

**It's Your Estate:
Estate Planning Basics
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I. **Do You Need A Will? Only If You Don't Like The Estate Plan The California Legislature Has Already Prepared For You.**

Unless you leave formal instructions about how your assets should be distributed after your death, the California legislature's estate plan will apply. In legalese, this is called *intestate succession*.

Your separate property will be distributed as follows:

If you are married at the time of your death but have no children, then 100% will pass to your spouse. If you are married and have only one child, then 50% will pass to your spouse and 50% will pass to your child or, if the child is deceased, then to his or her children equally. If you are married and have more than one child, 1/3 will pass to your spouse and 2/3 will be distributed among your living children and the descendants of any deceased children.

If you are not married at the time of your death, then all of your property will pass to your living children and the descendants of any deceased children. If you have no living children, grandchildren, great grandchildren, etc., then your property will be distributed jointly to your parents if they both survive you or entirely to your surviving parent if one of them is dead. If that doesn't work, then your property will be distributed among your living siblings and the descendants of any deceased sibling.

Your entire one-half share of your community property will be distributed to your spouse.

Separate Property	Community Property
<ul style="list-style-type: none">• Assets owned on date of marriage.• Gifts and inheritances no matter when received.• Growth of separate property during marriage except growth of business during marriage due to personal efforts.• On divorce, stays with owner.• On death, owner directs distribution.	<ul style="list-style-type: none">• Assets acquired (including wages and salary) during marriage.• Growth of community property during marriage.• On divorce, is split 50-50.• On death, each spouse directs distribution of 50%.

Note: At least in California, the name in which property is held is not decisive about the characterization of property. Facts and circumstances will be considered regardless of the actual name on the property.

II. What's In A Will?

The primary function of a Will is to govern what disposition will be made of the testator's property. (The person making a Will is often referred to as the *testator*.) Because it takes effect at the moment of the client's death and can be freely changed up to that point (as long as the client remains competent) the Will is usually the critical document.

In addition, the Will serves several secondary functions as the final statement of the client's intention on various matters. For example, the Will may appoint guardians for the testator's minor children or may exercise powers of appointment granted to the testator under trusts previously established by others.

There are formal steps that must be followed to create a valid Will, and these steps vary state by state. In California, a Will must be in writing, must be signed by the testator, and must be witnessed by at least two adult witnesses who are neither beneficiaries under the Will nor related to the testator (because they would be potential intestate heirs and could thus have conflicting interests). In addition, the testator must be competent and at least 18 years old. The witnesses may later be called to testify in court about whether the decedent appeared competent and aware of what was transpiring as the Will was executed.

The basic structure of a Will includes the following elements:

- [A] Exordium Clause - This states who the testator is, declares his or her domicile, states that the instrument is indeed the testator's Last Will and Testament, declares that this Will supersedes all prior Wills and declares them invalid.
- [B] Payment of Debts - This clause directs payment of the testator's funeral expenses, debts, and expenses of administering the estate. It directs in addition what sources are to be used for such payments, and may specify the manner of payment of secured debts; for example, a mortgage on real estate may not be paid, but instead the property may be bequeathed to a beneficiary subject to the mortgage.
- [C] Tax Payment Clause - This directs what source shall be used to pay the taxes due from the testator's estate. The taxes may all be paid from the residue, or they may be apportioned pro rata among all (or only some) bequests made under the Will. Under current default California law, the taxes are paid out of the taxable bequests under the Will because this maximizes the marital and charitable deductions and minimizes the estate taxes due.
- [D] Tangible Personal Property - The Will should specify the disposition of the testator's tangible personal property, such as automobiles, artworks, jewelry, furniture, and the like. If such property is actually held as community property, or is owned by the decedent spouse, it may be helpful to so state in the Will.

- [E] Bequests - The Will provides for specific bequests of cash or property to designated beneficiaries. Amounts may be bequeathed outright or in trust. The Will should include, after the various specific bequests desired by the testator, for an ultimate bequest of the residue of the estate (*i.e.*, everything that is left over after the specific bequests are fulfilled). That amount may be left to a beneficiary, transferred to a trust created under the Will (*i.e.*, a "testamentary" trust) or "poured over" to an existing trust created earlier.
- [F] Appointment of Fiduciaries - The Will must specify who will serve as executor to administer the estate and as trustee under any trusts created by the Will. It will also be necessary to identify successors to serve if any of the designated fiduciaries are unable or unwilling to serve or subsequently die or resign, etc. This may be done by actually naming the successors, or by providing a clearly defined mechanism for successors to be appointed. If successors are not provided for, it will be necessary for the estate or trust to incur the expense of a court proceeding to name the successor. In addition the Will may waive, or limit, the requirement that a bond or other security be posted by the named fiduciaries. The Will may also address the question of the appropriate compensation for the fiduciaries. If the testator has minor children, the Will should designate the person or persons to serve as guardians of the children and of their property, in the event they have no surviving parent.
- [G] Common Disaster Provision - The Will can provide whether the testator or his/her spouse shall be deemed to survive in the event they perish in a common disaster.
- [H] Testimonium and Attestation - This clause states that the testator was familiar with the instrument and intended that it be his/her Last Will and Testament. It will usually state the date upon which the testator is signing the Will and is followed by the signature of the testator and witnesses' attestations in accordance with local law.

