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Navigating a Non-Tax Estate Planning Maze with Some Tax Considerations

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By Marc S. Bekerman

Much attention is given to the income and transfer tax considerations in preparing and implementing an estate plan. But relatively few clients are affected by these concerns. This article will review some of the important nontax considerations that can affect the drafting and implementing of almost any estate plan.

Fundamental Skills

Although the field of trusts and estates lends itself at times to specific specializations, the attorney's fundamental skills are all equally applicable in preparing and implementing an estate plan for a client. One such skill is obtaining information from clients (usually referred to as the client interview). A successful client interview permits the estate planner to formulate an appropriate estate plan for the particular client, taking into consideration the client's individual facts and circumstances together with the applicable federal and local law. Any failure in the client interview will likely have a negative effect on the ultimate estate plan.

Another fundamental skill is the ability to proofread documents before execution by the client to ensure that the document is correct and does not contain any errors. This is especially true with estate planning documents, which often cannot be corrected after the death of the client. It is not unusual, however, to see typographical errors in estate planning documents that were executed by the client. Often these errors are unimportant, although such errors can lead to construction proceedings to determine how the instrument is to be read in light of the error. Further, depending on the error in question, even a construction proceeding may not result in the wishes of the client being effectuated. As such, proofreading is an important part of drafting and implementing any estate plan.

Patent and Latent Ambiguities

Unfortunately, despite the best efforts of estate planners and their clients, documents are frequently unclear. An ambiguity is classified as either patent or latent.

A patent ambiguity is apparent on the face of the instrument to anyone who may review the document, even if he is not familiar with the particular facts and circumstances. Most patent ambiguities are avoidable in that they can be addressed before execution of the document because thorough proofreading should identify these types of mistakes. An example of such an ambiguity is "I leave to my son the amount of One Hundred Thousand ($200,000) Dollars."

A latent ambiguity is not apparent on the face of the document but is instead created by applying the terms of the document to the particular facts and circumstances. Latent ambiguities are much more difficult to avoid because the ambiguity may result from a number of factors ranging from poor drafting, to a failure to have sufficient information to understand that the provision may be ambiguous under the client's particular facts and circumstances, to a change in circumstances after the execution of the document. An example of a latent ambiguity is "I leave my watch to my daughter," but the decedent dies with two watches and three daughters. The reason for such a clause can range from draftsman's error to the client's having only one watch and one daughter at the time of planning and execution. Although a latent ambiguity may be explained by parol evidence (as opposed to a patent ambiguity in which the admission of parol evidence is much more limited), it is still best to try to ensure that the terms of the document are not likely to have more than one interpretation no matter the facts and circumstances at a later time. Using our example, the instrument could have identified the specific watch that was the subject of the bequest (as opposed to a general statement of "my watch") or included all of the decedent's watches in the bequest (as opposed to only one). Further, the instrument could have identified either the particular child by name as the beneficiary or made the bequest to the class of the decedent's daughters, depending on the client's intent.

Drafting Issues

The client's intent is the ultimate consideration in formulating and drafting any estate plan. Another vital consideration is the applicable provisions of state law that can place limitations on what the client can do (such as a ban on the use of in terrorem clauses) or provide default provisions for an estate plan (such as the powers of a fiduciary and the laws of intestacy). An estate planner should understand the default provisions of his or her particular jurisdiction to determine when such defaults should be addressed (either by reinforcing the default or by opting-out of the default when possible) and to determine when the defaults should be accepted without further drafting. As

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Max Licht

part of his or her consideration of state law, the estate planner must account for the possibility that the client may change his or her domicile after preparation of the estate plan.

The powers to be given to a fiduciary are an excellent example of needing to consider both the needs of the particular client together with the defaults of state law. An estate planner must know what powers will be provided under state law and determine whether any additional powers should be granted (and whether any powers should be specifically denied) while balancing the possibility that the law of another jurisdiction may be involved after the client dies. Among the powers to consider granting a fiduciary include the following:

Tax Provisions:
—Authorize fiduciary to make any available elections under the Internal Revenue Code and applicable local law.
—Authorize fiduciary to file applicable tax returns (such as income tax or gift tax returns) together with the surviving spouse, if any.
—Authorize fiduciary to determine whether to use expenses as a deduction on the estate tax return versus the income tax return.
—Provide the ability to have a trust qualify as a shareholder of a Subchapter S corporation if needed (either as a qualified Subchapter S trust or an electing small business trust).

