|An Introduction to Estate Planning|

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Many people have questions about estate planning. From the importance of writing a will to the pitfalls of probate and the basic estate plan for married couples, this article seeks to answer questions we at Mellon address regularly. However, this is intended for general information only, and you should consult an experienced attorney, financial planner and tax advisor as everyone's situation is unique.

WHY IS WRITING A WILL SO IMPORTANT?

If you die without a will, the law in your state, not you, determines who will inherit your property, who will be named to administer your estate and who will be named as the guardian of your minor children. In addition, dying *intestate* – without a will – may result in unanticipated legal and tax problems:

THE STATE HAS A WILL FOR YOU

Each state has a statute that indicates who inherits your property in the event you neglect to write a will. For example, if a Massachusetts resident dies without a will and is survived by a spouse and children, the spouse inherits one-half of the decedent's property and the children inherit the other half. If you want to avoid the results of your state's intestacy statute, make sure you execute a will.

THE STATE CHOOSES WHO WILL ADMINISTER YOUR ESTATE

If you execute a will you may choose who will administer your estate. If you die without a will, you give up that right. Instead, the court will control who will be appointed to administer your estate, even if it is someone you would not have chosen.

THE STATE CHOOSES WHO WILL BE THE GUARDIAN OF YOUR MINOR CHILDREN

If you execute a will you may choose the person or people who will care for your minor children and their property. This person is known as a guardian. If you neglect to make legal provisions for your children, the court will appoint a person to act as the guardian of your minor children – even if it may not be the person you would have chosen.

YOUR ASSETS WILL BE SUBJECT TO PROBATE

If you die intestate, assets held in your name will have to be probated. *Probate* is the legal process of transferring the title to a decedent's assets to his or her beneficiaries. Probate may be an expensive and time-consuming process that can be avoided with adequate planning. The probate process is described in more detail below.

YOUR ESTATE MAY INCUR UNNECESSARY TAXES

Your estate may be subject to the Federal estate tax. The Federal estate tax is an excise tax levied by the Federal government on the value of all the assets you own at death. Careful planning may defer or, in some cases, eliminate the estate tax. However, if you neglect to execute a will, you may be missing many tax-saving opportunities.

WHAT ARE THE BENEFITS OF WRITING A WILL?

The basic instrument for transferring property at death is a will. A will is simply a legal document executed with certain legal formalities that states how property in your name will be distributed at your death. A valid will in connection with an inter vivos trust, which is discussed on page 5, forms the foundation of any comprehensive estate plan. A properly drafted will assists in the orderly distribution of your estate.

It allows you to:

- Name a person to administrate your estate
- Name a guardian for your minor children
- Provide for the payment of legacies, debts, expenses and taxes
- Indicate who will inherit your estate

Your will may be changed at any time before your death, assuming you are legally competent. At your death, the terms of your last will govern the disposition of your estate.

Your will has a number of important functions. First, your will expresses your dispositive intentions for your probate property. In other words, it enables you to indicate who will inherit property held in your name. Next, your will gives you the opportunity to name the person who you would like to act as the executor, also known as a personal representative, of your estate. The executor of your estate is an important function. Whoever you name as executor acts as the quarterback of your estate making sure that your assets are identified, your debts, expenses and taxes are paid and the balance is distributed to your beneficiaries. In writing a will it is usually a good idea to give your executor broad administrative powers so that your executor does not otherwise have to petition the probate court in order to obtain permission to do some particular act. A will also gives you the opportunity to transfer assets after your death to your living trust. This is done through the use of a so-called “pour-over” provision. This provision provides that the residue of your estate passes to your living trust. Using a pour-over provision in a will allows you to leave any assets that you have not otherwise disposed of to your living trust.

HOW DO I WRITE A WILL?

You should have your will prepared by an attorney. Your attorney can assist you with the technical requirements of a valid will, which vary from state to state. To fulfill the basic requirements for a valid will, you must:

- be competent and of legal age;
- state your intention that the document is your last will;
- sign the will or, if physically incapable to do so, have someone sign the will at your direction and, generally, in your presence; and
- have the signing of the will witnessed by two or more eligible witnesses who sign the will as witnesses.

In some states you can avoid having to prove the validity of the will by executing a *self-proved affidavit* at the time you execute your will. A self-proved affidavit is simply a notarized statement signed by you and witnessed by two or more witnesses which states that all of the legal requirements for executing a valid will were followed. The self-proved affidavit saves your executor from having to formally prove the will by testimony or other evidence after your death.

WHAT IS PROBATE?

In general terms, probate is the legal proceeding undertaken after your death to transfer the title to assets held in your name to your beneficiaries. At the time of your death whoever you name in your will to administer your estate will file your will in court and ask the court to formally appoint him or her as the legal representative of your estate. Depending on which state you live in, the fiduciary appointed by the court to administer your estate is called an executor, administrator or personal representative. For ease of reference,we'll refer to this person as your executor.

Once your executor has been formally appointed by the court, he will collect the assets of your estate and file an inventory of those assets with the court. Thereafter he will notify your beneficiaries and creditors, collect the income from your assets, pay your debts, expenses and taxes, and distribute the balance of your estate to your beneficiaries. In most states, probate is completed once your executor files a final account and the account is accepted by the court.

WHAT ASSETS ARE SUBJECT TO PROBATE?

At the time of your death there are two types of property which will pass to your beneficiaries: *probate property* and *nonprobate property*. Probate property is any property that is subject to the jurisdiction of the probate court. Generally, only assets that are in your name alone are subject to probate – they are called probate assets. Examples of probate property include: real estate, stocks, bonds, bank accounts and your interest in property held as tenants in common.(Property held as tenants in common give the co-tenant an undivided proportionate interest in the property. Such property does not automatically pass to the survivor as it does with joint property. Rather, a person must make specific provisions in a will or trust for the disposition of property held as tenants in common.) Nonprobate property is property that is not subject to the jurisdiction of the probate court and passes to your beneficiaries outside the probate process. Generally, nonprobate property is property that passes pursuant to a contract or is held in joint tenancy or as tenancy in the entirety. Examples of nonprobate property generally include proceeds of life insurance, retirement plan benefits, a jointly owned residence and assets held in a funded living trust.

Your will controls only the disposition of probate assets. The disposition of nonprobate assets such as life insurance, Individual Retirement Accounts and retirement plan benefits are governed by a beneficiary designation form issued by the insurance company or plan administrator. Jointly held assets (including assets held as tenants by the entirety) pass by operation of law to the surviving joint tenant(s).

