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The 2017 Estate Planning Teleconference Series

Participant Guide

Estate Planning for the 99%

Cannon Financial Institute, Inc.

Presents

The 2017 Estate Planning Teleconference Series

Tuesday, August 22, 2017

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CHARLES A. REDD

CHARLES A. REDD is a partner in the St. Louis, Missouri, office of the law firm of STINSON LEONARD STREET LLP. Mr. Redd concentrates his practice in estate planning, estate and trust administration and estate and trust-related litigation. Prior to joining Stinson, Mr. Redd was a partner in and Vice Chairman of the Trusts & Estates Practice Group at the law firm of SNR Denton US LLP (now Dentons US LLP). Mr. Redd was also previously a partner in the law firm of Armstrong, Teasdale, Schlafly & Davis (now Armstrong Teasdale LLP) and was Chairman of that firm's Trusts & Estates Department. He was previously employed as a Trust Administrator by First Wisconsin Trust Company (now U.S. Bank, N.A.), Milwaukee, Wisconsin, and as an Assistant Counsel by Centerre Trust Company of St. Louis (now U.S. Trust, Bank of America Private Wealth Management).

Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

Mr. Redd is a member of the State Bar of Wisconsin, The Missouri Bar (Probate and Trust Committee), the Illinois State Bar Association (Section on Trusts and Estates), The Bar Association of Metropolitan St. Louis (Probate and Trust Section, member and past chairman) and the Estate Planning Council of St. Louis.

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Estate Planning for the 99%

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A. Balancing the Use of Trusts and Outright Distributions

The American Taxpayer Relief Act of 2012, P.L. 112-240 (January 2, 2013) ("ATRA"), brought, indefinitely if not permanently, historically high applicable exclusion amounts and GST exemption (currently $5,490,000), indexed for inflation, and portability. Thus, ATRA has rendered trusts far less important in transfer tax planning than they were less than ten years ago. At the same time, the highest income tax rate on ordinary income (39.6%) and capital gains and qualified dividends (20%), and the new 3.8% Medicare surtax on "net investment income," applies to nongrantor trusts with taxable income over $12,500. Internal Revenue Code ("IRC") §§ 1, 1411.

Without transfer tax incentives to use trusts in their estate plans, coupled with income tax incentives to avoid using trusts, many estate planning clients and their advisors in 2017 have ample reason to ponder the utility of trusts for their surviving spouses, children and grandchildren.

1. Advantages of Trusts for Beneficiaries

a. **Dead Hand Control.** One of the main advantages of retaining assets in trust after the client's death is that, by carefully designing trust instrument's provisions, the estate planner can construct a dispositive arrangement lasting indefinitely and comporting precisely with the client's desires. In addition, the client can name the initial and successor Trustees whom the client trusts to carry out his or her wishes. The Trustee may be granted broad or narrow discretion over distributions. The Trustee may be given specific investment directions. A beneficiary may be given powers to withdraw trust assets upon reaching designated ages.

b. **Probate Avoidance.** Another advantage of holding assets in trust for beneficiaries, rather than mandating immediate, outright distribution to them at the client's death, is easy, automatic probate avoidance in the event of a beneficiary's incapacity or death.

c. **Protection From Creditors' Claims.** Trusts also offer an excellent method by which to protect a beneficiary's inheritance from the claims of his or her creditors. Asset protection may be achieved by means of a spendthrift clause, which prohibits a beneficiary from voluntarily or involuntarily assigning his or her interest in the trust, or by conferring extremely broad dispositive discretion on the Trustee, or by using a combination of these techniques. Depending on applicable state law and surrounding facts and circumstances, a beneficiary may be able to create and fund his or her own asset protection trust, but the likelihood of success of a trust created by the beneficiary as an asset protection vehicle, as

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compared to the likelihood of success of an asset protection trust created for a beneficiary by a parent or grandparent, is far less certain.