Wills can take several forms: holographic, statutory, and attorney drafted.

A **holographic Will** is one handwritten, signed and dated by the testator. In most cases, there are no witnesses to a holographic Will because the Will was prepared in a hurry (*e.g.*, just before the testator takes an unexpected trip) or in secret (*e.g.*, when the testator wants to make a change but doesn't want anyone else to know). The California courts and many, many heirs have spent untold hours working to clarify the meaning of holographic Wills. This is because a person who isn't trained in drafting Wills often uses language that leaves many questions and/or contradictions. As a result, you should not use a holographic Will unless you have no other choice. Instead, you should use a statutory Will.

A **statutory Will** is a variation on a holographic Will. A copy of the California statutory Will was provided to you. This form combines handwritten and preprinted instructions. It allows you to indicate your desire about how property should be divided and distributed by picking from several preprinted options. As a result, you can indicate your desires without the risk of using unclear language.

An attorney drafted Will is one prepared by an attorney based on information provided by the client.

III. The Probate Process: Putting Your Will Into Action.

The probate process is one of the most confusing and misunderstood concepts involved in estate planning. Stories in the popular press and books (some of which have earned fortunes for their authors) have created a public perception that the probate process is invariably expensive, time-consuming, unnecessary, and more-than-a-little sleazy. Like many popular perceptions, this characterization of the probate process is based upon some historical fact, but is exaggerated and somewhat dated under current conditions. In many states, probate procedures have been reformed and streamlined to minimize costs and delays, particularly with smaller estates. And in any event, the probate process plays an important and necessary role.

The word *probate* comes from the Latin word *probare*, which means "to prove." The probate process is aimed at "proving" the legitimacy of a person's Will, making sure that a person's property is distributed to the appropriate beneficiaries, and to insure that the estate is administered properly.

[A] What assets pass through probate?

It is important to recognize the difference between a person's *probate estate* and the person's *taxable estate*. Probate is a court proceeding to **transfer title** of a deceased person's assets. If title of an asset is going to transfer by operation of law, then that asset will not be part of the probate estate. (See the discussion of ways to avoid probate below.)

The *taxable estate* concept, on the other hand, has nothing to do with title; it is used to measure the **transfer of wealth** that occurs when a person dies. The following chart describes the current status of the federal estate tax applicable exclusion amounts and maximum rates over the next several years:

Year	Applicable Exclusion Amount	Maximum Estate Tax Rate
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	Unlimited - no estate tax	0%
2011 and beyond	\$1,000,000	55%

[B] The steps of probating an estate.

1. After a person dies, someone (usually the executor named in the Will) files a *Petition for Probate of Will and for Letters Testamentary*. When this paperwork is filed, the deceased person's Will is given to the probate court. The court then reviews the Will to determine if the evidence shows that the document offered is in fact the person's Will and that it was validly executed. If anyone wants to argue that the deceased person was not capable of executing a Will or that the Will was prepared under duress or fraud, then those arguments are made at the very start of the process; and the Court must resolve the dispute before anything else can happen.

2. Once the Will has been proved, the probate process begins in earnest. The Court issues *Letters Testamentary* to the executor, and this paperwork gives the executor authority to carry out the directions set forth in the Will. Depending on the circumstances, the court may require the executor to *post a bond*. The bond serves as insurance for the beneficiaries of the estate. The company that issues the bond agrees to pay to the court the fair market value of any assets that the executor disposes of inappropriately. If the Will doesn't specifically say whether a bond is required, the beneficiaries can waive the requirement. Of course, the Will can waive the requirement of a bond.

3. The first thing the executor must do is *publish notice of the death*. This notice must be placed in a newspaper of general circulation in the geographic area surrounding the deceased person's last residential address. By placing the notice, the executor is letting the world know that claims against the deceased person's estate must be made. California law gives creditors 120 days from the date of publication to come forward with claims. Any claim that isn't filed within that 120-day period becomes unenforceable. During this 120-day period, the executor gathers information about the assets in the probate estate, pays valid debts and expenses, and compiles an inventory of all the assets owned by the deceased person.

4. Once the executor has an inventory of assets, that list is given to a *probate referee*, who is appointed by the court to confirm the fair market value of the deceased person's assets.

