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The Basics of Estate Planning

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Introduction

The purpose of this memorandum is to provide a basic overview of a few of the basic estate planning techniques available to individuals, and their families. Estate planning is simply the process during both life and death of setting your legal and financial affairs in order. Estate planning can be categorized into two planning areas of emphasis, namely life planning and death planning. Unfortunately, many individuals incorrectly associate estate planning with only "death planning," and while much of estate planning deals with the ultimate demise of an individual, life planning is an integral part of each estate plan.

Estate planning encompasses both financial and non-financial issues. Proper estate planning during life can greatly reduce or eliminate many death-related expenses, and reduce the stress and confusion for the surviving beneficiaries. Preparing an effective estate plan will assist individuals is developing greater financial organization with their business and financial assets during life, and assist in the orderly disposition of those assets at death.

What is Probate?

In order to properly discuss these estate planning techniques, it is helpful to understand the definition of probate. Probate is simply the judicial and/or administrative process whereby assets titled in the name of a deceased person are transferred into the name of a living person.

The Probate Process

The probate process, while created to reduce the risk of mismanagement or misappropriation of assets of the deceased, creates delay and expense to the beneficiaries in receiving assets from the estate. While some attorneys provide probate services which are billed by the hour, others charge a percentage of the value of the estate, typically between 3-5 percent. Either way, it is advantageous to avoid the probate process.

Estate Planning: Only a Will

While the preparation of a will facilitates the orderly disposition of one's assets and designates your wishes concerning guardianship and other responsibilities, it subjects the estate of an individual to the probate process. Many individuals incorrectly believe that establishing a will avoids the need for the probate process. Unfortunately, having only a will guarantees that assets in your estate <u>must</u> pass through the probate process.

Therefore, various attorneys advertise very inexpensive wills to the public, knowing that their name and other contact information will be on the will when the individual dies.

The beneficiaries will likely find the will, look at the name of the attorney who drafted it, and call for him to represent them in the probate process for a percentage of the estate. This scenario is commonly referred to by some as the "don't pay me now, pay me later" approach to estate planning. Due to the initial costs of estate planning, various individuals choose this approach. The following example will illustrate this approach.

Example 1: At death, Mary, a widow, owns a small home, free and clear of any mortgage, valued at $200,000, an automobile valued at $15,000, a bank account with $10,000, and investments worth $75,000. Prior to her death, she met with her attorney for the purpose of drafting a will. She paid her attorney approximately $100 for this service. Her beneficiaries under the will are her three children. Shortly after Mary's death, the three children enter her home and find her will. They inspect the will, and determine that it was drafted by her attorney. They contact her attorney, and he agrees to handle the probate of Mary's estate for 5% of the value of the estate. The value of the probate estate is $300,000. The attorney earns 5% or $15,000, payable from property that would otherwise be given to the children.

This example illustrates the real costs associated with a "don't pay me now, pay me later" approach to estate planning, which ultimately is a lucrative arrangement for the attorney.

Estate Planning: Will and Beneficiary Deed

However there are ways to reduce the cost of probate, even with a will. One such strategy includes the use of a grantor's deed to become effective upon death, commonly called a, "beneficiary deed" or "transfer on death deed." In 2005, the Nevada Legislature passed a bill, which came to be known as NRS 111.109, authorizing the use of a deed that permitted the owner of real property to transfer an ownership interest to another individual or individuals at owner's death. The recording of the beneficiary deed does not immediately transfer ownership to the beneficiary, but rather provides the beneficiary with the right of ownership in the event the original owner dies owning the property. The original owner or grantor still retains ownership of the property until death, and can even sell the property without consent of the beneficiary, effectively voiding the beneficiary deed. The following example will illustrate this approach.

Example 2: At death, Mary, a widow, owns a small home, free and clear of any mortgage, valued at $200,000, an automobile valued at $15,000, a bank account with $10,000, and investments worth $75,000. Prior to her death, she met with her attorney for the purpose of drafting a will. He advised her that she could transfer her house at her death through the use of a grantor deed to take effect upon death ("beneficiary deed"). She paid her attorney approximately $500 dollars to prepare a will and beneficiary deed. The beneficiary deed is recorded. Her beneficiaries under the will are her three children. Shortly after Mary's death, the three children enter her home and find her will. They inspect the will, and determine that it was drafted by her attorney. They contact her attorney, and he agrees to handle the probate of Mary's estate for 5% of the value of the estate. The value of the probate estate is $100,000, calculated as $300,000 minus $200,000, which represents subtraction of the value of the home transferred under the beneficiary deed. The attorney earns 5% or $5,000, payable from property that would otherwise be given to the children.

This example illustrates the reduction of costs associated with a will and beneficiary deed. While this arrangement is also lucrative for the attorney, it results in less expense to the beneficiaries.

Estate Planning: Living (Revocable) Trust and Pour-Over Will

Due to the expense and delay associated with the probate process, many individuals have chosen to reduce or eliminate it completely by preparing a living (revocable) trust with a pour-over will. In order to understand the manner in which utilization of a living (revocable) trust can avoid probate, one must again consider the definition of probate. Probate is the judicial and/or administrative process whereby assets titled in the name of a deceased person are transferred into the name of a living person. When an individual establishes a trust, they are establishing an artificial entity that continues to exist even after their own death.