d. Protection From Claims of Spouses and Ex-Spouses. Although there has been some erosion in recent years in this trust advantage, in general, unless the trust is administered essentially as the beneficiary's *alter ego*, assets held in trust are unlikely to be considered property subject to division between the beneficiary and his or her spouse in the event of a dissolution of their marriage. Additionally, while in many jurisdictions ex-spouses of a trust beneficiary are considered "exception creditors" outside the otherwise applicable protection of a spendthrift provision to the extent they seek access to trust property to satisfy the beneficiary's legal obligations to pay alimony or separate maintenance, a wholly discretionary trust may well avoid alimony or separate maintenance claims (because its status as a protective device does not rely on a spendthrift clause). At the very least, it can be said that a distribution in trust for a beneficiary will provide better protection from the claims of a beneficiary's ex-spouse than an outright distribution (which provides no such protection). Furthermore, assets held in a trust created for a beneficiary by a parent or grandparent should never be considered community property or subject to a surviving spouse's elective share rights.

e. Providing a Nest-Egg for Beneficiary. An outright distribution to a beneficiary may be squandered. A trust for a beneficiary, depending on how it is designed and managed, may be in place as an ultimate financial safety net for the beneficiary regardless of negative developments affecting the beneficiary.

2. Disadvantages of Trusts

a. Costs. There are disadvantages of trusts for beneficiaries that an estate planning client and his or her advisors should consider. One drawback is the added cost associated with maintaining a trust. In addition to the fees associated with certain assets, whether held in trust or outright (*e.g.*, property taxes and brokerage fees and commissions), if assets are held in trust, there will be a Trustee who will often receive compensation for services rendered. Trust income or principal may also be used to pay additional expenses directly related to trust administration, such as for the preparation of separate fiduciary income tax returns, accountings and miscellaneous notices and disclosures to beneficiaries.

b. Additional Complexity. In addition to the costs, there are some additional complications arising from using trusts for beneficiaries as opposed to outright distributions. Getting funds to trust beneficiaries requires the Trustee to go through a deliberative process. It's often not as simple as merely writing a check. Accountings must be prepared and rendered periodically. Trust income tax returns must be prepared and filed each year. Selling trust property is sometimes more arduous than selling property held in an individual's sole name.

c. Income Taxes. As discussed above, there are severely compressed federal income tax rates for income accumulated and capital gains realized in nongrantor trusts. State income tax must be considered as well. If, however, the trust instrument contains

appropriately flexible dispositive and administrative provisions, and if the Trustee exercises his, her or its discretion judiciously, income generated within a trust may be subject to income tax at a lower rate if distributed to the beneficiaries.

d. Fiduciary Duties. The Trustee must remain constantly vigilant about his, her or its fiduciary duties to current and remainder beneficiaries. The Trustee's duties to the trust beneficiaries include duties of loyalty, prudence, impartiality, as well as the duty not to comingle trust property and the duty to inform and account to beneficiaries. Fulfilling these duties responsibly can slow down transactions that, if assets were not held in trust, would be very simple, fast and inexpensive.

e. Less Flexibility. The terms of a trust may become inappropriate depending on how circumstances evolve after the client's death. For example, a trust beneficiary may develop health problems or a disability, his or her financial position or family composition may change may change, or the designation of a given Trustee may prove to have been unwise. Depending on applicable law, it may be possible to resolve the problem through reformation, modification, decanting, a non-judicial settlement or court action, but any of these solutions would involve complication and expense.

These factors should be considered when determining whether trusts for beneficiaries, rather than outright distributions, is the better estate planning approach for a particular client. Ultimately, the anticipated value of the client's assets may be determinative. There is a point at which the size of a trust is just too small to justify the costs and complication of ongoing trust administration.

