

COMMON OVERSIGHTS IN ESTATE PLANNING AND SOME RECENT DEVELOPMENTS

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I. TRUST ME

Real-life example (1) from my practice: Betty is a woman in her early sixties who asked me to review her current estate planning documents. Her husband Don had died the previous year. Don was an evangelical Christian and his church suggested he remember them in his estate plan. They suggested he see Big Law Firm in downtown Phoenix for his estate plan. Don and Betty had a net worth of about \$250,000 exclusive of their home. They had both been married before and had children from their former marriages. Big Law Firm drew up the following documents for Don and Betty:

- A charitable remainder trust (CRT 1), which was to pay an annuity to Don's children for life and then pass to the church.
- A charitable remainder trust (CRT 1) which was to pay an annuity to Betty's children for life and then pass to the church.
- A revocable Don Trust to hold Don's separate property. Upon Don's death the property was to pass to CRT 1.
- A revocable Betty Trust to hold Betty's separate property. Upon Betty's death the property was to pass to CRT 2.
- A "Community Property Trust" to hold Don and Betty's community property. At the death of the survivor of Don and Betty, the trust was to be distributed equally to Don's children and Betty's children.
- Pour-over wills for Don and Betty naming their respective separate-property trusts as beneficiaries.

Big Law Firm charged thousands of dollars for these documents. No funding services were included, except for a quit-claim deed. When Don died, a lot of his money had been lost in the notorious Baptist Foundation scandal. Most of the rest was in an IRA which named Betty as the principal beneficiary. Nothing was ever titled in any of the trusts.

Real life example (2) from my practice: Dad, a widower, placed all of his property in a revocable living trust. The trust provided that upon Dad's death all of the trust property would be distributed outright in equal shares to his three daughters. Daughter #1 was named the successor trustee. The trust had a clause stating it would be construed under Arizona law. Daughter #1 lives in New Jersey. Dad dies. A year and a half later, nothing has ever been distributed to Daughters #2 and 3. Daughter #1 refuses to return calls or e-mails from her sisters.

While example (1) may be a particularly egregious example, it illustrates the following problems which could easily result in a malpractice claim:

- Needless complexity
- Too much plan and not enough assets
- Failure to see that trusts are funded

- Not recognizing that IRAs cannot be trust assets
- Billing clients for useless services
- Serving two masters (Big Law Firm obviously had a relationship and understanding with Church, which referred clients to it)

Example (2) is a case where the trust causes more harm than good. It has the following problems:

- Jurisdiction¹
- Conflict of Laws²
- Inability (short of litigation, after the first two problems are solved) to require trustee to divulge information or provide an accounting.

Note that in example (2), the client would have been better served without a trust and with a probate proceeding. The probate would have obviated all three of the above problems and required Daughter #1 to account for the estate.

II. WHEN ARE LIVING TRUSTS APPROPRIATE FOR CLIENTS?

The estate planning client has a choice of testamentary instruments. The traditional choice is a will. Over the last twenty years, revocable living trusts have dramatically increased in popularity as the chief testamentary instrument. Some of this popularity is attributable to marketing. Many attorneys, financial planners and investment advisors market free “seminars” to the general public at which the benefits of trusts are touted. “Trust mills” operated by non-attorneys and using one size fits all fill-in-the-blanks trust forms advertise that they will draft a trust instrument for clients for a fraction of what an attorney would charge. Clients can also do it themselves, using software packages and internet sites. It has been the author’s experience that many clients end up with trusts when those vehicles in fact provide little or no benefit or, even worse, actually place the client at a disadvantage.

1. Bogus Advantages of Living Trusts. On the shady side of the trust marketing effort, some unscrupulous or incompetent advisors put forth advantages which living trusts do not in fact have, such as protection of the settlor from creditors, income tax and estate tax savings.

i. Protection from Creditors. It is well settled law in all American jurisdictions that one cannot protect oneself from existing creditors by establishing a self-settled trust. Although some jurisdictions, such as Alaska, Delaware and Rhode Island seek to provide some creditor protection through a nominally independent trustee, no

¹ See A.R.S. § 14-7202. Subsection C provides that a trust’s principal place of administration is where records are kept or the trustee resides. It would appear an action to hold the trustee to account would have to be brought in New Jersey.