WHAT ARE THE DISADVANTAGES OF PROBATE?

In some states probate is fairly straightforward. However, in many states (e.g., Massachusetts, New Hampshire, California) probate can be a complicated, expensive and time-consuming endeavor. The primary disadvantages of probate are:

- Cost
- Delay
- Lack of Privacy
- Court Supervision

COST

If your estate is subject to probate, your estate will incur administration costs, filing fees, newspaper publication fees and estate administration fees. The costs associated with probate vary from state to state. Estate administration fees in some states are established by statute. In other states these fees are unregulated.

DELAY

The probate process in some states may take at least 18 months and can take substantially longer. Again, the delay will vary from state to state. Some states have efficient forms of probate while others involve significant delays.

LACK OF PRIVACY

In most states a probate file is a matter of public record. In other words, anyone can request the probate file and find out what you left, how much it was worth and who inherited it. If you want to keep your financial affairs private, you'll want to avoid probate.

COURT SUPERVISION

In most states probate is supervised by a court specializing in these matters. Thus, the court maintains control of the disposition of your estate until the executor is discharged.

CAN'T I AVOID PROBATE BY HOLDING MY ASSETS IN JOINT OWNERSHIP?

Many people think they can avoid probate by holding their assets in joint ownership. But joint tenancy may merely postpone probate until the death of the surviving joint tenant.

Joint tenancy is a form of co-ownership of assets by two or more people. For example, you and your spouse may own your house as joint tenants. The unique feature of joint ownership is that when one of the joint tenants dies, the other joint tenant automatically acquires the deceased joint tenant's interest in the jointly held property. The transfer is automatic at death and requires no probate. For example, if you and your spouse own your house as joint tenants and you die, your spouse automatically acquires your interest in the house at the moment of your death. Your spouse thereafter owns 100% of the house in his or her name. The house does not have to go through probate at the death of the first joint tenant. Thus, it is possible to avoid probate using the joint tenancy form of ownership. However, probate is only avoided at the death of the first of the two joint tenants. After the death of the first joint tenant, the property is owned solely by the surviving joint tenant. If the survivor continues to hold the property in his or her name at death, the asset is probate property. Thus, holding property as joint tenants does not completely avoid probate, it just delays the process.

An often overlooked disadvantage of joint ownership is the affect of the incapacity of one of the joint tenants. If you and your spouse own your house as joint tenants and one of you becomes incompetent, you may have trouble selling or refinancing your house. The incompetent spouse may be unable to sign a deed or mortgage to deal with his or her share of the house. You may have to petition the court to have someone appointed to represent the incompetent spouse's interest. That will involve delay and expense. An easy way to prevent this is for each joint owner to execute a durable power of attorney, appointing another individual to represent his or her interests in the event he or she becomes incompetent.

WHAT IS A DURABLE POWER OF ATTORNEY?

A durable power of attorney is a legal document by which you nominate a representative (called the "attorney-in-fact") as your agent to handle your financial affairs. A durable power of attorney can take effect upon its execution or only upon the occurrence of a later event such as incapacity. A durable power of attorney is not affected by your incapacity *i.e.*, your attorney-in-fact is able to handle your financial affairs even though you, the principal, are not competent to do so. The major advantage of a durable power of attorney is that it is the easiest and least expensive way to manage the financial affairs of an incapacitated person and it avoids a potentially expensive and time-consuming court proceeding. The disadvantages of a durable power of attorney are (1) the attorney-in-fact is not supervised, (2) third parties may be unwilling to accept the power of attorney and (3) when you die, your assets will have to be probated. Thus, like joint ownership, a durable power of attorney is a temporary fix.

WILL MY ESTATE BE SUBJECT TO PROBATE IN MORE THAN ONE STATE?

Your estate is normally subject to probate in the state in which you are domiciled. However, if you own real estate in your own name that is located in another state, that asset may have to be probated in the state where it is located. Your estate may be subject to probate in multiple states in the absence of careful planning.

WHAT IS A LIVING TRUST?

A living trust is simply a private contractual arrangement between you and a trustee by which you agree to transfer assets to the trust and the trustee agrees to manage the assets according to the terms of the trust for the benefit of the beneficiary of the trust. A living trust is frequently referred to as a "will substitute" because it accomplishes many of the same goals as your will. The person who established the trust is known as the *grantor, donor* or *settlor*. The grantor selects the representative who manages the trust assets – this person is the *trustee*. The person for whose benefit the trust is established is known as the *beneficiary*. The terms of the trust document instruct the trustee how to manage the trust assets and how to dispose of the income and principal of the trust.

There are two types of trusts: a *living trust* (also known as an inter vivos trust) and a *testamentary trust*. A living trust is a document established by the grantor during his or her life. A living trust can be either *revocable* or *irrevocable*. A revocable trust may be altered, amended or revoked at any time by the grantor while he or she is alive and competent. An irrevocable trust, as the name suggests, may not be altered, amended or revoked. Unlike a living trust, which is effective and can operate during the grantor's life, a testamentary trust is a trust established under the terms of the grantor's will. Because it is established under a person's will, a testamentary trust is effective only after the grantor's death – it does not operate during a person's life.

Testamentary trusts generally cause administrative problems and delays that are not present with living trusts. Since the terms of a testamentary trust are contained in a person's will, the assets of a testamentary trust must go through probate before they are transferred to the testamentary trust. A testamentary trust in most states is subject to the continued supervision of the local court. Thus, a testamentary trust suffers from all of the disadvantages of probate – the delay, lack of privacy, cost and court supervision.

As a result of the administrative problems that accompany wills and testamentary trusts, many people look for a way to dispose of their estates without incurring the disadvantages associated with wills and testamentary trusts. The use of a funded living trust allows you to accomplish your dispositive objectives without the disadvantages associated with wills and probate.

A *funded living trust* is simply a trust that is funded, in whole or in part, by transferring the title to your assets to the trustee of the living trust during your lifetime. Its prime purpose is to avoid probate for those assets transferred to the trust during your life. An *unfunded living trust* is a trust that does not hold any assets – it is funded after you die. A living trust which is unfunded is usually funded with the residue of your estate after those assets have been probated. This is accomplished by a "pour-over" provision in your will, which "pours over" the balance of your probate estate to your living trust. A pour-over provision will usually indicate how your tangible personal property is to be disposed and leaves the residue of your estate to your living trust. The provisions of your living trust will provide for the disposition of most of your assets and are usually structured to obtain the optimum tax benefits.

