to accommodate their well-being. ✤

Avoiding probate: How to do it (and why)

Few estate planning subjects are as misunderstood as probate. But circumventing the probate process is usually a good idea, and several tools are available to help you do just that.

Why should you avoid it?

Probate is a legal procedure in which a court establishes the validity of your will, determines the value of your estate, resolves creditors' claims, provides for the payment of taxes and other debts, and transfers assets to your heirs.

Depending on applicable state law, probate can be expensive and time consuming. Not only can probate reduce the amount of your estate in the form of executor and attorney fees, but it can also force your family to wait through weeks or months of court hearings. In addition, probate is a public process, so you can forget about keeping your financial affairs private.

Is probate ever desirable? Sometimes. Under certain circumstances, for example, you might feel more comfortable having a court resolve issues involving your heirs and creditors. Another possible advantage is that probate places strict time limits on creditor claims and settles claims quickly.

How do you avoid it?

There are several tools you can use to avoid (or minimize) probate. (You'll still need a will — and probate — to deal with guardianship of minor children, disposition of personal property and certain other matters.)

The right strategies depend on the size and complexity of your estate. The simplest ways to avoid probate involve designating beneficiaries or titling assets in a manner that allows them to be transferred directly to your beneficiaries outside your will. So, for example, you should be sure that you have appropriate, valid beneficiary designations for assets such as life insurance policies, annuities and IRAs, and other retirement plans.

For larger, more complicated estates, a revocable trust (sometimes called a living trust) is generally the most effective tool for avoiding probate.

For assets such as bank and brokerage accounts, look into the availability of "pay on death" (POD) or "transfer on death" (TOD) designations, which allow these assets to avoid probate and pass directly to your designated beneficiaries. Keep in mind, though, that while the POD or TOD designation is permitted in most states, not all financial institutions and firms make this option available.

Some people avoid probate on their homes or other real estate — as well as bank and brokerage accounts and other assets — by holding title with a spouse or child as "joint tenants with rights of survivorship" or as "tenants by the entirety." But joint ownership has several significant drawbacks.

First, unlike with beneficiary designations, once you retitle property you can't change your mind. Second, holding title jointly gives your spouse or child some control over the asset and exposes it to his or her creditors. Finally, adding someone to the title may be considered a taxable gift of half the asset's value.

A handful of states permit TOD deeds, which allow you to designate a beneficiary who will succeed to ownership of real estate after you die. TOD deeds allow you to avoid probate without making an irrevocable gift or exposing the property to your beneficiary's creditors. This tool may become available in more states in the future.

What if your estate is more complicated?

For larger, more complicated estates, a revocable trust (sometimes called a living trust) is generally the most effective tool for avoiding probate. A revocable trust involves some setup costs, but it allows you to manage the disposition of all of your wealth in one document while retaining control and reserving the right to modify your plan. It also provides a variety of tax-planning opportunities.

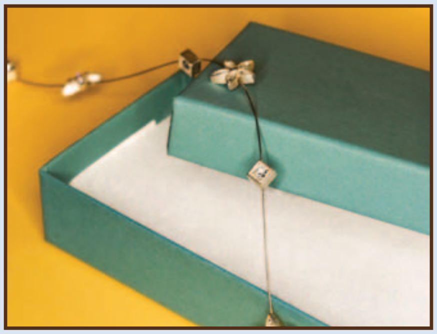
To avoid probate, it's critical to transfer title to all of your assets, now and in the future, to the trust. For IRAs and retirement plans, you can avoid probate simply by naming a beneficiary other than your estate, though it may be desirable to name a trust as beneficiary to control how the assets are distributed. Also, placing life insurance policies in an irrevocable life insurance trust (ILIT) can provide significant tax benefits.

The big picture

Avoiding probate is just part of estate planning. Your estate planning advisor can help you develop a strategy that minimizes probate while reducing taxes and achieving your other estate planning goals. ✤

Estate Planning Red Flag

Your plan doesn't provide for personal items



It's natural that your estate planning efforts focus on big-ticket items, such as real estate, business interests, retirement assets and brokerage accounts. But don't ignore the "small stuff," like artwork, jewelry, furniture, antiques, clothing and collectibles. These items may not be as insignificant as you think.

You may be surprised to find out how valuable your artwork and other personal items really are. Plus, even if an item has little monetary value, it may have strong sentimental value, so failing to provide for its disposition can lead to hurt feelings, arguments among family members or even litigation.

It's important to monitor the value of your personal property. For estate tax purposes, if an item is worth more than $3,000 — or if a collection of similar items is worth more than $10,000 — a written appraisal by a qualified appraiser must accompany the estate tax return. Gifts or bequests of art valued at $20,000 or more will, upon audit, be referred to the IRS Art Advisory Panel.

And professional appraisals are required for certain charitable deductions. For income tax purposes, for example, noncash charitable gifts worth more than $5,000 must be supported by a qualified appraisal.

If you plan to leave personal property to your heirs in a will or trust, it's usually preferable to bequeath specific items to specific people. Transferring personal property through residual gifts — that is, gifts of assets left over after all other gifts and expenses have been paid — or allowing family members to choose the items they'd like to keep can result in disputes and, in some cases, unexpected tax liabilities or other negative tax consequences.