B. Designing Estate Plans That are Both Effective and Practical

1. Basis Step-Up

Today, with portability and a historically high applicable exclusion amount, inclusion of the value of trust assets in a beneficiary's gross estate will often be desirable. IRC § 1014(a) provides that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent, shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death. Accordingly, assuming the fair market value of each asset exceeds its basis, inclusion will facilitate a step-up in the basis of the assets to their fair market value as of the decedent's death. For low-basis, highly appreciated assets, a step-up in basis will minimize what would have been a sizable gain realized by the beneficiary upon the sale or exchange of such assets. At the same time, so long as the value of the beneficiary's gross estate is equal to or less than his or her unused applicable exclusion amount, no federal estate tax will result.

a. Distributions. The clearest, simplest and most direct method of causing inclusion in the gross estate of a trust beneficiary of the value of assets is to distribute the assets to the beneficiary.

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In pursuing distribution strategies with a view towards optimizing basis step-up, a trustee must be mindful of his, her or its fiduciary duties to all trust beneficiaries – current, future and remainder beneficiaries, vested and contingent. By increasing current trust distributions to put low basis assets into the hands of beneficiaries, the trustee may be making distributions that are excessive in relation to the distributee's needs, the size of the trust and the standards set out in the trust's governing instrument for the making of distributions. Moreover, by maximizing current trust distributions with a singular focus on tax planning, the trustee may be jeopardizing the interests of other or future or remainder beneficiaries by depleting the trust's asset base and depriving those other or future or remainder beneficiaries of their legitimate beneficial interests in the trust.

In the design phase, the estate planner, in consultation with the client, should craft trust dispositive provisions that strike an appropriate balance between promoting the client's non-tax-driven objectives (*e.g.*, health, education, maintenance, support) and enabling distributions to achieve desired tax planning goals.

The Uniform Trust Code provides that a "trustee who acts in reasonable reliance on the terms of the trust as expressed in the trust instrument is not liable to a beneficiary for a breach of trust to the extent the breach resulted from the reliance." Uniform Trust Code § 1006. Applicable state law and the terms of the trust will guide the trustee and delineate the authorities and powers of the trustee. A trustee, in considering whether to make distributions to beneficiaries with a view to minimizing income taxes, should ascertain that the governing instrument would allow maximizing distributions of income to promote tax advantages.

b. General Powers of Appointment. IRC § 2041(b)(1) defines a general power of appointment as a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. IRC § 2041(a)(2) provides that "the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised."

Whether the holder of a testamentary power of appointment chooses to exercise it, the property that was subject to the power will be deemed to have been acquired from the deceased testator and will, therefore, qualify for the step-up in basis. *See* Treas. Reg. §§ 1.1014-2(a)(4), (b)(2). Thus, it is important to consider under what circumstances and to what extent it is wise to confer a general power of appointment with respect to property held in trust to generate basis step-up and income tax savings.

A testamentary general power of appointment can be conferred by means of a formula in such a way that the power would be exercisable only to the extent holding such power would not, by itself, cause imposition of any estate tax. Such a formula could effectively be further refined in such a way so as to have effect only with respect to certain assets in a trust, or to subject to such power, first, those trust assets having the lowest basis and then cascading to each next

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lowest basis asset until holding the power would no longer not cause any imposition of estate tax.

2. Beneficiary Designations

a. **<u>In General</u>.** The completion of beneficiary designation forms is often viewed as a perfunctory task that the client can handle him or herself or assisted by a retail banker or life insurance agent. Such is rarely the case. Beneficiary designations are frequently the mechanism by which our clients' most significant assets are disposed of at death, and so it is of critical importance that such designations be completed in a manner that effectively coordinates the disposition of such assets with the client's estate planning documents and does so in a tax-efficient manner. In addition, beneficiary designations should be clear and unambiguous and should address all contingencies.