Use of a funded living trust allows you to dispose of your assets as you would in a will and avoid all of the disadvantages of probate.

WHAT ARE THE ADVANTAGES OF A LIVING TRUST?

A funded living trust has the following advantages:

1. PROBATE AVOIDANCE
   Only assets held in your name at your death are subject to probate. Assets transferred to your living trust prior to death are not held in your name – they are held in the name of the trustee. Thus, assets held in a living trust are not subject to probate as long as legal title is transferred to the trust prior to your death.

2. PROFESSIONAL MANAGEMENT OF ASSETS
   A professional trustee will develop an investment strategy based on your individual objectives, income needs and tax status. In addition, the trustee will perform all of the day-to-day recordkeeping and other administrative burdens required to manage your assets.

3. PROTECTION IN THE EVENT OF INCAPACITY
   A living trust can assure your financial independence if you should become legally incapacitated. Your trustee can be authorized to step in and pay your medical bills, your household expenses, insurance, taxes and, in general, keep your financial affairs in good order for as long as necessary. Since the title to assets held in a funded living trust is in the name of the trustee, no guardianship or conservatorship proceedings have to be instituted to deal with those assets if you become incapacitated. Even if at the time the trust is created you desire to manage your own assets and name yourself as trustee, the trust can provide for a successor trustee in the event of your incapacity. The title and the management of your assets remain in the trust allowing you to avoid a guardianship or a conservatorship.

4. PROVIDE CONTINUED ASSET MANAGEMENT
   Your living trust can outlive you, assuring continued, experienced asset management for the benefit of your spouse, a child, or any others for whom you wish to provide. The flow of income from your trust need not be interrupted or delayed by the settlement of your estate, because your living trust is already functioning at the time of your death.

5. COORDINATE LIFE INSURANCE AND EMPLOYEE BENEFITS
   You can arrange to have the proceeds of your life insurance policies or retirement benefits distributed directly into your living trust at your death. This will allow your trustee to invest immediately the proceeds, rather than place the burden on your beneficiary to manage a large lump sum of money.

6. PRIVACY

Your living trust agreement is a private agreement between you and your trustee. Your will, on the other hand, is generally a public document and is filed in the local probate court. In most states your will is open to public inspection. Placing your assets in a funded living trust ensures the privacy of your financial affairs.

A living trust gives you flexibility. It can be changed at any time while you are alive or even revoked by you if it doesn't live up to your expectations. You keep control of your assets. Not only will the trust provide for you during your lifetime but it can continue to provide important benefits, including professional asset management, beyond your lifetime.

HOW DO I SET UP A LIVING TRUST?

A living trust is very easy to establish. First, you sign a trust agreement that has been drafted by your attorney. Next, you transfer certain assets to your trustee who follows the instructions in the trust agreement on how you wish those assets to be managed and distributed.

HOW DOES A LIVING TRUST WORK?

The living trust is really a contract setting forth how the trust is to be managed during your life and how the trustee should dispose of the assets remaining at your death. Your living trust will be structured to allow you the right to receive the income and principal from the trust at any time during your life. In the event of your incapacity, your trustee will continue to manage the trust assets and pay the income and principal to you and others as provided in the trust document. You retain the power while you are alive and competent to alter, amend, revoke or terminate the trust. Upon your death the trust becomes irrevocable and the trust assets are administered and distributed in accordance with the provisions of the trust. Because legal title to the assets is held by the trustee, these assets need not be probated. They may remain in the trust for the benefit of others or may be distributed free of the trust to your beneficiaries.

HOW DO I FUND MY LIVING TRUST?

A living trust is funded by simply transferring assets to the trust. Most property can be held in your living trust. Usually the assets consist of income-producing assets such as cash, stocks and bonds.To transfer title of your assets to the trust you simply place the title of your assets in the name of your trustee. For example, the title to 100 shares of XYZ common stock would be placed in the name of Mellon Financial Corporation, Trustee of the [your name] Trust.

HOW DOES THE LIVING TRUST OPERATE?

The trustee of your living trust is charged with the care of the securities that you have placed in the trust and will recommend investment changes whenever the trustee deems them to be to your advantage. The trustee will keep records of the income that is received by the trust as well as the expenses that are paid out. The trustee will pay the net income to you, or to anyone you designate such as members of your family, a friend or a charity. The trustee will periodically (usually monthly or quarterly) furnish you with an accounting of the trust's activities. You are free to make withdrawals in any amount from the trust principal whenever you wish or to put additional assets into the trust.

WHAT ARE ESTATE TAXES?

The federal estate tax is an excise tax imposed on the transfer of assets at death. The tax is imposed on your *taxable estate* which is, in general terms, all of the assets you have an interest in at death (called the *gross estate*) reduced by various deductions. The federal government imposes a death tax on the fair market value of all the assets you have an interest in (e.g., real estate, stocks, bonds, cash, life insurance, retirement benefits, business interests, etc.). The tax is due nine months after death. Naturally, the government gets its money before any of your beneficiaries.

ARE THERE ANY EXEMPTIONS FROM ESTATE TAX?

An estate tax return must be filed only if the gross estate exceeds the amount of the current estate tax exemption. Current federal estate tax law gives each person an exemption from estate, gift and generation-skipping transfer taxes.

WHAT ARE THE ESTATE TAX RATES?

Estate taxes are assessed at a graduated rate – the greater the value of the estate, the greater the tax and the higher the marginal estate tax bracket.

FEDERAL ESTATE, GIFT AND GENERATION-SKIPPING TAX EXEMPTIONS

Based on legislation passed in 2001, federal gift, estate and generation-skipping wealth transfer taxes are undergoing changes. The federal estate and generation-skipping transfer taxes are scheduled for repeal, but only for people dying in the 2010 calendar year. In the meantime, the estate and generation-skipping tax exemptions are increasing and the tax rates are decreasing. It will take an act of Congress to continue the repeal beyond 2010. The gift tax, which is not scheduled for repeal, is subject to a $1,000,000 exemption. Even with the scheduled changes, federal estate and gift taxes are now among the highest in the federal taxation system.

Listed below is the schedule for the various gift, estate and generation-skipping tax exemptions and rates planned through 2011, at which time Congress will -- most likely -- respond with future exemptions and revised tax rates.

YEAR	FEDERAL ESTATE AND GST EXEMPTION AT DEATH	MAXIMUM FEDERAL ESTATE TAX RATE
2003	Estate Tax : $1,000,000 GST Tax: $1,120,000	49%
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	No Tax – estate and GST tax repealed	No Tax – gift tax equal to top individual tax rate of 35%
2011 and thereafter	Estate Tax : $1,000,000 GST Tax: $1,060,000 indexed from 2001	55% (plus 5% surtax on certain estates over $10 million)

The gift tax exemption is $1,000,000 for all of the above years.

