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COMMON ESTATE PLANNING DISASTERS AND HOW TO AVOID THEM

By Anne C. Cyr and Skye Christakos

Well, maybe "disasters" is too strong a word. "Mistakes" or "severe oversights" that result in a decedent's testamentary wishes being thwarted may be more accurate. However, for the individuals involved in stressful and expensive estate litigation cases after the death of a loved one, "disaster" oftentimes feels like the more suitable word.

Although avoiding the mistakes identified in this article seems like basic common sense, (you won't be hearing here about the appropriate tax allocation clauses to use in your trust or how to best avoid imposition of the generation-skipping transfer tax), litigation arises all too frequently as a result of these errors. For estate planning attorneys, care and diligence in the client interview process can minimize the chance of problems arising in these areas and maximize the chance of a client's testamentary wishes being attained.

MISTAKE #1: Failing to coordinate the estate plan with assets passing by operation of law.
Normally, by the time a client starts the formal estate planning process, they have already engaged in a certain degree of "informal estate planning" with their bank tellers, financial advisors and real estate agents. In other words, clients have named individuals as joint tenants or "pay on death" payees on their bank accounts and certificates of deposit; made beneficiary designations on their Individual Retirement Accounts, pensions and annuities; added joint owners on real estate titles; and designated beneficiaries on their life insurance policies. Usually, the process of making these choices happens over decades, and the client's memory of their selections is less than accurate.

Clients often assume, incorrectly, that once they sign their will or trust, all of their previous beneficiary designations will automatically coincide with their new estate plan. However, the bottom line is that a client's IRAs, retirement accounts, annuities, and life insurance policies will all pass to the beneficiaries designated on the plan documents themselves, regardless of the fact that the client's will or trust may name different beneficiaries. If a client has named a joint tenant, "pay on death" or "transfer on death" payee on accounts, then those designations--*not* the provisions in the client's will or trust--will normally control the disposition of said accounts.

If a client wishes to ensure that the entirety of their estate will pass to the beneficiaries named in their will or trust, then care must be taken to coordinate the beneficiary designations on such assets as IRAs, pensions, life insurance and annuities. Likewise, joint tenancy or "pay on death" designations that were unintended or no longer reflect the client's wishes, should be changed. Failure to coordinate the estate plan with a client's beneficiary designations will usually result in unintended consequences. (Yes, that ex-girlfriend you named as the beneficiary on your life insurance policy when you thought the relationship would last your lifetime, will still receive the funds unless you change the beneficiary designation forms!). In order to promote awareness of these issues, a prudent policy is to prepare a schedule of all trust assets as well as *non-trust* assets; for the non-trust assets, indicate the client's designated beneficiaries.

MISTAKE #2: Failing to fund the bypass trust after the death of the first spouse to die.
It is quite common for a traditional husband and wife trust to "split" into two or more sub-trusts on the death of the first spouse to die–generally known as the "bypass trust" and "survivor's trust." Typically, the bypass trust holds the assets of the first spouse to die (i.e. that spouse's separate property and their one-half interest in the community estate), and the surviving spouse's portion of the estate is allocated to the survivor's trust. The distribution standards for each sub-trust are usually different: the surviving spouse can freely use the survivor's trust assets, but the bypass trust is normally reserved for the survivor's health, education, support and maintenance. Equally important, in most cases the surviving spouse cannot change the beneficiaries of the bypass trust (but can freely change the survivor's trust beneficiaries)–thus, on the death of the surviving spouse, the bypass trust assets pass to the beneficiaries left in place by the first spouse to die. Sometimes, but not commonly, the trust is drafted so that the survivor's trust must be exhausted before the survivor can use the principal of the bypass trust.

That all sounds well and good, but with some frequency people do absolutely nothing when the first spouse dies. They don't value the assets. They don't separate the assets between the survivor's trust and the bypass trust. They don't obtain a separate EIN for the bypass trust or file separate tax returns. They do, however, amend the survivor's trust to benefit a new spouse or kids from a prior marriage or a charity that their deceased spouse never cared for. Then, they go on, business as usual, with no thought of the trust.

Failure to allocate between sub-trusts presents obvious problems on the death of the surviving spouse, especially when the beneficiaries of the respective sub-trusts are not the same. Who gets what? What assets should rightly be in each trust? Can you trace the separate property of either spouse? How should the expenses of the surviving spouse have been allocated had an appropriate split been done? What if the survivor gave away assets? Nightmares ensue.

