Insight on estate planning

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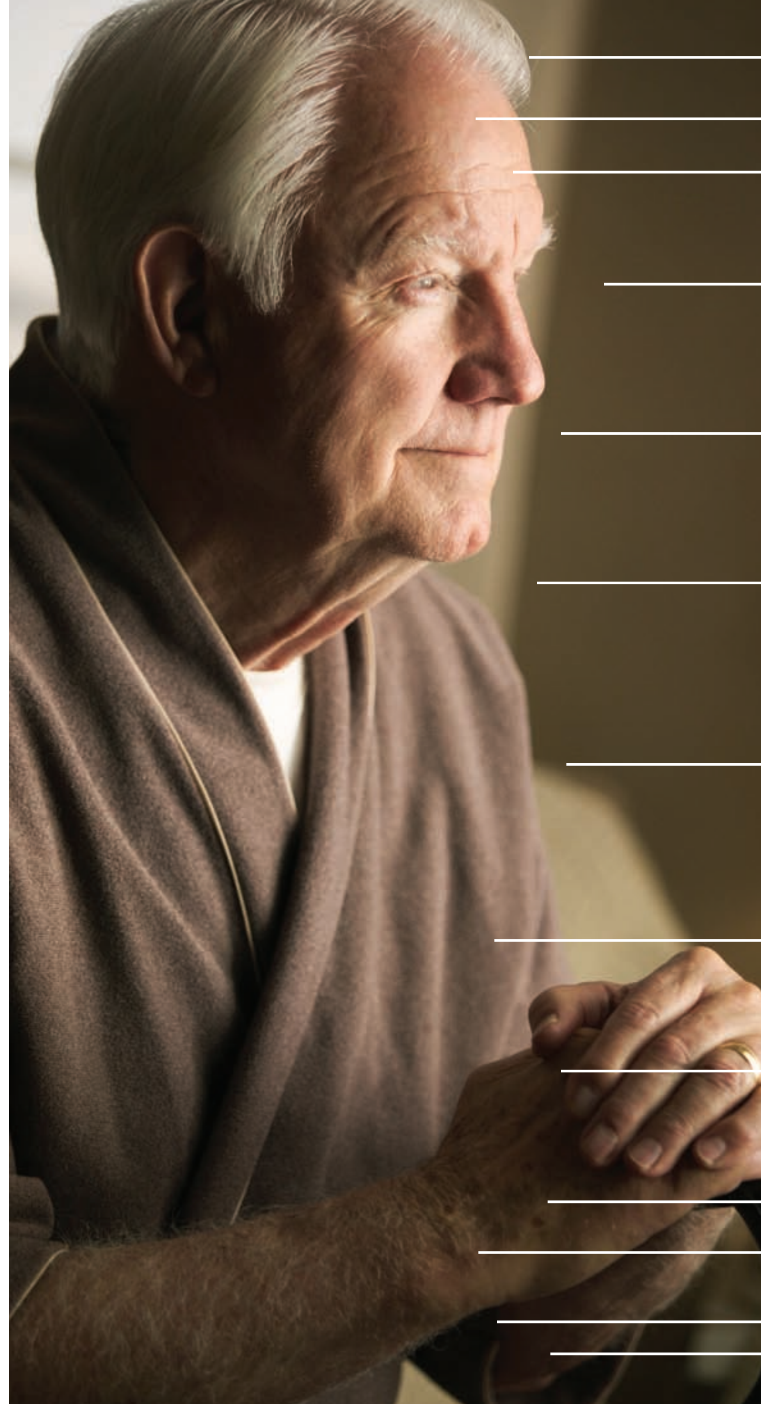

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Making tough decisions on incapacity and guardianship

There are many tangible signs of the effects of aging, such as a slower step or worsening eyesight and hearing. But the intangible signs, such as mental health, can be more difficult to discern.

An incompetent adult can't communicate rationally about his or her well-being because of an illness, an accident or advanced age. If a family member, such as your mother or father, seems not to have the intellectual wherewithal to manage daily affairs, you may have to step in and make the difficult decision to have a judge declare him or her incompetent and assign a guardian (a conservator in some states).

Defining capacity

The legal definition of capacity varies from state to state, but generally it's the mental ability to adequately function. More specifically, it's the ability to continue to live in the manner to which one is accustomed.