When seeking to cause assets passing by beneficiary designation to flow into a trust, reference should be made to the "then acting Trustee or Trustees" of the subject trust (because who will be in place as Trustee when the beneficiary designation is activated is impossible to predict). The formal name of the instrument under which the recipient trust will come into existence, specific reference to the trust under such instrument into which the subject assets are to flow and the date of the trust instrument should be recited. If the recipient trust is to be established under the client's Will, the date of the Will ordinarily need not be included (because, upon death, absent very unusual circumstances, an individual has only one Will).

b. **<u>Additional Complications Involving Qualified Plans</u>.** Although the governing documents of qualified retirement plans have to comply with all requirements imposed by federal law, they do not have to include all options allowed by the IRS regarding distributions of a deceased participant's interest. Instead, plan documents may specify their own rules regarding such distributions, as long as they are consistent with the Internal Revenue Code and ERISA. Administrators of qualified retirement plans generally prefer to distribute a deceased participant's interest in the qualified retirement plan as quickly as possible and with the most administrative ease. Therefore, certain beneficiary designations, as well as certain dispositive schemes, for qualified plan interests may not be permitted by the plan documents.

Estate planners should ensure that the relevant plan documents allow for the client's desired dispositive scheme. In addition, estate planners should ensure that the beneficiary designation form is correctly completed. It is prudent for the estate planner to obtain a plan administrator's consent to the client's beneficiary designations for the client's qualified plan interests, even if the plan document does not require such consent. This approach may help avoid serious dispositive problems that could otherwise arise after the participant's death. Trytten, "Retirement Plan Myth Busters," AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, 2011 Fall Meeting.

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C. Using Special Purpose Trusts in the Right Situations

1. Third Party Created and Funded Special Needs Trusts

a. <u>In General</u>. "Third party special needs trusts" are funded with assets that are not owned by the beneficiary for whom the special needs trust ("SNT") is established. Third party SNTs can help maintain the beneficiary's eligibility for government benefits. For example, a third party SNT can provide for other beneficiaries who are not in need of government benefits and can be established by a trust instrument or by a Will. Grassi, "Special Needs Requires Special Attention: Estate Planning for a Family With a Special Needs Child," HECKERLING INSTITUTE ON ESTATE PLANNING (2009). Most commonly, a third party SNT is utilized when the parents of a disabled child wish to include a SNT as part of their estate plans.

b. <u>Absolute Discretion</u>. A third party SNT instrument must grant the Trustee absolute discretion over the distribution of trust assets and provide that the Trustee may only supplement the needs of the beneficiary who is receiving benefits. If the third party SNT provides distributions to the beneficiary for food, shelter and other basic needs of the beneficiary or for medical services that are paid for by Medicaid or SSI, the beneficiary's eligibility for the government benefit program may be lost. The trust instrument should not provide that distributions will be made based on a standard such as support and maintenance. Social Security Administration Program Operations Manual System (POMS) SI 01120.200D. Thus, the purpose of the trust usually is to distribute money for certain "extra" quality of life items and services not provided for by government benefits, such as recreation, transportation and supplemental nursing care expenses. Krooks, Frolik & Fleming, "Sophisticated Special Needs Trust Drafting and Administration Issues," HECKERLING INSTITUTE ON ESTATE PLANNING (2016).

c. <u>Avoid Powers to Revoke, Terminate or Withdraw Property</u>. Similarly, the beneficiary must be prohibited from revoking or terminating the SNT or controlling distributions from the SNT for his or her support and maintenance. The beneficiary should not hold a power such as a *Crummey* withdrawal right over the assets in the third party SNT because, during the time period in which the beneficiary can exercise the withdrawal right, the assets over which the power may be exercised will be considered a resource for determining the beneficiary's eligibility for Medicaid or SSI. In addition, the lapse of the withdrawal right may result in a transfer giving rise to a period of ineligibility. Instead, if the settlor wishes to employ *Crummey* withdrawal rights in a third party SNT, the trust instrument may provide withdrawal rights to the contingent remainder beneficiaries. Hook & Smith, "Special Needs Planning – It is More Than Drafting a Trust," HECKERLING INSTITUTE ON ESTATE PLANNING (2009)*; see Estate of Cristofani v. Commissioner,* 97 T.C. 74 (1991).