² The trust had a provision that it was to be construed under Arizona law; but a legal action would likely occur in New Jersey.

jurisdiction will allow such protection against existing creditors or those who have claims known to the settlor when the trust is established.

ii. Trusts cannot be challenged whereas wills are easily challenged. Of course wills are easily challenged; anyone can file a petition once a probate has been opened. Wills are very difficult, however, to overturn. In this regard there is no difference between wills and trusts.³

iii. Estate tax savings. While touted as an advantage, the use of the A-B trust structure at the first death of a married couple can be accomplished through a will using testamentary trusts. Moreover, many of the people setting up these trusts are well below the asset level where federal estate tax planning is necessary.

iv. Income tax savings. Far from saving taxes, trusts are either neutral or disadvantageous. Revocable living trusts are treated as grantor trusts under the Internal Revenue Code, meaning all trust items of income and expense are attributed to the settlor or settlors and the trust is ignored as an entity. If the trust is irrevocable and not otherwise a grantor trust, any trust income retained will be taxed at trust rates, which are greatly compressed brackets attributable to individuals.⁴ Moreover, the trustee will be obliged to file a fiduciary income tax return on form 1041. In abusive cases, some trusts have been held to be shams for income tax purposes and can even land their promoters in jail.⁵

2. Real Advantages of Living Trusts. Here are some legitimate reasons why a revocable living trust may be right for a client.

i. Holding Title. When funding a testamentary marital and/or bypass trust, assets held as joint tenancy or which have beneficiary designations other than the estate are not available since they are paid directly to the named beneficiary. Living trusts solve this problem by holding title to assets in trustee name. All such assets are available to fund sub-trusts which may arise after a death.

ii. Incapacity. If the Settlor becomes incapacitated, a trust is an effective vehicle to provide management of the settlor's affairs. The trustee (or a successor trustee if the incapacitated person was the trustee) can continue to manage the affairs of the trust notwithstanding the incapacity and generally with little question about his authority. Absent a trust, durable powers of attorney can be used, but these sometimes present a problem where vendors or financial institutions may be loath to accept the holder's authority, particularly if the granting powers are vague or the power is relatively old. There are also significant legal differences in a trustee and the holder of a power of attorney. For example, the power of attorney can bind the principal while the trustee can bind only the trust; death of the principal will automatically terminate the power of attorney (as will the death of the holder of the power) but will not end a trust;

³ See *Mullin v. Brown*, 455 Ariz. Adv. 7, 115 P.3d 139 (App. 2005) discussed *infra*.

⁴ A trust moves into the top bracket when taxable income reaches \$8,900 and is not eligible for the 10% bracket for any income. Internal Revenue Code § 1(i).

⁵ See, e.g., IRS Notice 97-24; *Muhrich v. Commr.*, 87 AFTR2d ¶2001-432 (7 Cir 2001); *U.S. v. Estate Preservation Services*, 202 F.3d 1093 (9 Cir. 2000); *U.S. v. Scherping*, 187 F.3d 796 (8 Cir. 1999).

the fiduciary duty of the holder of a power of attorney runs only to the principal whereas a trustee has duties to all of the trusts beneficiaries.

iii. Control and Management During Life. A client concerned with leaving a trust after his death may want to establish it during lifetime in order to observe the management of the trustee and change trustees if necessary.

iv. Maintain Business and Tax Records. If a professional trustee is used, this could be an advantage. There is no advantage, however, where the settlor or a layman family member acts as trustee.

v. Avoid Probate. While often touted as an advantage, there is actually little advantage in avoiding probate in Arizona if no will challenge is expected and heirs are not expected to engage in protracted battles. In Arizona, informal probate procedures may be used the vast majority of the time and are neither unduly complex nor lengthy, and in most cases does not require any intervention by a judge. If the decedent holds property out of state, however, an ancillary probate would be required unless a trust were used. In that case, a trust could be a significant advantage in avoiding costs and delays. On the other hand, example 2 above illustrates a situation where the availability of the court is advantageous, at least to the beneficiaries who are not in control.

vi. Privacy. A trust may provide greater privacy and confidentiality of information than a will, if that is a consideration for the client. However, even here, marketers tend to overplay their hand. The personal representative does not, for example, have to file an inventory of property with the court.

d. Disadvantages of Living Trusts.

i. Costs. A trust can cost considerably more to draft than a will. If there is to be a professional trustee, there will also be ongoing expenses.

ii. Complexity. A trust can cause some clients concern because of its complexity. See Example 1 above for an over-the-edge, but actual, situation. Some clients will find the method of holding title to their assets as trustees to be cumbersome. If the settlor is not the trustee, there is added complexity in the formal dealings with the trustee. The author has encountered many clients who had trusts drafted for them but never actually funded the trust by transferring assets to it. Unless the professional advisor takes an active interest and helps the client fund the trust, it will not accomplish the purposes for which it was designed.

iii. Taxation. The possible income tax disadvantages of a trust have already been touched on.

iv. ALTCS/Medicare planning. While beyond the scope of this outline, living trusts can be disadvantageous to certain clients who may seek to qualify for public assistance in meeting the costs of nursing home care or assisted living. For example, under current ALTCS rules, a home held in a revocable trust is treated as a countable asset in determining financial eligibility, whereas a home held directly in the person's name is not a countable asset. Also, all of the income flowing from a trust may constitute income for purposes of the income eligibility test and for co-payment of

benefit rules. Finally, there is a five-year look-back rule for gifts from a revocable trust as opposed to a three-year period for direct gifts.