A person is presumed competent unless an adjudication process determines otherwise. That is, a judge must declare a person incompetent. Factors leading to such a decision will depend on the circumstances. Often, the barometer of whether someone is able to adequately function is the person's ability to

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understand basic financial matters. Similarly, a person unable to adequately attend to his or her own health needs might be considered to lack capacity.

Sometimes the line between having and lacking capacity is less than clear. In fact, a person may be competent for many things, but not for everything. And going from having the capacity to understand and manage things to not having such capacity doesn't typically happen overnight.

In an ideal world, a parent who's slipping will realize it and ask for your assistance. (See "Alternatives to guardianship," on page 3.) But if your mother or father doesn't realize what's happening — or can't bring him- or herself to ask for help — you should step in for everyone's sake.

Guardianship responsibilities

If you've made the gut-wrenching decision to have an incapacity determination and the judge agrees your parent is no longer competent, the court will appoint a guardian. The

guardian will be responsible for managing your parent's affairs on his or her behalf.

There's no reason that you shouldn't be appointed guardian, and, in fact, it's logical that a child would be so appointed. More often than not, it will be a child or adult grandchild. But there is similarly no reason that the named guardian has to be a family member. In some states a person can designate whom he or she wants to act as his or her guardian.

The guardianship will specify whether the guardian has been appointed for the management of all aspects of your parent's life or if there's a narrower applicability, such as for only financial matters. Whatever the decision, the guardian will owe a duty of care to your parent, and will be held accountable by the court for showing that the actions he or she takes are appropriate.

If the guardianship extends to financial management, the guardian will be responsible for regularly reporting to the court — at least in most jurisdictions — a summary of money received on your parent's behalf and expenditures made for his or her benefit.

Making the right choices

There are many issues with which to deal when it comes to an aging parent. Having to face the possibility of a loved one becoming legally incompetent can be particularly difficult. But a guardianship is a decision that ultimately might be best for the entire family.

Alternatives to guardianship

If your mother or father realizes he or she needs some assistance and requests it, the entire family may be better off. Why? Because the expense and emotional toll of a guardianship proceeding can be avoided, and, most important, your parent still receives the needed help. Here are four ways you or someone else can assist your parent:

1. **Bill paying.** If your parent needs someone to write checks and pay his or her bills, you or another sibling may be able to fill the role. Alternatively, there are many banks and professional firms that provide those services. The expense of paying someone to help your mother or father may be worth the increased feeling of control he or she feels by delegating the work and freeing up time and energy for other things.

2. **Powers of attorney.** If your parent consents to giving you or another trusted individual power of attorney over his or her financial and health care matters, the result is similar to what you would achieve through the guardianship process. The difference is that your parent still is treated as legally competent to make decisions, though he or she is providing someone with the legal right to act on his or her behalf.

3. **Living trust.** If your parent creates — or already has created — a living trust that names a successor trustee, such as you, a professional advisor or the trust department of a bank, all he or she needs to do is step down as trustee and the successor takes over the trust's management. With respect to property, this is the same function as the agent acting pursuant to a power of attorney, though the trusteeship by definition applies only to those assets titled in the name of the living trust.

4. **Joint ownership.** Your parent could add someone as joint owner of his or her accounts to provide that person rights similar to those of his agent under the power of attorney for property and the trustee under the living trust. The major difference is that, while the agent and trustee are merely managing assets on your parent's behalf, the joint tenant is treated as a joint owner of the property. In the case of joint tenancy there are potential gift tax consequences of such transfers, so before creating joint ownership be sure you know the tax implications.

Should you settle for a life settlement?

Jim, 67, bought a permanent life insurance policy a decade ago, but unfortunately his health has deteriorated markedly in the past year — so much so that it's unlikely he would qualify for a policy today. To make matters worse, his policy has virtually no cash value, as Jim has made significant cash withdrawals.

To keep the policy from lapsing, Jim must pay the premiums out-of-pocket because the policy's cash value no longer is enough to pay them. If he doesn't want to continue paying the premium at this time he has two options: a) take whatever cash is left in the policy, let the policy lapse and lose its death benefits or b) sell the policy — the sale is referred to as a life settlement — to an investor for more than its cash surrender value, but less than its net death benefit.

To sell or not to sell?