Upon the beneficiary's death, the property can pass as designated in the SNT, by the beneficiary's Will, by the exercise of a limited testamentary power of appointment or by the laws of descent and distribution. There is no requirement that the remaining assets be used to reimburse the state for Medicaid services provided. Hook & Smith, *supra*.

2. Incentive Trusts

a. In General. An incentive trust is a trust that is designed not merely as a vehicle for investment management, funds distribution and, possibly, tax savings but, in addition, as a motivational tool -- one that promotes and encourages "good" behaviors and tendencies and discourages or even punishes "bad" behaviors and tendencies. The terms of an incentive trust should be carefully constructed to confer on the Trustee the necessary discretion to make distributions that align with the settlor's desired incentives.

b. Shaping of Beneficiary's Behaviors and Choices. A parent may wish to encourage a child's academic success, stimulate and reward productivity or encourage favored occupational choices. A trust's governing instrument may, for example, provide for distributions for tuition, room and board, etc., and financial rewards for achieving certain scholastic milestones, direct the Trustee to make payments or distributions to or for the child that match the amount of earnings that the child receives from employment as proven by the child's annual Form W-2 or instruct the Trustee to make a payment or payments to a child who joins the family business, works the family farm or starts his or her own business (perhaps, in this last case, directing the Trustee to match seed capital infusions that the child secures from third parties).

Criminal activity, excessive spending and excessively generous gifts may be effectively discouraged through using an incentive trust. Trust distributions to an incentive trust beneficiary may be reduced or eliminated in cases in which the beneficiary is charged with or convicted of committing certain categories of offenses, has a lavish lifestyle that could not be maintained without support from the trust, or makes large gifts to individuals or charities that he or she could not independently afford to make.

c. Drafting Tips. Further, for an incentive trust to operate to its maximum positive potential, it will ordinarily be important to authorize the Trustee to make payments or distributions either to the beneficiary or directly to the providers of goods and services to the beneficiary. For example, it may be appropriate for the Trustee to make tuition and room and board payments directly to the college or university where a beneficiary is conscientiously pursuing a degree.

Failure to provide flexibility in the governing instrument may inadvertently result in a frustration of the settlor's original intentions when circumstances change. For example, an incentive trust beneficiary may, through no fault of his or her own, become disabled, impeding that beneficiary from being an economically productive and self-supporting member of society. In such a case, it would be inappropriate and unfair if the trust instrument required, or even permitted, the Trustee to withhold distributions solely because the beneficiary failed to meet a full-time employment threshold for receiving distributions. Furthermore, if distributions are based on wages earned, will retirement cause trust distributions to cease? The Trustee should have the discretion to deal appropriately with these situations as they arise.

Definitions should be carefully crafted to avoid unintended results. For instance, what is encompassed by the term "full-time employment" or "employed on a full-time basis"? Should a

beneficiary whose right to receive trust distributions depends upon not using drugs or alcohol be considered to have failed that performance standard if the beneficiary drinks a beer or two while at a sporting event with friends?

D. Skillfully Addressing all Dispositive and Fiduciary Appointment Contingencies

1. Dispositive Provisions

a. **Withholding of Mandatory Distributions.** In addition to discussing with the client and drafting the primary dispositive provisions of the estate plan, the estate planner and the client should consider whether the Trustee should be given the discretion to take extraordinary steps to address unforeseen circumstances. For example, the Trustee may be given the discretion to withhold otherwise mandatory distributions if the Trustee determines that the beneficiary should not receive such distributions due a concern that a distribution would be attached by a creditor. To encourage the Trustee to exercise this power over otherwise mandatory distributions as the Trustee deems appropriate, the trust instrument should limit the Trustee's potential liability for exercising such discretion, such as by providing that no Trustee shall incur liability for exercising such discretion in good faith.