Investment and Property Management Provisions:
—Retain property even if disregarding the current rules regarding diversification.
—Retain property even if nonincome producing (but need to be careful if using a marital deduction trust).
—Sell property at either a public or private sale.
—Sell property for either cash or credit.
—Grant options on the sale or purchase of property.
—Manage real property, including leasing and renewing of such leases (even if beyond the term of the service of the fiduciary), insuring the property, making repairs to the property (even extraordinary repairs), razing buildings, and partitioning the property (including an agreement to such a partition).
—Grant broad authority as to the nature of investments to be held.
—Borrow on behalf of the estate in the discretion of the fiduciary and execute applicable loan and security documents (including mortgages).
—Allow prepayment of debts.
—Exercise stock options (including employee stock options).
—Continue the operation of a business (including the ability to create and use an entity to minimize the estate's potential liability, if appropriate).
—Extend the time of payment of any obligation either owed to the client or owed by the client.
—Use arbitration to resolve claims and issues to the extent that local law permits such a procedure and the fiduciary believes it to be in the best interest of the estate.

Principal and Income Provisions:
—Allocate all receipts between principal and income in the discretion of the fiduciary.
—Allocate payments from the estate between principal and income in the discretion of the fiduciary.

Miscellaneous Provisions:
—Authorize the fiduciary to appoint agents to act on behalf of the estate (consider whether the fiduciary's discretionary powers may be delegated to such agents under local law).
—Authorize fiduciary to retain legal, accounting, investment, and custodial services and to pay reasonable compensation for such services.
—Dispense with the filing of a bond (even if a preliminary or temporary appointment).
—Satisfy general legacies by a distribution in kind.
—Permit distributions in kind to all beneficiaries.

One approach that may be useful is to incorporate certain fiduciary powers by reference. This technique permits the draftsman to specifically incorporate into the document the powers granted to a fiduciary under state law. Such a provision could read:

> My [Executor/Executrix/Personal Representative/Trustee] shall have all of the powers granted under the applicable provisions of the law of the State of [Current Jurisdiction] together with the powers granted under the applicable provisions in every jurisdiction in which my fiduciaries may act. In addition, the following powers are conferred upon my fiduciaries: [followed by any specific powers to be inserted].

Issues Pertaining to Bequests

One concern to both the estate planner and the estate administrator is the treatment of a bequest made to a beneficiary who did not survive the client. If the gift is to a predeceased family member within a certain degree of consanguinuity, current law may prevent a lapse of such a gift by providing that the gift instead pass to the beneficiary's descendants. An estate planner must understand his or her jurisdiction's anti-lapse statute and how it would apply to a particular estate plan. Generally, there are three issues to consider:

1. Does *the anti-lapse statute apply to the instrument in question?* For example, the anti-lapse statute in New York applies to wills but not to inter-vivos trusts. If the anti-lapse statute will not apply to a particular document, particular care needs to be taken to provide for alternative beneficiaries to ensure that the client's donative intent will be satisfied.
2. How *does the anti-lapse statute apply to a particular gift?* The estate planner should discuss with a

client the intended contingent beneficiaries for gifts made under the estate plan to determine whether they are in accord with the result under the anti-lapse statute.

3. How *do we draft in consideration of the anti-lapse statute?* If the anti-lapse statute does not apply to a particular bequest it is usually a simple matter to ascertain the client's intended contingent beneficiaries and draft accordingly. If the client wishes for the bequest to lapse, then no additional drafting need be done (although there may be nothing wrong with specifically stating in the document that the bequest will lapse if the beneficiary fails to survive). If the client does not wish for the bequest to lapse, then the contingent beneficiaries should be recited appropriately.