How much an investor is willing to pay for a policy is a function of its face value, the premiums that are due and the insured's life expectancy. Usually, an investor won't even consider such a transaction for someone who's not at least 65 years old. The reality is that, all else being equal, there is a direct relationship between life expectancy and how much an investor will pay for a policy. That is, the shorter the insured's life expectancy, the more willing someone will be to buy a policy.

Whether you want to sell a policy, on the other hand, will depend on your financial needs and what you're offered. View the policy as you would any other investment, and consider not just the gross sales price, but what you'll end up with on a net, after tax, basis.

Income tax consequences

The tax implications of a life settlement can vary widely depending on the circumstances. The portion of your settlement that represents a return of capital — what you paid for the policy — will be tax free.

Anything beyond that amount up to the policy's cash surrender value is taxed as ordinary income. And though there's no definitive guidance from the IRS, most professionals in the field believe the balance — anything beyond the cash surrender value — would be taxed as a capital gain.

So long as you've held the policy for more than a year, the gain will be long-term. Because life insurance policies typically have a two-year contestability period, an investor, such as a life settlement company, won't purchase a policy unless it's at least two years old. The determining factors, therefore, will be how much you get for the policy, what you paid for it (your basis) and its cash surrender value.

Returning to the previous example, let's suppose Jim's policy has a $500,000 death benefit and a premium of $2,500. He can

afford the premium, but is intrigued by the prospect of receiving the $250,000 an investor has offered him to purchase the policy. Jim will receive the money up front, and the investor will receive the policy proceeds after Jim dies, which is expected to be in about five years. It's a win-win, right? Well, it's not quite that easy.

In Jim's case, his basis in the policy is $100,000, and the cash surrender value is $125,000. Of the $250,000 settlement, the first $100,000 is tax free. The $25,000 difference between the cash surrender value and his basis ($125,000 – $100,000) is taxed as ordinary income and the balance of $125,000 ($250,000 – $125,000) is capital gain. So, Jim's tax on the settlement, assuming a 25% rate for ordinary income and 15% for capital gains, is $25,000, leaving him $225,000.

Jim understands that, if he can find some way to keep the policy, his family will receive the full $500,000 income tax free on his death. It's wise to consider this option along with any offers to purchase the policy.

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How the investor benefits

In addition to knowing how a life settlement can benefit you, it's important to understand how the investor may benefit — there must be a reason someone sees it as a good investment. Indeed, the investor expects the cash outlay for your policy — plus the additional premiums paid throughout your life — will pay off handsomely at your death. In fact, how good the investment pays off depends on how soon you die.

After all, the $250,000 purchase price offered is largely determined by Jim's five year life expectancy. If he dies at the five year period, the investor will realize an average annual return of 14%. If he lives for another five years, the return is down to just more than 6.25%. On the other hand, should Jim die after just three years, the investor's return increases to nearly 25% on an annual basis.

Is a life settlement in your future?

The essence of a life settlement is that it lets you live the balance of your life without financial worry. If you're in declining health, have cash flow concerns and own a life insurance policy, a life settlement may be right for you. But don't take action until you understand the tax and legal implications. ▮

A tax education for an executor

If a loved one dies and names you as the executor of his or her estate, would you know what's expected of you? As an executor, your job will include administering the estate and distributing assets to beneficiaries, paying estate debts and expenses, ensuring that all life insurance and retirement plan benefits are received, and, perhaps the most confusing, filing any necessary tax returns and paying the appropriate federal and state taxes.

Dig into the financials

Suppose your Aunt Charlotte did little planning before her death, and she's named you as the executor of her estate. The best place to begin is to take an inventory of your aunt's assets. This can be easier said than done. If you're fortunate enough to know where she did her banking, where she held her investments and what other assets she owned, the job shouldn't be too difficult. But the reality is that you'll probably need assistance tracking down her accounts.

One strategy is to find her most recent income tax return and use the interest and dividend income section as a starting point. The rest of the income tax return might also provide clues as to whether any other information exists regarding her assets and liabilities, such as IRAs, mortgages and partnership interests. For instance, if Aunt Charlotte used a professional tax advisor to prepare the return, he or she might be able to provide additional information, such as the names of other professionals on which she relied.

Take an inventory of assets

After gaining knowledge of Aunt Charlotte's assets and liabilities, you'll need to determine whether you must file a federal and/or state estate tax return. The federal return — Form 706 — essentially is a snapshot of the assets and liabilities that exist at death. Currently, a federal return is required for

estates with a gross value greater than $2 million. You may need to file one or more state returns even if a federal return isn't required.