WHAT DEDUCTIONS MAY BE TAKEN AGAINST THE ESTATE TAX?

The estate tax law allows a deduction for certain administration expenses such as attorneys', accountants' and executor's fees, as well as other expenses incurred in administering the estate. In addition, the estate tax law allows two very important deductions: the marital deduction and the charitable deduction.

WHAT IS THE MARITAL DEDUCTION?

You get a deduction, unlimited in amount, for whatever qualifying assets you leave to your surviving spouse. This is known as the *marital deduction*. This deduction is available for whatever assets you leave to your spouse as long as your spouse is a citizen of the United States. (A modified marital deduction is available for assets left to a non-citizen spouse if the bequest meets certain technical requirements that are beyond the scope of this discussion.) The marital deduction allows you to leave your entire estate to your spouse and not pay any estate tax at your death. Instead, the tax is deferred until the second death. The marital deduction is permitted on the premise that the property interest received by your surviving spouse will be included in your spouse's estate at his or her subsequent death.

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF THE MARITAL DEDUCTION?

Under the federal estate tax, an unlimited marital deduction is available for transfers to your surviving spouse. The advantages of the unlimited marital deduction are as follows:

1. All federal estate taxes can be eliminated upon the death of the first spouse.
2. Deferring the federal estate tax liability until the death of the surviving spouse gives the surviving spouse more money for support and/or investment during the life of the surviving spouse. That is, there is more money available for investment because the investable assets have not been reduced by any federal estate tax.
3. Eliminating estate taxes on the first spouse's death may eliminate the need to liquidate valuable but illiquid assets such as stock in closely held businesses, farms, real estate and other illiquid assets.
4. The surviving spouse may have an opportunity during his or her lifetime to further deplete the estate by making gifts to family members or by using such property for his or her support needs. Annual exclusion gifts are particularly attractive for this purpose.

There are also reasons why the unlimited marital deduction might not be favorable. The disadvantages of using the unlimited marital deduction are as follows:

1. The survivor's estate likely will be taxed at a higher tax rate because the estate tax will be imposed on the sum of both the assets passing to your spouse in the form of a marital deduction and your spouse's separate assets. Also, the likely appreciation or inflation of the value of your assets and your spouse's assets will result in those assets being subjected to a higher federal estate tax rate.
2. In order to receive the benefit of the marital deduction, the marital deduction gift must either be left outright to your surviving spouse or it must be left in a trust which must meet technical specifications.
3. The surviving spouse cannot be required to make, and the trustee of a marital trust cannot be permitted to make, distributions from the marital deduction trust to any person other than the surviving spouse.Thus, the surviving spouse and the trustee of the marital trust are not able to make distributions to persons who might be dependent upon either you or your spouse for support. Your surviving spouse could, of course, ask the trustee to make distributions to himself or herself and then turn around and make distributions to anyone he or she wants from his or her own funds.

WHAT IS THE CHARITABLE DEDUCTION?

Like the marital deduction, you get a deduction, unlimited in amount, for whatever assets you leave to charity. This is known as the *charitable deduction*. Like the marital deduction, the charitable deduction allows you to leave your estate to charity and not pay any estate tax at your death assuming the requirements for the deduction are met.

HOW CAN I STRUCTURE MY ESTATE TO TAKE ADVANTAGE OF THE MARITAL DEDUCTION AND THE APPLICABLE EXEMPTION?

The marital deduction allows you to leave all or a portion of your total estate to your surviving spouse, free of federal estate tax. This will allow you to defer the federal estate tax until the death of your surviving spouse. However, leaving your entire estate to your spouse at your death may not be the best course of action from a tax perspective, even though the unlimited marital deduction might reduce the tax in your estate to zero. Such a plan, for example, would not enable your estate to take advantage of your estate tax exemption.

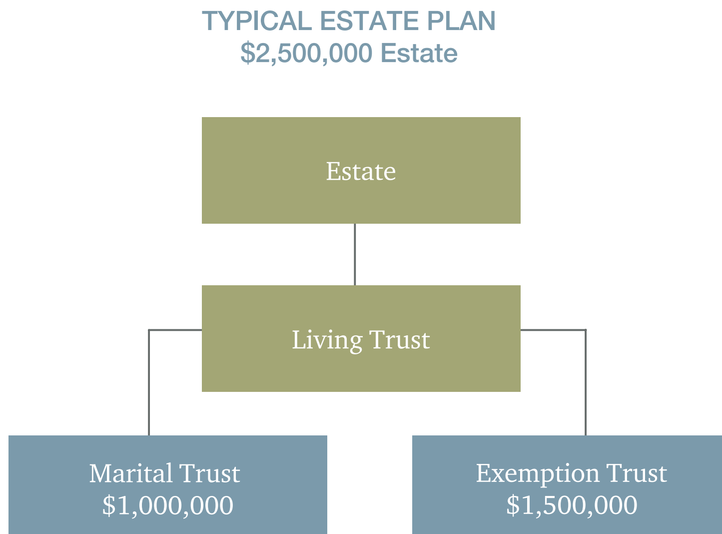
As mentioned above, each individual has the benefit of an estate tax exemption. If you leave all of your assets to your spouse to take advantage of the unlimited marital deduction, your exemption is lost. That's because the marital deduction reduces the estate tax to zero, leaving nothing for your exemption to offset. Rather than using an unlimited marital deduction, the best planning technique is to coordinate the use of the marital deduction and the estate tax exemption. Thus, if you are married, you should seek to *optimize* rather than *maximize* the estate tax marital deduction.

HOW DO I OPTIMIZE THE MARITAL DEDUCTION?

You can coordinate the use of the unlimited marital deduction with the estate tax exemption and still pay no estate tax at the death of the first spouse. Here's how it's done. Your documents will provide that upon your death your trust (and any assets received from other sources such as your estate) will split into two shares: the marital deduction share and the exemption share. Usually both shares constitute separate trusts. The exemption trust is funded with assets equal in value to the then existing exemption. If you were to die in the year 2005, your exemption trust would be funded with $1,500,000, the amount of the estate tax exemption for 2004 and 2005. The marital trust would be funded with the balance of your estate.