5. Once the expenses have been paid and the inventory finalized, the executor files *an accounting* with the court. This tells the court what expenses were paid and what assets remain in the estate. Once this accounting is accepted by the court, the executor can make distributions to the beneficiaries.

6. The executor can ask to be paid for the time he or she spent administering the estate. The *executor's compensation* is based on a percentage of the total fair market value of the deceased person's assets. This percentage is established by the California legislature. Right now, the percentages are as follows:

4% on the first \$100,000	1% on the next \$9,000,000
3% on the next \$100,000	1/2% on the next \$15,000,000
2% on the next \$800,000	For all amounts \$25,000,000+, court determines

7. The *legal fees* for the attorney who helped the executor are also calculated using the same percentages.

[C] Should you avoid probate?

Despite all of the hullabaloo about avoiding probate, there are two advantages to the probate process that may make the process worthwhile.

First, the probate process performs a valuable function by providing an **impartial and orderly** means for assuring that a decedent's estate is administered and distributed in accordance with the decedent's Will, or the applicable law. By accomplishing this in a judicial setting, the customary procedural safeguards are obtained along with a definitive public record.

Second, the probate process also provides a 120-day time deadline that creditors must meet or **their claims will be lost forever**. This advantage is so meaningful that the legislature changed the probate code so that trustees of revocable trusts (see below) can take advantage of the same 120-day deadline. If the probate process is not implemented, claims against the estate will usually be cut off one (1) year after death.

[D] Abbreviated Probate Procedures

There are several abbreviated probate procedures provided for under California law. These include the following:

1. 13100 Declaration - If the gross value of the probate estate does not exceed \$100,000, 40 days have elapsed since death and no formal probate proceeding has been instituted, the successor (whether by Will or intestacy) may collect the personal property by submitting a properly prepared and executed "13100 Declaration" to the holder of the personal property. ("13100" refers to the California statute that permits this procedure.) Thus, for example, if a decedent died with only \$10,000 in a bank account and his only living heir was his daughter, the daughter could submit the 13100 Declaration to the bank and have the monies transferred to her own account without having to go to court.

2. Petition Regarding Succession to Real Property - Again, if the gross value of the probate estate does not exceed \$100,000, 40 days have elapsed since death and no formal probate proceeding has been instituted, the successor (whether by Will or intestacy) may file a petition with the court requesting a court order determining that the successor has succeeded to the California real property.

3. Affidavit Procedure for Real Property Valued at \$20,000 or Less - An affidavit procedure may be used to transfer California real property valued at \$20,000 or less if the gross value of all real property held in the probate estate is \$20,000 or less, 6 months have elapsed since death and no formal probate proceeding has been instituted, the successor (whether by Will or intestacy) may collect the real property by filing a properly prepared and executed affidavit to the court and recording it with the appropriate county recorder's office.

4. Transfer of Automobiles - The California DMV website contains a form for transferring automobiles without probate if forty days have elapsed since death, there is no probate estate but for such automobiles and no formal probate proceeding has been instituted and the automobiles have no liens against them. If you are a member of AAA, they can also assist in completing this paperwork.

5. Transfers to Spouses - There are several abbreviated procedures for transferring assets otherwise subject to probate to spouses. These procedures can effect the spouse's right to community and quasi-community real property, the spouse's intestate share of the decedent's property, and property devised to the spouse under the Will.

V. Ways To Avoid Probate -- Forms Of Ownership.

How one holds title to an asset governs whether he or she may dispose of that asset by Will or trust on death and may also dictate who gets the asset:

- [A] Joint Tenancy - If assets are held in joint tenancy, they automatically pass to the surviving owner(s) on the death of one owner. Joint tenancy is created by using special language in the title of the asset: John Smith and Mary Smith, *as joint tenants with right of survivorship*. Joint tenancy is not always an appropriate way to avoid probate. Joint ownership with a spouse, other than in a first marriage, can cause problems if the client wants his or her interest in the asset to pass to anyone other than the spouse. When one joint owner dies, his/her share immediately goes to the other owner. This can cause unintentional disinheritance of the deceased joint owner's family.
- [B] Community Property With A Right of Survivorship - If assets are held as community property with a right of survivorship, they automatically pass to the surviving spouse on the death of the first spouse to die. This ownership is created by using the special language in the title of the asset: John Smith and Mary Smith, *as their community property with right of survivorship*. The advantage of this form of ownership vs. joint tenancy ownership is that the entire asset held as community property with a right of survivorship will receive a "step-up" in income basis at the first spouse's death. (This is discussed in more detail below.)
- [C] Revocable Deed - By recording a "revocable quitclaim deed" on real property, the grantor retains all rights to the real property until death, at which time the real property automatically passes to the grantee named in the revocable deed. The difference between this technique and placing property in joint tenancy is that a revocable deed can be "revoked" before death to change the "beneficiary" of the real property. The "beneficiary" has no rights to the real property until the grantor's death. This technique (revocable deed) avoids any issues of taxable gifts as well. Also, the California legislature is in the process of statutorily providing for a "Beneficiary Deed" that works in a similar fashion.

