Basic Estate Planning Documents: Wills, Trusts, and Gifting

Editor's note: The following narrative is edited from part of a series produced by John Baker, Esq. of the Iowa Beginning Farmer Center. It has been edited to account for the recent changes in the Federal Estate Tax that became law on January 1, 2011. Note the current law is set to expire December 31, 2012.

A **Will** is a legal document that directs the court how to distribute your assets after death. In order to create a will you must be competent enough to know the nature and extent of your estate, be able to formulate a plan of distribution, know the natural objects of your bounty and understand the relationship of the above.

A will must also be signed by the testator (person for whom the will is written) and signed by two competent and disinterested witnesses - who will not benefit under the will - in the presence of the testator and each other. Wills must be revoked and/or amended with the same formality with which they are made. Any handwritten modifications to a will have no effect, absent certain legal formalities.

What happens to my property if I don't have a will?

It is often said that there is no such thing as no estate plan. If you do not have a properly executed - and therefore valid - will, there is a plan for the distribution of your property and farm business assets in the general statutes. Dying without a will is known as intestacy. The intestate distribution scheme under state law covers exhaustive scenarios based on who is living and not living at the time of your death. Suffice it to say, if you plan to keep land interests in the family or pass a farm business within the family or to someone else, the ownership diffusion of intestate succession on the farm assets makes it highly unlikely that your farm will pass intact.

Can I disinherit my family in my will?

If a surviving spouse is not happy with property given by will, the spouse can elect to take against the will and take the statutory amount instead. In Virgnia, this is known as the Augmented Estate, and the surviving spouse can elect to receive a share of the decedent's total net assets. In Virginia there is no statutory provision protecting disinherited children. However, if fraud, undue influence, or improper execution of the will can be proven, children may be able to assert inheritance rights.

What will happen to my estate after I die?

The probate process is the legal process for proving the validity of a will and distributing your assets according to that will. The person who is named in the will as executor will be in charge of the probate process. The process can be lengthy and costly and usually lasts several months. With the supervision of the county clerk of court or probate clerk, the executor must identify and inventory property of the deceased, have the property appraised, pay all debts and taxes and finally distribute the remaining property as the will directs. If you die intestate (without a will), the same process will take place except the court will appoint an administrator of its choosing to carry out the probate process and the remaining property will be distributed according to state law instead of as directed by a will.

Probate is a public process and the proceedings will be available in public records. The property may also be tied up in the process for several months and will not be readily available to the heirs. For these reasons, many people try to avoid extensive probate proceedings. Property held in living trusts, joint bank accounts or pay on death accounts, real estate held in joint tenancy, and some life insurance proceeds are not subject to probate. However, it is strongly advised you not take probate-avoidance manoevers without the advice of a legal professional. Also, probate may be necessary to get real property titled in the name(s) of the proper successor(s).

Trusts

A trust is a legal entity that separates the management of property from the enjoyment of property. A settlor, the creator of a trust, transfers title of his or her assets into the name of the trust; this is called funding the trust. This property, which is held in trust, is called corpus, principal or the trust estate. A trust instrument is the set of documents creating and detailing the terms of the trust. The instrument names a trustee to manage the trust property and one or more backup trustees. It

also names the beneficiaries who will receive proceeds from the trust during the life of the trust and the beneficiaries who will receive the trust assets when the trust is dissolved.

Reasons for establishing trusts include: avoiding or minimizing probate costs, guard against will contests, protect privacy in property transfers, protecting assets from risks associated with beneficiaries, allow for someone else to manage your property when you no long wish to or in the case you are no longer able to, allow someone else to manage property for minors, and in some cases to save estate tax. Trust options today are only limited by the creativity of the settlors and may serve different purposes depending on the terms. Outlined below are several of the more common types of trusts.

Living Trusts

A revocable living trust is created by the settlor during their lifetime and the settlor retains the power to destroy (revoke) the trust at any time during their life. Only at the death of the settlor does the trust become permanent (irrevocable).

A revocable living trust is sometimes referred to as a substitute for a will because its main purpose is to avoid probate of trust assets. Probate is avoided because the assets are no longer property of the deceased, but are owned by the trust – even though the deceased may have been both the trustee and the beneficiary. These trusts are particularly useful when property is held in several states and therefore would have to be probated in each respective state. Although probate costs are avoided, trusts cost more to create than a will because trusts are much more complicated to draft and fees may be associated with changing the title of assets if placed in the trust. In addition to avoiding probate, trusts are less susceptible to attack than a will, because the trust has been in existence for some time before death. The court accepts the fact that the settlor could have changed the terms of the trust during their lifetime as proof that the trust will operate in accordance to their wishes.

Because the settlor retains control of the assets during life (settlor retains the power to revoke the trust and have the property returned), the property remains part of the taxable estate. Revocable living trusts are not useful for reducing the value of the estate for estate tax planning purposes, except for enabling spouses to split their estates to keep the value of their separate estates under their applicable exemptions.