   If the anti-lapse statute will apply to a particular bequest, further analysis will be necessary. If the client wishes to permit the anti-lapse statute to apply, no additional drafting need be done (again understanding that it may be appropriate to make some sort of statement in the instrument regarding the desired contingent beneficiary). If the client wishes to "opt out" of the anti-lapse statute, the estate planner will need to know how to do so under local law because some jurisdictions require a specific and clear statement of intent for a bequest to fall outside the anti-lapse statute (that is, the mere phrase "if she survives me" after the bequest will not be sufficient to have the bequest fall into the residuary estate if that is the testator's intent absent an additional statement somewhere within the terms of the instrument).

When discussing contingent beneficiaries, clients will often look to the descendants of the original beneficiary whether or not the anti-lapse statute is applicable (for example, a gift to a child of the client that passes to the grandchildren should the child predecease).

Estate planners frequently employ the phrase "issue per stirpes" to represent such a gift. It is interesting to note, however, that many states have changed their laws so that either the definition of per stirpes is not the "classic" definition of per stirpes or that distributions are made using a concept of "representation." It is important to note the potential effect of state law on descent and distribution whether it is a "per stirpes" distribution or a "representation" distribution.

One concern to both the estate planner and the estate administrator is the treatment of a bequest made to a beneficiary who did not survive the client.

Example: A decedent provides that her estate is to be distributed to her issue per stirpes. The decedent's spouse and two children predecease the decedent. The decedent is survived by three grandchildren (one from his predeceased son and two from his predeceased daughter). The "classical" per stirpes distribution would result in one grandchild receiving 50% of the estate (the son's child) and the other grandchildren each receiving 25% of the estate (each of the daughter's children). It may be that this corresponds to the decedent's intent, but given the facts and circumstances, the decedent may have wanted to treat each of his grandchildren equally (that is, one-third to each grandchild). As such, it is important to know the effect of the language used under state law.

Because of the potential for confusion, it may be helpful to provide an example within the document of the client's intent where appropriate.

Another frequent request from clients is to use trusts for the benefit of their children and other descendants. In addition to the use of the terms "per stirpes" or "by representation," another issue that faces estate planners and their clients is whether to use one trust for multiple beneficiaries (a "pot trust") or separate trusts for each beneficiary. A pot trust contemplates that the entire amount distributable from the estate be paid into one trust for the benefit of all of the beneficiaries until the termination of the trust (usually when the youngest child reaches a certain age). At termination, the remaining property is split equally among the remaindermen without consideration of prior distributions either outright or in further trust. By comparison, separate share trusts contemplate the division of the property among the beneficiaries before distribution from the estate to the trust. Each trust is then managed for the benefit of the beneficiaries of the particular trust. Each approach has both its benefits and drawbacks.

- Pot trusts permit all trust resources to be available to all beneficiaries during the duration of the pot trust. This may be helpful if one beneficiary has greater needs than other beneficiaries (for example, because of educational or medical expenses). This also may be helpful if one beneficiary has significantly more resources than other beneficiaries (for example, a financially successful professional versus a civil servant).
- Younger beneficiaries of pot trusts may find themselves with lesser inheritances if the funds have been used for older beneficiaries. Correspondingly, older beneficiaries may be told that there are limits on their benefits to preserve property for younger beneficiaries.
- Pot trusts require the oldest children to wait for the youngest children to attain a certain age, thereby deferring their outright receipt of their inheritance.

As with many other aspects of estate planning, the trust should be drafted in

accordance with the wishes of the particular client.

One area where a client will often have particular desires to be implemented is the disposition of his or her tangible personal property. This can be a difficult task for the estate planner, depending on the client's intent. Under appropriate circumstances, the client may simply leave such disposition to the discretion of either the beneficiaries or the fiduciary. One possible provision that accomplishes this goal is:

> I give my household and personal effects to my children as they shall agree. If my children are unable to agree upon a division of such property, then I direct my Executors to make such division among said children in equal shares in the Executors' absolute discretion, and such division shall be binding and conclusive on said children. In the event my Executors do not distribute such property, then my Executors shall sell such undistributed property and the proceeds shall be disposed of as part of my Residuary Estate.