b. **Facility of Payment Provisions.** In addition, to address a situation in which the Trustee determines that the beneficiary is unable to manage his or her financial affairs, because of incapacity or otherwise, the Trustee may be given discretion to withhold distributions to that beneficiary, make distributions to another trust for the beneficiary's benefit, use trust funds to purchase an asset (such as a home) for the beneficiary's benefit, make a distribution to an adult relative of the beneficiary (such as the beneficiary's parent) or apply the distributive amount for the beneficiary's benefit.

c. **Making Interim Distributions.** When designing a Will or revocable trust instrument, the drafting lawyer should consider the possibility that the beneficiaries of the post-death irrevocable trusts may have to wait many months from the client's death before such trusts are funded and distributions begin. The Will or trust instrument could explicitly grant the fiduciary discretion to make interim distributions of estate or interim trust assets in accordance with the terms of the post-death irrevocable trusts during estate or interim trust administration. Such a provision may be particularly useful to enable the Personal Representative under a "pour-over" Will to make interim distributions directly to post-death irrevocable trusts under the separate trust instrument.

d. **Failure of Beneficiaries.** Without exception, all Wills and trust instruments should contain provisions addressing to whom any remaining assets will pass in the event all named, designated or contemplated beneficiaries are deceased. That said, in most cases, the likelihood that such a provision will ever be needed is remote. Accordingly, it is usually inappropriate to include an elaborate "failure of beneficiaries" clause. For most clients, designating one or a few charitable organizations of long standing, or those who would have been the client's intestate successors had the client died without a Will, should suffice. The point

is to have a dispositive plan that is 100% complete so that court involvement to construe the Will of trust instrument, perhaps many decades in the future, will not be necessary.

2. Fiduciary Appointment Provisions

a. In General. Among the aspects of designing an estate plan that deserve the most attention, although often relegated to the status of an after-thought, is carefully identifying who would be most qualified and effective in the roles of fiduciary and successor fiduciaries. The client and the lawyer need to discuss the characteristics of the estate plan and the characteristics of the potential fiduciary to determine whether the fiduciary designations are appropriate. These characteristics include the terms and purposes of the estate plan, the nature and value of the assets, the personalities of the beneficiaries, the fiduciary's expertise and accountability and potential conflicts of interests.

b. Facilitating Coordination Among Fiduciaries. As with other aspects of an estate plan, the lawyer should ensure that there is enough flexibility regarding fiduciary appointments to deal with unforeseen circumstances. The drafting lawyer should explain to the client the benefit of keeping the succession of fiduciaries the same in the Will, trust instrument and durable power of attorney for financial purposes. Assuming the person or institution designated is trusted by the client and is otherwise qualified to act as a fiduciary, the administration of a client's assets during the client's incapacity and after death will be more efficient if the same fiduciary (or co-fiduciaries) is in control regardless of the titling of the assets or which instrument governs the disposition of such assets. The fiduciaries designated in a Will, revocable trust instrument and durable power of attorney often interact with each other. For example, the attorney-in-fact may transfer assets to the successor Trustee, or the Personal Representative may transfer assets to the successor Trustee. If the fiduciary is the same among all such instruments, the successor fiduciaries are the same and the succession occurs at the same time and for the same reasons (*e.g.*, a fiduciary who meets the definition of "incapacitated" under one instrument will meet that same definition in all the instruments), these interactions will be seamless.

c. Fiduciaries Serving Different Purposes. There need not be a consistency between, on the one hand, fiduciaries named in a Will, trust instrument and durable power of attorney for financial purposes and, on the other hand, a durable power of attorney for health care purposes. The client may believe that the person who is more knowledgeable and trustworthy regarding the client's health care philosophy and priorities is not the same person that the client would prefer to make decisions under his or her other estate planning instruments (which are primarily financial decisions). The person who is serving as fiduciary under the Will, trust instrument and durable power of attorney for financial purposes may not be the person to whom the client is comfortable disclosing private health information. Furthermore, a corporate fiduciary, even if designated to serve under the client's Will, trust instrument and durable power of attorney for financial purposes, will not serve under the durable power of attorney for health care.

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August 22, 2017

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