Significant problems can also arise during the lifetime of the surviving spouse, such as where a remainder beneficiary (for example, a child of the first spouse to die) requests information relating to the bypass trust, and the survivor's use thereof. Many surviving spouses are stunned to learn that they even have a duty to provide any information at all to the remainder beneficiaries! (Probate Code sections 16060 and 16061 entitle the remainder beneficiaries to substantial information). To learn that a remainder beneficiary also has a right to question the survivor's use of the bypass trust assets (to make sure that the distribution standard set forth in the trust has been respected), and that the survivor should have formed a bypass trust at all, can be overwhelming. Not long ago, my office received a frantic call from a client who had been served with a complaint by a step-child for breach of fiduciary duty and removal as trustee for failing to form a bypass trust. She commented, "Can I actually be removed as the trustee of my own trust? These are my assets–I earned them!"

Always read the terms of the trust when the first spouse dies. Allocate! Trying to piece together what should have or could have happened, after the fact, is both expensive and stressful to those involved. If you are advising in the planning phase, make sure your clients understand the significance of creating a bypass trust (i.e., the duties on the surviving spouse to actually value the estate and form the bypass trust, and the rights of the remainder beneficiaries to receive information during the survivor's lifetime).

MISTAKE #3: Failing to select the right trustee.
The selection of a successor trustee or fiduciary to serve in the event of a settlor's incapacity or death is arguably one of the single most important estate planning decisions to be made. Litigation involving trustees is commonplace. It can involve disputes between co-trustees who can't get along (co-trustees must act unanimously per California law unless otherwise specified in the trust), trustees who fail to follow the terms of the trust, fail to distribute, make loans to themselves and their friends, or self-deal. Or it can involve beneficiaries who accuse trustees of failing to invest properly, distributing too much, distributing too little, taking improper expenses, taking too much in the way of trustee fees, unfairly allocating trust assets, etc., etc.

Clients generally look to their children as the logical successor trustee choices. In the case of blended families, some clients actually feel that having one child from each side of the family serve as a co-trustee makes sense and promotes family harmony. Barring the exceptional circumstance, such a choice generally makes no sense whatsoever, and only serves to stagnate the trust administration process when the two co-trustees can't get along. If the kids don't get along now, forcing them to work together as co-trustees almost certainly won't do the trick.

Nominating one of multiple children as a sole successor trustee also has its drawbacks. If a child serves as successor trustee for a parent while the parent is still living and the trust is revocable, the child only has a present duty to account to the parent (and not the other kids who may be remainder beneficiaries –*see* Probate Code sec. 16062(a) and 16069). Depending on the family dynamics, it can breed disharmony when only one child has access to the proverbial family purse without present accountability to the other children. My office regularly receives calls from the disgruntled "non-trustee" children in such circumstances ("My brother just bought a new car...I just know he used dad's money to get it! He hasn't had a real job in years!"). If a client strongly desires to name only one child as successor trustee, consideration should be given to requiring that child to account to the remainder beneficiaries even where the trust is still revocable and such an accounting is not legally required. Providing such an accounting can both quash unfounded suspicions on the part of the non-trustee remainder beneficiaries, and protect the trustee from later attacks (as under current case law, a trustee may ultimately be held accountable for their actions as trustee pre-dating the time that the trust became irrevocable. S*ee In Re: the Estate of Giraldin* (2012) 55 Cal.4th 1058). The drawback, of course, is loss of financial privacy.

It is essential to consider the actual family dynamics when choosing the trustee. As previously noted, a child may, or may not, be a good choice for successor trustee. Similarly, if the kids from a prior marriage have always resented their father's new wife, it's doubtful that naming her as trustee of the father's bypass trust will be an unproblematic experience.

Close family friends, private professional fiduciaries and corporate trustees may end up being more logical trustee choices, despite the probable increased expense. In fact, compared to a year or so of litigation, the increased expense of a professional trustee may be nominal. In any event, detailed discussions should take place regarding the selection of successor trustees. A client should consider the different events that will trigger the need for the successor trustee (i.e. incapacity vs. death) and evaluate methods to avoid any expected problems within the family.