Unfortunately the disposition of tangible personal property is not always accomplished by this relatively simple provision because the children may not be able to agree, not all of the children may be executors, there may be other beneficiaries to be included (such as a second spouse who is not the parent of the children), or the client may have very specific ideas about which items should go to which beneficiary. Under more complicated circumstances, additional analysis and consultation with the client will be necessary.

One possible solution is to use incorporation by reference as permitted by local law. For a jurisdiction that does not permit incorporation by reference, the will must recite all of the specific bequests, and any item not specifically bequeathed will pass as part of the residuary estate. But, if a jurisdiction does permit incorporation by reference, the client can leave a writing outside of the will that identifies the items of the decedent's property and the decedent's intended beneficiary for each item (again, any item that is not the subject of a specific bequest will fall into the residuary estate). Although incorporation by reference permits greater flexibility to a client, it is important to explain to the client whether any particular rules govern the use of an outside writing in the jurisdiction as well as the importance of leaving the last writing in a place where it will be easily located. As such, incorporation by reference addresses certain concerns while raising other concerns.

One area where a client will often have particular desires to be implemented is the disposition of his or her tangible personal property.

There are other considerations in drafting provisions for the handling of the client's tangible personal property after his or her death besides the actual disposition of the property. Because there is usually a delay between the decedent's death and the disposition of the decedent's tangible personal property either by sale or distribution, it will likely be prudent for the property to continue to be insured until the actual disposition by the estate. Further, depending on the particular facts and circumstances, it may be necessary for the estate to pay for storage of the decedent's property until distribution or sale can be effectuated. As such, the estate planner should consider whether the fiduciary should be authorized to use estate funds to pay for insurance and storage. Similarly, there may be significant expenses in the beneficiary's taking possession of the property, depending on the nature of the item and the location of the beneficiary, that must be borne by either the estate or the beneficiary. The estate planner should determine the client's wishes for who should bear the burden of this expense and draft the instrument accordingly. This may be a significant issue, especially if the beneficiaries of the tangible personal property are not the residuary beneficiaries of the estate. One sample provision is:

> All costs incurred by my Executor in connection with obtaining possession, appraising, safeguarding (including storing and insuring such property), delivering, or selling such property shall be paid as expenses of administering my estate.

Another issue that may arise in the distribution of personal property is when an item that is specifically bequeathed or devised is not present in the decedent's estate, thereby raising the issue on whether the gift is to be satisfied. Such a gift is said to adeem, and this will usually occur when the subject property has been disposed of by the decedent during her lifetime (perhaps by sale or inter-vivos gift).

Consider the bequest, "I give my 2005 Honda Accord to my son." If the decedent does not own a 2005 Honda Accord at the time of his death, the bequest is said to adeem and will fail unless local law or the instrument seeks to save the bequest. Assuming that the bequest fails, the beneficiary under the will does not even receive the value of the property that has adeemed. Contrast this result with a bequest that provides, "I give a 2005 Honda Accord to my son." If the decedent does not own a 2005 Honda Accord at the time of his or her death, local law may indeed require the fiduciary to either obtain a 2005 Honda Accord with estate assets to distribute to the decedent's son, or to simply give the decedent's son the cash value of a 2005 Honda Accord. Because of the transitory nature of ownership of tangible personal property, an estate planner should confirm the client's wishes when making gifts of specific property

that may not be in the decedent's estate at death to properly address the possibility of ademption.