- [D] Totten Trust or Pay-on-Death Account - One way to avoid probate without the pitfalls of joint tenancy is to set up a financial account as a Totten Trust or Pay-on-Death ("POD") account. Again, specific language is used in the title of the asset: Rex Rexall, *in trust for Roxanna Rexall*. Or Rex Rexall, *POD Roxanna Rexall*. Sometimes POD terms are not in the account title but are instead set forth on the account signature card kept on file by the bank or brokerage. When Rex dies, whatever is left in the account will pass to his daughter, Roxanna. However, Roxanna has no signature rights or withdrawal rights as to the account during Rex's lifetime. Note that if Rex holds an account POD Roxanna and his Will leaves everything to his fifth wife Tiffany, Roxanna still inherits the account because it is not a probate asset.
- [E] Contract Provisions/Beneficiary Designations - Your insurance policy proceeds and retirement plan assets will be paid to the people you identify in your beneficiary designations. To make this happen, your beneficiaries simply present the company with a death certificate and, in some cases, an affidavit of domicile. Depending on the company's procedures, the proceeds will usually be paid out within 6 - 8 weeks. **There are some special rules that apply to the payment of retirement plan benefits and you should think carefully about these when you make your beneficiary designations.**
- [F] Revocable Living Trust - A revocable trust may be used as the primary means of transferring a decedent's estate, with such trust holding and passing virtually all of the deceased person's property. (Oddly, the deceased person will almost certainly need a scaled down Will that directs distribution of any assets in his or her probate estate to the trust, since it is virtually impossible to get all property, especially tangible personal property, into the trust.) The primary difference between a Will and a revocable trust is that the trust also provides for administration of property while the person remains alive. Despite some perceptions to the contrary, there are no tax savings realized through the use of a revocable trust.

VI. Income Tax Cost Basis; The Much Sought After Step-up In Basis.

A person's cost basis in an asset is generally what he paid for it. For real estate, depreciation lowers basis and capital improvements increase it. When an appreciated asset is sold, capital gains taxes are paid on the profit, or capital gain, which is equal to the excess of the sales price over cost basis. **EXAMPLE:** Max buys a residence for \$450,000. He has an addition built onto the house at a cost of \$100,000. Max's basis in the residence is now \$550,000.

Federal tax law allows a single person to avoid capital gains taxes on up to \$250,000 of capital gains on the sale of a home, and a married couple to avoid capital gains taxes on \$500,000 of gains. The house must have been used as a principal residence for two of the five years immediately preceding the sale.

When you make a gift, the recipient takes your basis in the asset. EXAMPLE: Lilly buys a painting for \$50,000 in 1990. In 2000, when the painting is appraised at \$150,000, she gives it to Jeff. In 2005, Jeff sells it for \$350,000. Jeff's capital gain is \$350,000 less Lilly's basis of \$50,000, or \$300,000.

When you die**, all assets you own at death receive a "stepped up" basis equal to their "fair market value" at your death. If a couple owns a community property asset, then when one spouse dies, 100% of the asset gets a stepped up basis. EXAMPLE: Husband and wife purchase a home with community funds for \$150,000. (This is their "cost basis" or "CB.") At the first spouse's death, the home's fair market value is \$1,000,000. RESULT: Community property title results in a "100% step-up" in income tax cost basis at the first spouse's death. Joint tenancy title between spouses results in only 50% "step-up" on the death of the first spouse to die.

If an appreciated asset is held at least 12 months before sale, the gain on sale will be **long-term gain**, which is taxed at lower rates than ordinary income. The long-term capital gains tax rate this year is generally 15% (in 2008). Short-term gain (on the sale of an asset held for less than 12 months) is taxed at the same rates as ordinary income, with the highest federal rate currently at 35% (in 2008). California has no special lower rate of tax on long-term gains.

The recipient of a gift or beneficiary at death takes the holding period of the donor of the gift or the decedent for purposes of **determining whether gain on sale is long term or short term**. EXAMPLE: Ruth buys a duplex for \$200,000. Three years later, when it is worth \$300,000, she gives it to her son, Jake. Jake sells it for \$320,000 six months later. Jake takes Ruth's basis, so he has capital gains of \$120,000 (\$320,000 - \$200,000). He also takes her holding period, so his profit is long-term gain even though he held the duplex for only six months.

****CAVEAT** - When Congress enacted the law that repeals the estate tax altogether for persons dying in 2010, Congress also substantially limited the "step-up" in basis heirs receive on assets in estates of persons who die in 2010. Essentially, however, the change does not affect estates valued at \$1,300,000 or less.