For example, if your estate was $2,500,000 and you died in 2005, the exemption trust would be funded with $1,500,000 and the marital trust would be funded with the balance, or $1,000,000. It would look like this chart:

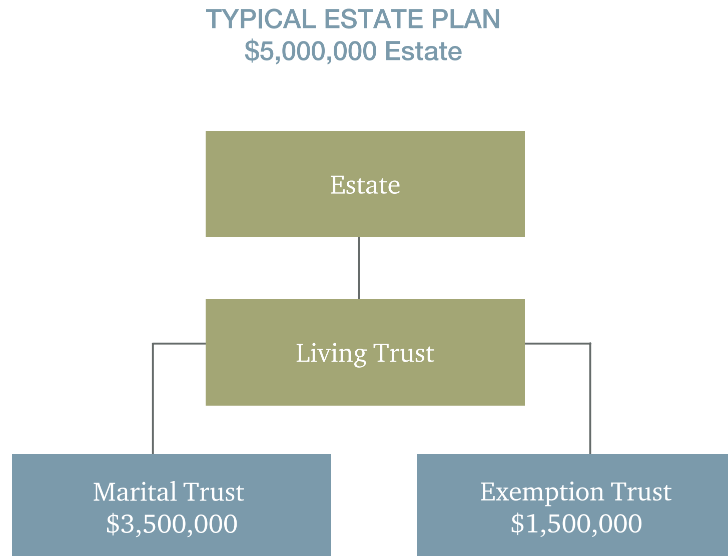
TYPICAL ESTATE PLAN
$2,500,000 Estate



The amount that goes into the marital trust and the exemption trust is determined by a formula that is incorporated into your trust. As the amount of your estate changes, so does the amount that goes into each trust.

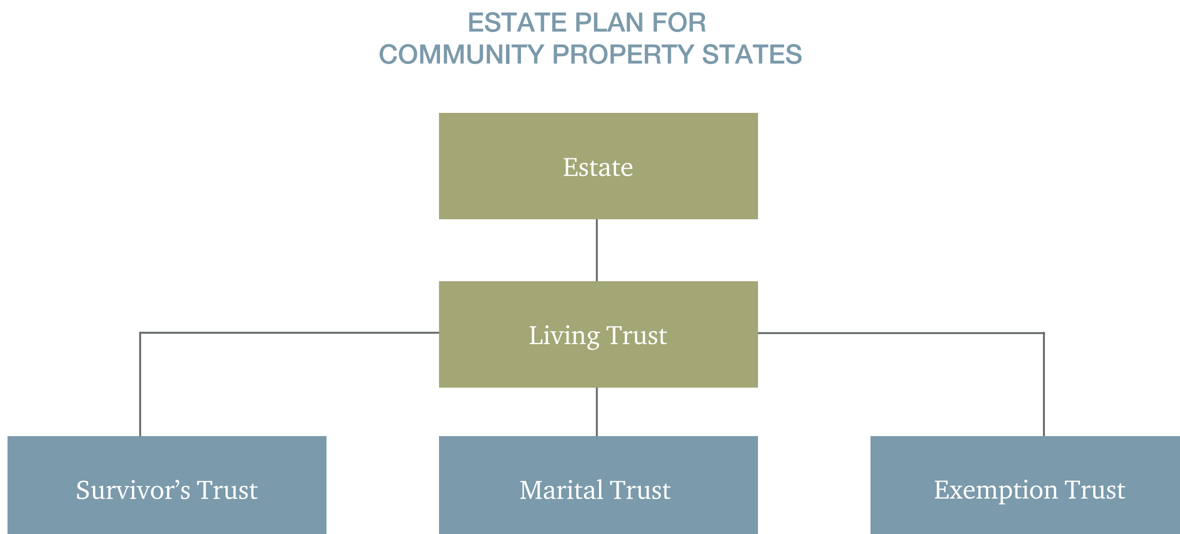
For example, if your estate had increased to $5,000,000 and you were to die in the year 2005, $1,500,000 would still go into the exemption trust and the balance of $3,500,000 would go into the marital trust. It would look like this chart:

TYPICAL ESTATE PLAN
$5,000,000 Estate



If you lived in a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin), the structure would be a little different. In general terms, community property is all property acquired during marriage by either spouse while domiciled in a community property state with the exception of property acquired before marriage or received by inheritance or gift. Essentially, each spouse is considered to own half of the property classified as community property. In addition, a spouse may have his or her own separate property e.g., property acquired before marriage or acquired by inheritance or gift. Each spouse generally has the right to dispose of his or her half of the community property at death as well as his or her own separate property. The characteristics of the community property system cause the typical estate plan in a community property state to be different from the typical plan used in a common law (non-community property) state.

ESTATE PLAN FOR
COMMUNITY PROPERTY STATES



The surviving spouse's separate property and half of the community property is allocated to the survivor's trust. The survivor's trust is structured as a revocable trust. The surviving spouse has absolute control over the assets in the survivor's trust. In fact, in some cases the surviving spouse's separate property and half of the community property passes outright to the surviving spouse rather than being allocated to the survivor's trust. The decedent's separate property and the decedent's half of the community property is allocated between the marital trust and the exemption trust in the same manner as in a common law state.

WHAT ARE MY SURVIVING SPOUSE'S RIGHTS UNDER THESE TRUSTS?

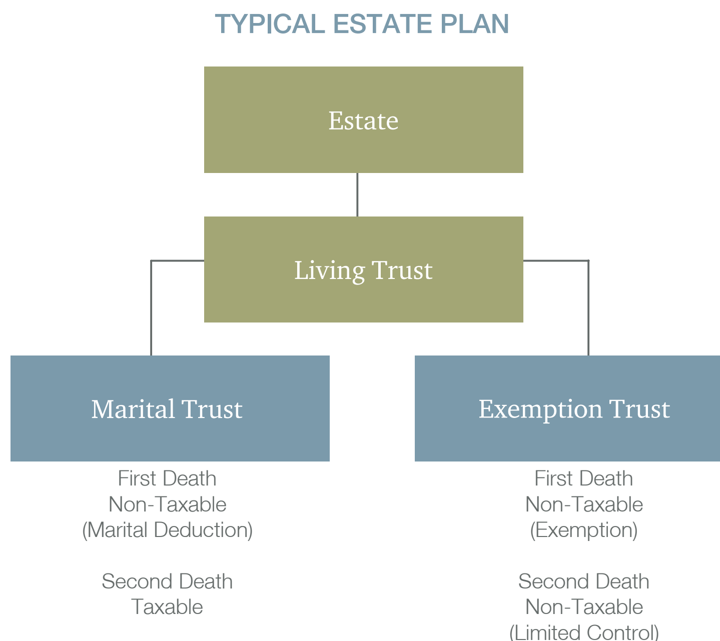
Your spouse's rights over the marital trust may be different than your spouse's rights over the exemption trust. The marital trust is designed to qualify for the Federal estate tax marital deduction. There are various ways in which your estate can qualify. For example, the marital share may be left outright to your spouse or can be left in trust. If left in trust, the trust can give your spouse broad powers over principal or can restrict access to principal. The most common way to qualify for the marital deduction is to structure the marital share as a *qualified terminable interest property (QTIP)* trust. A QTIP trust requires that all of the income of the trust be distributed annually to your surviving spouse. In addition, no one but your spouse can have rights in the QTIP trust while your spouse is alive. The trustee also can (but need not) be given the power to make discretionary distributions of principal. A QTIP trust allows you to control the ultimate disposition of the property remaining in the trust at your surviving spouse's death. However, you can give your surviving spouse the power to distribute the balance remaining in the QTIP trust at his or her death among a certain limited class of beneficiaries. Thus, your surviving spouse must receive the income from the trust annually and may or may not receive distributions from principal. The important point is that the marital share must be in a form, whether an outright distribution or in trust, that qualifies for the estate tax marital deduction.