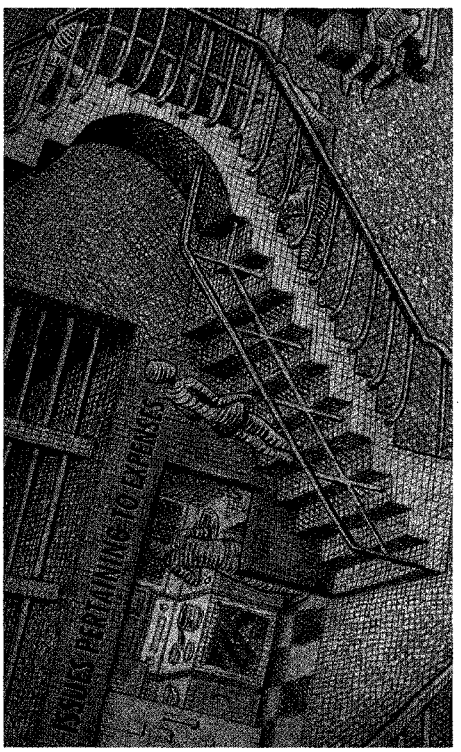
Issues Pertaining to Expenses

The expenses incurred in the settlement of an estate are typically allocated to the residuary estate (or remainder of a trust). There may be times, however, when certain expenses may be allocated to shares other than the residuary estate. For example, when a client owns real property subject to a mortgage, the estate planner needs to determine whether the client wishes for the mortgage to be satisfied before distribution (that is, the expense is allocated to the residuary share) or whether the client wishes for the beneficiary to take the property subject to the mortgage (that is, allocated to the pre-residuary gift).

One expense that is the subject of much discussion is the apportionment of estate taxes among beneficiaries. It is important to consider that such apportionment is as important as the dispositive provisions of a will in that it is taking money from certain beneficiaries to meet a legal obligation of the estate. Each state has its own law that provides the default provisions for how estate taxes are to be apportioned among the beneficiaries. Typically, an attorney should explain how state law would allocate the estate taxes among the beneficiaries and adjust in accordance with the client's wishes. Clients may want to consider some of the following:

- **Pre-residuary Bequests vs. Residuary Bequests**—Apportioning estate taxes against residuary bequests will reduce the amounts passing to those beneficiaries who are usually the beneficiaries that the client intends to benefit the most. But apportioning estate taxes against the pre-residuary bequests may delay the satisfaction of such bequests as the fiduciary will likely need to determine the estate tax allocable to each preresiduary bequest and secure payment before making distributions to such beneficiaries. There are also the following additional considerations in making an apportionment of estate taxes against the preresiduary gifts:

—*Specific Bequests of Tangible Personal Property*—If a client wishes to leave an item of tangible personal property to a beneficiary, it may be best to allocate any estate tax attributable to such bequest to be paid from the residuary estate so as to avoid the beneficiary's needing to sell the item to pay the applicable estate tax.



—*Specific Devises of Real Estate*—Although the considerations are similar to the specific bequest of tangible personal property, the client may wish to consider that the beneficiary may be able to obtain a mortgage secured by the property to permit payment of the applicable estate tax without the need to sell the property (although timing of the payment may be a concern given that estate taxes must generally be paid nine months after death).

—*General Legacies*—The client must weigh whether he or she wishes to make a bequest of a gross amount or a gift of the net amount (that is, the amount of the gift in the instrument less the applicable estate tax).

- **Nontestamentary Assets**—The estate taxes attributable to nontestamentary assets can be specifically apportioned against such assets. If such an apportionment is made, the fiduciary will usually need to collect the applicable estate tax from the beneficiary because nontestamentary assets are often collected by the beneficiary shortly after the decedent's death. Again, care should be taken that such an apportionment comports with the wishes of the client.

  A special example of nontestamentary assets is a QTIP trust in the estate of the surviving spouse. Under the Internal Revenue Code, the principal of the QTIP trust is available to pay the estate tax attributable to the QTIP trust in the amount by which the inclusion of the QTIP trust increases the estate tax (as opposed to the percentage approach usually employed in an apportionment of estate taxes).
- **Special Beneficiary Problems**—It should be noted that qualifying bequests to surviving spouses and certain charitable organizations do not generate an estate tax because the gifts qualify for an estate tax deduction. But, if estate taxes from other beneficiaries are apportioned against a marital or charitable share that would otherwise qualify for an estate tax deduction, such allocation of estate taxes will result in a reduction of the allowable deduction. This will result in an interrelated calculation that will increase in the estate taxes ultimately payable versus an apportionment of the estate tax to the nonqualifying beneficiary.

Conclusion

The nontax issues in formulating and drafting an estate plan are applicable to many clients, and proper attention must be paid to these issues to properly implement the client's wishes. ■