Revocable living trusts should be used in conjunction with a "pour over will". Since a will directs the court how to dispose of your assets at death, this provision will act as a catch-all and direct property still titled under your name to "pour" into the trust, normally to take advantage of an estate tax exemption of the first spouse to die.

Irrevocable Trusts

An irrevocable intervivos trust is a trust created during life that cannot be terminated once created. If created and managed correctly, these trusts can reduce the value of the taxable estate. The property will not be included in the value of the settlor's estate only if the settlor has permanently forfeited the property. Therefore, the settlor must not retain any interest in the income or corpus of the trust; it must benefit others. Additionally, the settlor cannot retain the power to change or transfer the property or the property will be included in the settlor's taxable estate. These trusts are often used to own life insurance policies, as insurance proceeds are normally part of your taxable estate.

Transferring property into an irrevocable trust is essentially a gift to the beneficiaries and transfers may be subject to gift tax. Annual amounts over the current annual gift exemption transferred into the trust will be subject to gift tax. Under current law, an election can be made to transfer up to $5 million into the trust without paying gift tax; however, the transfer will reduce the unified credit and increase the amount of your estate that will be subject to estate tax. (as noted above, this amount is only in place until December 31, 2012) For very large estates, it may be valuable to make the election so that property appreciates in the trust instead of in the estate. Since the property must be forfeited by the settlor, the beneficiaries must have a present interest in the trust property.

Other types of trusts include testamentary or pour over trusts which are established by will. Spendthrift trusts protect assets which may be recklessly spent by beneficiaries, by limiting the rights of the beneficiary to sell or spend the trust corpus or principal. A Qualified Terminable Interest Trust (QTIP) provides a surviving spouse income during his or her lifetime.

Charitable remainder trusts allows the settlor to contribute their property to charity and receive the income from the property over their lifetime. Special Needs Trusts can protect a disabled or elderly

individual's qualification for supplemental security income or medicaid.

Consequences of creating a trust including managerial capabilities, tax advantages and disadvantages, and revocability will vary greatly depending your specific circumstances. Consult with your attorney for more details.

Gifting

Giving assets to the next generation before death may be useful to decrease the size of very large taxable estates or to pass farm assets to cash poor successors. Gifting may seem simple at first, but there are several potential problem areas.

In order to make a gift you must have intent to give the property and there must be actual or constructive receipt of the gift. If property to be given cannot actually be moved into the possession of the recipient, there must be constructive delivery. Constructive delivery is some action or transfer that is symbolic of the actual transfer; for example, giving the keys to a car if the car is not in the same vicinity as you. Other examples of constructive delivery include handing over (or recording) the deed to land or a photo of the object to be transferred. Additionally, delivery must take place at the same time as intent to give is expressed. For example, Dad says, "I want you to have my John Deere A when I die." This statement does not satisfy the requirements of a gift because the tractor was not actually handed over at the same time Dad expressed his intent to give. The tractor will become part of Dad's estate and be distributed according to his will. Some one else may end up with the tractor.

Gifts must be given free of any restrictions and are not revocable. The donor (giver) must be ready to completely part with the property. For example, Dad gives Son five cows and the cows are moved to the Son's pasture. However, Dad still checks them every day, decides which bull to breed them to, and continues to make all managerial decisions regarding the five cows; anyone challenging the gift could argue it was not a gift but a loan or a lease, and the cows will still be part of Dad's estate. Additionally, if Dad reserves the right to take the cows back or receive proceeds from use or sale, no gift was made. It is a good practice to execute a gift declaration describing the property, and to have the gift recipient sign the declaration acknowledging receipt of the gift.

Tax Implications of Gifting

In 2012, the annual exclusion amount remains $13,000. This means that any one donor can make a gift of $13,000 to each recipient without filing a gift tax return, being subject to gift tax or affecting the unified credit (amount of your estate excluded from estate tax) of the donor. Husbands and wives can combine their annual exclusion and give any recipient an annual tax-free gift of $26,000. Any gifted amount in excess of $13,000 per donor/donee will result in a corresponding reduction in their federal estate exclusion and thus affect the size of the donor's taxable estate at death. Gifts for payment of educational and medical expenses are tax exempt. In 2013, the annual exclusion is scheduled to increase to $14,000. (See "About the Estate Tax" pg 57 for more information on the lifetime gift tax exemption).

Gifts in any amount are excluded from the recipient's gross income for tax purposes. However, if the recipient decides to sell gifted property there may be significant capital gains taxes. Generally, "basis" is your cost of acquiring property plus the cost of improvements less cumulative depreciation. Capital gain is the sale price of the property minus your basis. When property is transferred by gift, the recipient must take the donor's basis in the property which may be much less than the current fair market value and may result in large capital gains if sold. If an heir receives an asset at death by will or living revocable trust instead of during the life of the donor, they will receive a "stepped up basis" which is equal to the fair market value at the time of death. Time of death transfers will significantly reduce capital gains tax if the recipient decides to sell the property.