The exemption trust is designed to escape estate taxation at the death of the surviving spouse by limiting your spouse's control over the trust and access to principal. Your spouse does not have to be the only income beneficiary of this trust as is the case with the QTIP trust. In fact, your spouse doesn't even have to be a beneficiary of this trust. However, most estate plans provide for the spouse to be one of the beneficiaries of the exemption trust. The beneficiaries of the exemption trust can be given either the right to the income annually or the income may be distributed to the beneficiaries at the trustee's discretion. However, to avoid inclusion in your spouse's estate, your spouse's rights to principal are limited. Generally, your spouse may receive principal at the trustee's discretion or according to an ascertainable standard (health, education, maintenance or support). In addition, your spouse may have the right to appoint the balance of the trust to a certain limited class of beneficiaries. The objective of this trust is to limit your spouse's control over this trust so that the balance remaining in the trust at his or her death escapes estate taxation in his or her estate.

WHAT DOES THIS STRUCTURE ACCOMPLISH?

Using a marital trust and an exemption trust allows you to maximize the estate tax exemption, optimize the marital deduction and minimize the amount included in your surviving spouse's estate. This structure allows you to escape estate tax at your death – the $ 1,500,000 going to the exemption trust in 2005 is offset by the $1,500,000 estate tax exemption, while the balance of your estate qualifies for the marital deduction. Thus, there is no estate tax if you die first. Upon the death of your surviving spouse, the amount in the marital trust is subject to estate tax. However, the amount in the exemption trust at your surviving spouse's death, regardless of how much that trust has increased in value since your death, is not subject to estate tax at your surviving spouse's death. This structure allows you to defer estate taxes until the death of the surviving spouse and to prevent the amount in the exemption trust from being taxed at either death. The estate tax consequences of the marital and exemption trust are illustrated below.

Please note that the assets in the marital trust are taxed at the second death, while the assets in the exemption trust are not taxed at either death.



HOW SHOULD THESE TRUSTS BE INVESTED?

From a tax point of view, the marital trust generally should be weighted more towards fixed income and less towards equity investments. Since the assets in the marital trust are subject to tax in the surviving spouse's estate, it makes sense to invest for income and to limit the capital growth of the trust. In addition, if the surviving spouse has unexpected expenses, those expenses should be paid out of the marital trust. The less the value of the marital trust at the surviving spouse's death, the less the estate tax that is payable.

On the other hand, the exemption trust should take the opposite approach – weighted more heavily in equities. In addition, the trustee should avoid making unnecessary distributions of principal during the surviving spouse's life. Increasing the value of the exemption trust maximizes the amount that passes estate tax free to your beneficiaries.

HOW SHOULD THE TITLE TO MY ASSETS BE HELD?

Title to your assets may not be all held in the exact same manner. Some of your assets may be held solely in your name, while others may be held by you and your spouse jointly. Furthermore, the beneficiary of your insurance proceeds and retirement plan benefits may not be coordinated with your overall estate plan. In order to have an effective estate plan, the ownership of your assets must be coordinated with your estate plan. Jointly held assets are not subject to probate and pass outside of the dispositive provisions of your will or trust. In other words, the provisions of your will and the provisions of your trust do not control how jointly held assets are distributed. Thus, in order to dispose of jointly held assets pursuant to your trust, the title to those assets would have to be changed from joint name to your name alone or, alternatively, transferred to the name of the trustee of your living trust.

Insurance and any retirement plan benefits also should be coordinated with your estate plan. Insurance policy proceeds as well as retirement plan benefits are nonprobate property. As such, they pass outside of the dispositive provisions of your will and trust. Insurance policy proceeds or retirement plan benefits pass to whomever you designate as the beneficiaries of the insurance policy proceeds or the retirement plan benefits. In order to coordinate these assets with your overall estate plan, it may be advisable to name your living trust as the beneficiary of insurance policy proceeds or retirement plan benefit proceeds.

If you name your living trust as the beneficiary of these proceeds, it is advisable that the payment options of the insurance policy or the retirement plan benefits be coordinated with your estate plan. This is particularly important if you want your retirement plan benefits to qualify for the marital deduction.

HOW CAN I USE LIFE INSURANCE TO PAY ESTATE TAX AT THE SECOND DEATH?

Most estate plans are designed to defer any estate tax until the death of the surviving spouse. A comprehensive estate plan should consider using the proceeds of a life insurance policy to provide liquidity to pay part or all of the estate tax due at the death of the surviving spouse.

WHAT TYPE OF LIFE INSURANCE SHOULD I USE?

Estate plans that defer the estate tax until the death of the surviving spouse generally use a special type of insurance called *second-to-die* or *joint-and-survivor insurance*. Traditional life insurance insures the life of the insured; when the insured dies, the policy pays. Second-to-die insurance is different – it insures the lives of both the husband and wife but only pays at the death of the survivor. When the surviving spouse dies, the insurance death benefit is paid to the beneficiary of the policy.

Paying at the death of the survivor makes sense, because that is when the estate tax is owed. Since the policy insures two lives and pays at the death of the survivor, the actuarial risk to the insurance company is lower, meaning the insurance premiums are lower.

HOW DO I AVOID BEING TAXED ON THE LIFE INSURANCE PROCEEDS?