During an individual's lifetime, he or she can transfer title to his or her assets to a living (revocable) trust for his or her benefit during life, and at death, for the benefit of his or her beneficiaries. Therefore, an individual can do the work entailed in the probate process by transferring assets to the trust prior to his or her death, and thus reduce or eliminating the cost and/or need for the probate process. A pour-over will is prepared as precautionary measure to transfer any assets not transferred to the trust prior to an individual's death. Any assets not transferred to the trust will be probated under the pour-over will. The following example will illustrate this approach

Example 3: At death, Mary, a widow, owns a small home, free and clear of any mortgage, value at $200,000, an automobile valued at $15,000, a bank account with $10,000, and investments worth $75,000. Prior to her death, she met with her attorney for the purpose of drafting a living (revocable) trust and pour-over will. She paid her attorney approximately $1500 for these services. Mary then transferred her assets, including her home, automobile, bank account, and investments to her living (revocable) trust. Her beneficiaries under the living (revocable) trust are her three children. The sole beneficiary under her pour-over will is the living (revocable) trust. Shortly after Mary's death, the three children enter her home and find her trust and will. They inspect trust and will, and determine that it was drafted by her attorney. They contact her attorney, and he explains that probate is unnecessary, because all of Mary's assets have already been transferred to her trust. The attorney bills $300 for his one hour consultation with the beneficiaries.

This example illustrates the reduction of overall costs associated with an individual who elects to reduce and/or avoid the expenses associated with the probate process by utilizing a living revocable trust with a pour-over will.

Joint Tenancy with Right of Survivorship v. Living (Revocable) Trust

Taking title as joint tenants is a common substitute for proper estate planning. Holding titled assets as joint tenancy can eliminate the need for probate upon the death of the first joint tenant. However, assets held in joint tenancy are subject to the creditors of both joint tenants during life, and create negative gift tax consequences in various situations where the joint tenant is not a spouse of the other joint tenant. Unfortunately, if there is no joint tenant living at the death of the only surviving joint tenant, then the probate process will likely be required. The following examples will illustrate the approach.

Example 4: John and Mary took title to their home, automobile, bank account, and investments as joint tenants with right of survivorship. John recently died, leaving Mary as the surviving joint tenant. Mary files an affidavit of termination of joint tenancy with a certified death certificate for John to the county recorder and/or other necessary institutions (i.e. bank, etc.), and by operation of law, title to the home, automobile, bank account, and investments are placed (vest) in Mary's name. Mary dies two months later, leaving a will. At Mary's death she owned a small home, free and clear of any mortgage, value at $200,000, an automobile valued at $15,000, a bank account with $10,000, and investments worth $75,000. Her beneficiaries under the will are her three children. They contact her attorney, and he agrees to handle the probate of Mary's estate for 5% of the value of the estate. The value of the probate estate is $300,000. The attorney earns 5% or $15,000, payable from property that would otherwise be given to the children.

This outcome can be avoided through the establishment of a living (revocable) trust and pour-over will.

Example 5: John and Mary establish a living (revocable) trust with pour-over will. They transfer their home, automobile, bank account, and investments to their living (revocable) trust. John recently died, leaving Mary as sole trustee of the trust. Mary dies two months later. She is survived by her three children, who are beneficiaries under the trust. The home, automobile, bank account, and investments pass to the children without the need for probate.

Community Property with Right of Survivorship: Advantages Over Joint Tenancy with Right of Survivorship

The author has dealt with many real estate and loan brokers through my years as an attorney. Approximately five years ago, a mortgage loan broker inquired as to whether it was more advantageous for a married couple to take title to their home as community property with right of survivorship, or as joint tenants with right of survivorship. He explained that the real estate community usually just chose the latter option for the buyer, due largely to the fact that they were taught by their employers to choose joint tenancy.

The author explained that a married couple should take title to their home (property) as community property with right of survivorship, because it is superior to joint tenancy with right of survivorship in a very key aspect relating to federal income tax. Upon the death of the first spouse, there will be a step up in basis on both halves of the community property for federal income tax, making the basis equal to the fair market value. Conversely, if the married couple took title to their home as joint tenants with right of survivorship, there would only be a step up in basis of one-half of the property's fair market value, potentially creating increased federal income tax upon the subsequent sale of the home.

Example 6: John and Mary purchase a home for $100,000 and take title to that home as community property with right of survivorship. John dies. Upon John's death the home has increased in fair market value to $200,000. The basis in the home is valued for federal income tax purposes at $200,000, because the basis is equal to the fair market value on both halves of the property. Mary sells the home 1 year later for $250,000, the fair market value of the home. Mary would pay federal income tax on $50,000, assuming no other exemption applied[1], which is the fair market value ($250,000) minus her basis ($200,000).

Example 7: John and Mary purchase a home for $100,000 and take title to that home as joint tenants with right of survivorship. Upon John's death the home has increased in fair market value to $200,000. John dies. The basis in the home is valued for federal income tax purposes at $150,000, because the basis in the home is equal to one-half of the original basis ($50,000), and one-half of the fair market value ($100,000). Mary sells the home 1 year later for $250,000, the fair market value of the home. Mary would pay federal income tax on $100,000, assuming no other exemption applied[2], which is the fair market value ($250,000) minus her basis ($150,000).

Conclusion

As with many worthwhile endeavors, estate planning does require strategic planning throughout your life. However, simple steps can be taken to avoid probate and maximize the amount of money that can be transferred from one generation to the next. Legal fees can be significantly reduced or eliminated through proper estate planning techniques.

[1] IRC 121
[2] Id.