Regardless of whether an estate tax return is necessary, Aunt Charlotte's estate may have to file federal and/or state income tax returns. The federal estate income tax return — Form 1041 — is where you report the income earned by the estate. It's akin to the personal income tax return — Form 1040. Thus, in the year of her death, Aunt Charlotte may have three federal returns — her estate tax return, an income tax return for her estate and a personal income tax return. Aunt Charlotte may have state returns as well.

Interplay of Forms 706, 1041 and 1040

Your next responsibility is ensuring deductible expenses are allocated to either the estate tax return or the estate income tax return. Let's suppose Aunt Charlotte is required to file an estate tax return. Even though many expenses can be reported only on Form 706 — such as

the expenses of Aunt Charlotte's last illness and her funeral and burial costs — other expenses can be included either there or on the estate's income tax return.

For instance, administrative expenses related to the estate can be deducted on either return. Similarly, the expenses related to managing estate property, such as real estate, can be deducted on either return, depending on the facts and circumstances. For example, if there's no estate tax payable but there is an estate income tax return, you'd want to allocate the expenses to the income tax return. The important thing to remember is that there is a choice.

With respect to income tax returns, determine whether income and expenses are properly allocated between the estate's return and Aunt Charlotte's personal return. Any income earned up to the date of death should be reported on the personal income tax return. Income earned after that time is reported on the estate income tax return.

Expenses incurred by Aunt Charlotte prior to her death but paid after it aren't properly allocable to her personal income tax return. Those amounts should be deducted on her estate tax return or her estate's income tax return.

Carry out your loved one's wishes

If a loved one names you as the executor in his or her will, remember that there are many factors that go into whether the three tax returns discussed will be necessary. Because acting as an executor can be complicated, don't hesitate to hire a professional tax advisor to help you with your responsibilities. He or she can prepare the necessary estate and income tax returns, leaving you with the sole responsibility of answering questions and providing missing details.

Estate Planning Pitfall

Not using a trust when you should

Determining if a trust is appropriate for you depends on your objectives and your needs. Suppose, for instance, you have adult children in whose ability to handle the financial responsibility of inheriting your estate you have complete confidence. You're unsure whether the idea of keeping assets in trust for them after your death is appropriate.

It would still make sense to use a trust during your life, as doing so will allow for the seamless transition of control of the assets at your death. And assets held in your trust prior to your death will pass to the beneficiaries without being subject to probate, which can be expensive and always is a public process.

In deciding whether to keep assets in trust after your death, though, you need to weigh the disadvantage of burdens — and, more important, the idea of having the assets "tied up" rather than going outright to your children — against the potential estate tax benefits down the road.

Your circumstances will help to determine whether the assets should remain in trust. For instance, depending on the size of your estate, the trust can provide a means of keeping assets outside of the estate tax system forever or, at a minimum, for at least a generation.

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A message to our clients and friends:

Hall Render is excited to provide you with this issue of *Insight on Estate Planning*. Should you have any questions regarding the articles in this newsletter, please feel free to contact one of the attorneys listed below.

We are experienced in assisting clients in implementing a wide range of estate planning and tax strategies, including the use of:

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- Wills
- Estate and Trust Administration
- Estate and Trust Litigation
- Estate and Gift Valuation Planning
- Federal Estate & Gift Tax Strategies
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- Grantor Retained Annuity Trusts
- Guardianships and Conservatorships
- Income Tax Planning
- Irrevocable Trusts
- IRS Controversies
- Life Insurance Taxation & Planning
- Pension & IRA Planning
- Qualified Domestic Trusts (QDOT)
- Marital Trusts (QTIP)
- Qualified Personal Residence Trusts (QPRT)
- Real Estate Management & Transfer

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  - Limited Liability Companies
  - General and Limited Partnerships
  - Family Limited Partnerships
  - Limited Liability Partnerships
  - Business Succession Planning
  - Family Business Planning

- Charitable Trusts & Foundations
  - Gift Annuities
  - Charitable Lead Trusts
  - Outright Gift Planning
  - Private Family Foundations
  - Charitable Remainder Trusts
  - Donor Advised Funds
  - Public Charities

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