Generally, the proceeds of life insurance are included in your estate for estate tax purposes. The general rule is that the proceeds of life insurance are subject to estate tax if: (1) the proceeds are payable to your estate; or (2) you, as the insured, have incidents of ownership in the policy. Incidents of ownership means that you have some sort of control over the policy, e.g., you can change the beneficiaries of the policy, borrow on the policy or surrender the policy. Insurance, however, is very easy to remove from the estate tax base. Assuming the insurance is not payable to your estate, it will be excluded from your estate if you avoid having any incidents of ownership in the policy. Insurance can avoid estate tax by setting up a separate irrevocable insurance trust, having the trustee purchase the life insurance policy and naming the trust as the owner and beneficiary of the policy.

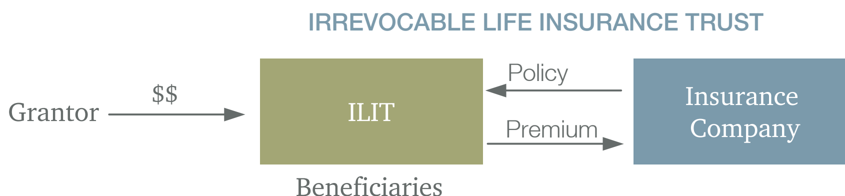
HOW SHOULD I STRUCTURE THE PURCHASE OF THE LIFE INSURANCE POLICY?

Establishing an irrevocable life insurance trust is a multi-step process. Each step must be carefully followed to protect the policy proceeds from estate taxation. A properly structured life insurance trust will result in the life insurance policy proceeds being excluded from your estate for estate tax purposes.

First, have your attorney draft the trust. Second, transfer sufficient cash to the trust to cover at least the initial premium on the insurance. The trustee pays the insurance premium with the cash you transfer to the trust. Premiums in later years could be covered by future gifts to the trust.

The transfer of assets to the trust constitutes a gift for gift tax purposes. Your attorney can discuss with you how to structure the trust to avoid or minimize the gift tax consequences of transferring assets to the trust. Sometimes this is as simple as giving the beneficiaries of the trust the right to withdraw any addition to the trust, which is called a Crummey withdrawal power, named after a famous case, **Crummey v. Commissioner of Internal Revenue**. Third, the trustee of the trust purchases the life insurance policy. Fourth, the irrevocable insurance trust is named the owner and beneficiary of the life insurance policy.

This is how it looks:



Steps:
1. Set up Trust
2. Transfer cash to Trust
3. Trustee purchases insurance policy
(ILIT is owner and beneficiary of policy)

Result:
Life insurance proceeds exempt from Federal Estate Tax

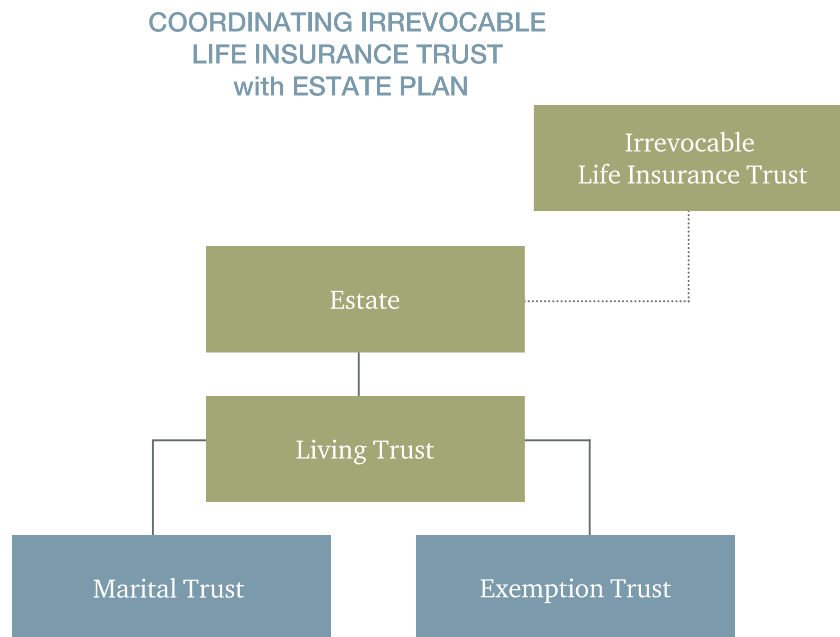
IF THE LIFE INSURANCE IS PAYABLE TO THE IRREVOCABLE INSURANCE TRUST, HOW IS IT USED TO PAY ESTATE TAXES?

Although the life insurance is owned by and payable to the life insurance trust, a properly drafted trust will allow the trustee to use the trust principal to lend money to your estate or to purchase assets from your estate. Lending money to or purchasing assets from your estate is one way to provide for liquidity in your estate.

HOW DOES THE IRREVOCABLE LIFE INSURANCE TRUST FIT WITH THE REST OF MY ESTATE PLAN?

The irrevocable life insurance trust is a separate trust from your revocable trust. The irrevocable life insurance trust stands by itself, ready to use the insurance proceeds to provide liquidity to your estate.

This is how it looks:



WHAT IS THE GENERATION-SKIPPING TAX?

In addition to the estate and gift tax (with their current exemptions), there is also a generation-skipping tax. The generation-skipping tax is designed to tax transfers to beneficiaries who are two or more generations younger than you. Prior to the imposition of the generation-skipping tax, trusts could be structured allowing lower generations to avoid the Federal estate and gift tax. The generation-skipping tax was designed to plug that loophole and is a separate tax from the estate and gift tax. The generation-skipping tax has its own separate exemption of $1,500,000 for 2004 and 2005 which will be increasing in the same amount as the estate tax exemption through 2009.

WHY SET UP A GENERATION-SKIPPING TRUST DURING LIFE?

Current Federal gift tax law allows you to transfer up to $1,000,000 free of Federal gift tax. The estate tax, on the other hand, has a $1,500,000 exemption, which is scheduled to increase gradually over the next few years until 2009 when the exemption will reach $3,500,000. You may use this so-called gift tax exemption during life to reduce the gift tax, or, to the extent not used during life, the estate tax exemption may be used at death to reduce the estate tax.

One of the goals of estate planning is to make effective and efficient use of the available credits, deductions and exemptions allowed by the tax law. Funding an irrevocable generation-skipping trust during life with up to $1,000,000 is one way to make effective and efficient use of your exemptions.

The purpose of funding a generation-skipping trust during your lifetime is to pay no or a lower transfer tax now and allow the trust corpus to grow transfer tax-free for the benefit of future generations.