MISTAKE #4: Failing to build flexibility into the estate plan.
In most trusts which divide into a survivor's trust and bypass trust on the death of the first spouse, the bypass trust (which holds the property attributable to the first spouse to die) is "irrevocable" following the death of the first spouse. This means that regardless of a change in circumstances, the surviving spouse typically cannot change the beneficiaries named to inherit the trust on the death of the surviving spouse. This may be precisely what the clients want. Many couples, when asked, don't want their surviving spouse to have the opportunity to leave the entire estate to a new (younger and better looking) spouse. However, it is quite possible to give the surviving spouse a limited power of appointment. This can be used to change the beneficiaries among a *limited* class or category of people in order to address changed circumstances, such as a disability or drug problem of a beneficiary. For example, a surviving spouse can be given the right to change the beneficiaries, or restructure their shares, provided that the beneficiaries are still the children or grandchildren of the deceased spouse.

Many surviving spouses appear surprised to learn that they can't change the beneficiaries of the bypass trust. Minimally, clients should be educated about the nature of the trust they are signing, and about the possibility of building in some limited flexibility into the estate plan.

MISTAKE #5: Building too much flexibility into the estate plan.
Given that transfer tax exclusion is now $11,700,000, fewer married couples need to use bypass trusts for the sole purpose of sheltering an estate from federal estate tax. Instead, they often leave the entire estate to the surviving spouse, giving him or her the ability to change the beneficiaries at will. For blended families, this is rarely a good plan and can lead to feelings of intense resentment when the surviving spouse disinherits the children of the first spouse to pass away.

MISTAKE #6: Failing to account.
A trustee of an irrevocable trust has a duty to account annually (Probate Code section 16062) to the beneficiaries. Accounting starts the commencement of a three-year statute of limitations (Probate Code section 16460), or a period as short as 180 days if provided for in the trust instrument (*see,* Probate Code section 16461). Many trustees fail to account for years and years, until an accusation of mismanagement or breach of trust is made by a beneficiary. As years pass, records and receipts get misplaced, and memories of expenditures fade, making the feasibility of constructing an accurate accounting all the more challenging. It becomes difficult to reconstruct the work performed by the trustee, which is needed to justify any trustee fees claimed.

Annual accounts will best protect the trustee, and allow the beneficiaries to comment on the details of the trust administration. Beneficiary input may help identify potential problems, and result in the trustee changing course before problems arise.

MISTAKE #7: Transferring appreciated real estate to children during lifetime.
At least several times a year, a client discloses that they have transferred a house to a child. "What is the basis of the property? And did you file a gift tax return?" I ask. Invariably, the answer is that the client purchased the property back in the 1960s for $25,000, that it is now worth $750,000, and that no gift tax return was filed.

If you transfer property to a child during your lifetime, it has a carry-over basis. Thus, in the example, the $25,000 basis is transferred to the child. If the child then goes to sell the property, they will pay capital gains taxes on the difference between the basis ($25,000) and the sales price (subject to any applicable exclusions that may exist). On the other hand, if the child inherits the same piece of property, they receive a stepped-up basis, i.e. if it is worth $750,000 when the parent dies, and the child then sells the same piece of property for $750,000, there is zero gain.

Given the high transfer tax exclusion (now $11,700,000), fewer estates are subject to federal estate tax (making lifetime transfers unnecessary for estate tax avoidance). For non-taxable estates, planning for optimal capital gains tax treatment is oftentimes more significant. Educating clients about basis issues is essential.

MISTAKE #8: Failing to tie the estate plan to the reality of the situation.

This sounds extremely basic, but it is critical that the estate plan be tied to the realities of the estate. Many plans merely indicate that the entirety of an estate shall be divided equally among children. However, this simple drafting is often insufficient and can throw a family into litigation. A simple directive that the estate be "divided equally" will be highly problematic when, for example, one child has used their own money to construct an expensive residence on the parents' 165 acre ranch (and the ranch can't be subdivided), another child has been living in a house co-owned between the parents and the child, and that house is subject to a mortgage, another child received a $100,000 gift from the parents pre-death -- and the estate has no cash. Situations like these call for more thought and more work to be put into the drafting. Should the children residing on the parents' properties have buy-out rights? If so, for how long and through what procedure? What if a child can't secure financing? Should they be allowed to make payments? How are the purchase prices and credits applied? Is the $100,000 an advance on an inheritance or a gift? How are administration expenses to be paid?

Drafting the estate plan to coincide with the special circumstances within an estate will minimize areas of disagreement among the family.

Anne C. Cyr and Skye Christakos are partners at George, Cyr & Christakos, Inc., and are both certified specialists in Estate Planning, Trust and Probate Law. They can be contacted at (805)528-3394.