HOW DOES A GENERATION-SKIPPING TRUST WORK?

Here's how the concept works. Your attorney drafts an irrevocable trust giving the trustees the discretion to distribute the income and principal of the trust to your issue *i.e.*, your children, grandchildren, great grandchildren, etc. In addition, under certain circumstances your spouse may also be a discretionary beneficiary. You "fund" the trust by transferring up to $1,000,000 to the trust. Funding the trust with $1,000,000 is a gift for gift tax purposes. However, your $1,000,000 gift would be offset by your gift tax $1,000,000 exemption. Thus, you would use your Federal gift tax exemption to shelter $1,000,000 from gift tax. When the gift tax return is filed on April 15th of the year after the transfer, you would make an election to allocate $1,000,000 of your generation-skipping tax exemption to the newly funded generation-skipping trust. This results in you having used the available exemptions under the gift tax law and the generation-skipping tax law to "shelter" the corpus of the trust from further transfer taxes. If your trustee elects to aggressively invest the trust corpus, the trust corpus may increase significantly from the date you transfer assets to the trust until the time of your death. Upon your death, the assets in the generation-skipping trust are not taxable in your estate - remember, you used your gift tax exemption and the generation-skipping tax exemptions to shelter the gift from transfer taxes. Assuming you have not made subsequent transfers in excess of $1,000,000 to the trust, the corpus of the trust and whatever it grows to is protected from further transfer taxes as long as the assets remain in the trust. For example, if the trust grows to $5,000,000 by the time of your death, the $5,000,000 avoids estate tax in your estate. In addition, any distributions made to generations below your children are not subject to the generation-skipping tax. Thus, you have sheltered the value of the trust corpus at your death ($5,000,000 in the example) from estate and generation-skipping tax. In addition, the trust assets are protected from transfer taxes in the estate of your issue (children, grandchildren, great grandchildren, etc.) to the extent the assets remain in the trust. Alternatively, if you had not funded the generation-skipping trust and left the $1,000,000 in your name and it grew to the same $5,000,000 at your death in 2004, the estate tax, assuming you survived your spouse, would be at least $1,665,000!

Only the balance of the $5,000,000 after paying the estate tax, or $3,335,000, would be available for your issue rather than the $5,000,000 that would be available if you had funded a generation-skipping trust during life. Thus, lifetime transfers to a generation-skipping trust makes much more efficient use of the available transfer tax exemptions and shelters any growth from future transfer taxes.

HOW LONG DOES THE PROTECTION FROM TRANSFER TAXES LAST?

As mentioned above, this protection from estate tax and generation-skipping tax exists only as long as the corpus stays in trust. Whatever the trustee distributes to the beneficiaries will be subject to transfer taxes, if any, in their hands. In other words, if the trustee makes distributions to a beneficiary, the beneficiary may be taxed on that money if he or she gives it away or dies prior to spending the distribution. Thus, it makes sense for the trustee to retain the corpus in the trust for as long as possible and to make distributions of principal and/or income to the beneficiaries only when the trustee, in his or her discretion, deems it wise.

CAN A GENERATION-SKIPPING TRUST LAST FOREVER?

At some point, however, laws in most states require a trust to terminate. At that point, the corpus of the trust would be distributed to the beneficiaries and would re-enter the transfer tax system *i.e.*, would be subject to estate and gift and generation-skipping tax in the hands of the beneficiaries. It is therefore advantageous for the trust to last as long as possible. The duration of the trust is a function of state law. Therefore, a taxpayer may want to consider setting up the trust in a state that allows the trust to continue for the longest period of time.

IS THERE A PARTICULAR STATE WHERE I SHOULD SET UP A GENERATION-SKIPPING TRUST TO ENABLE THE TRUST TO LAST FOR AN EXTENDED TIME PERIOD?

Delaware (among others) is such a state. Delaware law allows a trust to exist indefinitely. That's why many generation-skipping trusts are referred to as Delaware trusts – they have been established under Delaware law to take advantage of the law allowing a trust to exist indefinitely.

ARE THERE OTHER ADVANTAGES TO SETTING UP A GENERATION-SKIPPING TRUST IN DELAWARE?

Delaware law offers the trust beneficiaries better protection from creditor's claims if a trustee is a Delaware bank. Mellon can act as the trustee of such a trust. In addition, Delaware has a stricter privacy policy. Also, Delaware law has adopted a "total portfolio approach" to investment management. This permits greater flexibility in investing trust assets.

AM I LIMITED TO FUNDING A GENERATION-SKIPPING TRUST WITH $1,000,000?

As a practical matter, you are limited to funding a generation-skipping trust during your life with $1,000,000. Any transfer in excess of your $1,000,000 gift tax exemption will trigger a gift tax. However, if you are married, you and your spouse each have your own exemptions from transfer taxes. Thus, each of you could set up your own generation-skipping trust *i.e.*, a $1,000,000 trust created by you and a $1,000,000 trust created by your spouse. Under current law, additional assets can be sheltered from generation-skipping tax at death.

CONCLUSION

There are numerous types of trusts and related estate planning issues to consider. The wealth management experts at Mellon are ready to answer your questions and work with you and your attorney to establish the most effective plan for you and your family.

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Jere Doyle is an Estate Planning Strategist for Mellon's Private Wealth Management group and a Senior Director of Mellon Financial Corporation. He has been with the firm since 1981. Mr. Doyle is admitted to practice law in the Commonwealth of Massachusetts and before the following federal courts: United States District Court, United States Court of Appeals (First Circuit), United States Tax Court. He formerly served as a member of the Joint Bar Committee on Judicial Appointments. He is the editor and co-author of the *Income Taxation of Trusts and Estates* and a co-author of *How to Complete Estate Tax Returns*, a co-author of *Understanding and Using Trusts* and a co-author of *Drafting Irrevocable Trusts*, all published by Massachusetts Continuing Legal Education. Mr. Doyle received a LL.M. in banking law from Boston University Law School, a LL.M. in taxation from Boston University Law School, a Juris Doctor from Hamline University Law School and a BS in accounting from Providence College. He is a member of the American Bar Association, Massachusetts Bar Association, Boston Estate Planning Council and the Essex County Bar Association. He is president and also the immediate past president and a member of the Executive Committee of the Boston Estate Planning Council and was a member of the Executive Committee of the Essex County Bar Association for more than 20 years. He has spoken at numerous professional education programs throughout the country on various topics and has been quoted in numerous business publications.

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