III. TITLING OF ASSETS

When meeting with a client to devise an estate plan it is critical to get a list of the client's assets and *exactly how they are titled*. I do not depend on clients to tell me this; I request that clients provide me with copies of brokerage and bank account statements, life insurance policies, IRAs and 401(k) plans, deeds to real property. Some observations on various types of assets follows. **Note: the suggestions below indicate commonly used ways to hold title but they will not be appropriate for every situation.**

1. Real Estate. When dealing with a married couple, one often finds real estate titled as community property with right of survivorship or, for property held longer than eight years, as joint tenants with right of survivorship. Held this way, the property will pass to the surviving spouse without probate. Whether the title is appropriate depends on the type of estate plan:

<u>Type of Plan</u>	<u>Possible Methods of Holding Title</u>
Married couple, small estate, single will, all-to-spouse	Comm. Prop. WROS
Married couple, large estate, QTIP and bypass trusts	Revocable trust
Single person, small or moderate estate, pass to children	Beneficiary deed
Single or married, large estate, emphasis on reducing taxable estate, responsible children	Personal Residence Trust

2, Life Insurance. Will pass by beneficiary designation⁶ and will not be controlled by a will or trust (unless the estate or trust is named as the beneficiary). Rarely owned by a revocable trust but in large estate may be owned by an irrevocable life insurance trust. If the estate plan sets up trusts at death for beneficiaries, name the particular trust or trusts as beneficiaries; otherwise name the spouse and/or children or other beneficiaries.

3. IRAs. Cannot be owned by a trust. If using a revocable trust as the principal testamentary instrument, name surviving spouse as primary beneficiary and trust as secondary (to preserve tax advantages to spouse); otherwise name the children as direct beneficiaries (with instruction to PR to divide the account into separate inherited IRAs for each child). Name a trust as beneficiary only if (a) the trust will qualify as a

⁶ But note that A.R.S. § 14-2804 provides that a power of appointment, or revocable disposition of property granted to a spouse is automatically deemed rescinded upon dissolution of the marriage.

see-through trust⁷ and (b) the estate plan is one other than outright distribution to beneficiaries.⁸

4. Automobiles, checking accounts. As long as the aggregate value of these assets (with any other assets in the probate estate) is less than \$50,000 no probate will be required. If the plan uses a revocable trust, it is usually not worth the bother to title a car or checking account in the trust.

5. Bank savings accounts. In small estates consider using a pay-on-death designation if there are only a few beneficiaries. If a trust is used, these accounts would normally be re-titled in the trust. Failure to do this may cause the account to pass to a pay-on-death beneficiary notwithstanding a declaration in a trust schedule of property that the account is held in the trust.⁹

IV. THE OVERFUNDED FAMILY TRUST

Existing trusts for married couples should be reviewed in light of the increasing federal estate tax exclusion amount. This amount is \$2 million in 2006. Bills introduced in Congress would either repeal the estate tax altogether or at least significantly further raise the exemption amount. In the case of married couples, the result may be an overfunded family and underfunded marital trust.

Most living trusts drafted for married couples will subdivide upon the death of the first spouse to die into two or more subtrusts. A common arrangement calls for the decedent's property to be divided between two pieces: a marital portion, which may be an outright gift or a QTIP trust; and a bypass trust. While the first part is principally intended to benefit the surviving spouse, a bypass trust may or may not pay the income to the spouse and principal may be paid to the spouse only under strictly controlled circumstances: a discretionary standard if the trustee is independent of the surviving spouse; an "ascertainable" standard which will permit distributions only for the survivor's health, education and maintenance of living standards; or a "5 by 5" power under which the surviving spouse can invade principal for any reason in an amount limited annually to the greater of 5% of the trust value or \$5,000. In other cases, the bypass may provide none of the above features and be held to benefit the decedent's children of a former marriage.

The division of the decedent's assets upon the first death is accomplished by use of a funding formula. The formula may be either a pecuniary or fractional formula. A commonly used technique, a favorite of form books, is a pecuniary marital formula, the relevant portion of which might read as follows:

The trustee shall fund the Marital Trust with a pecuniary amount equal to the minimum amount allowable as a marital deduction for federal estate tax purposes necessary to reduce the amount of federal

⁷ See Treas. Reg. 1.401(a)(9)-5.

⁸ That is, the funds are to be held in further trust; if a revocable trust is to be dissolved and distributed outright at the death of the grantor it makes little sense to name it a beneficiary.

⁹ See *In the Matter of Estate of Moore*, 97 P.3d 103, 435 Ariz. Adv. Rep. 9 (App. 2004).

estate tax payable by the Deceased Trustor's estate to the smallest possible amount. . .

Numerous variations on the above are possible, and sometimes it is the bypass trust, which is accorded the pecuniary amount.

1. The Increased Exclusion Amount Will Result in Greater Bypass Trusts and Smaller Marital Trusts. Most funding clauses seek to save estate taxes by making maximum use of the decedent's exclusion amount. As the exclusion amount has been dramatically increased over its former \$600,000 limit, the bypass trust will be allocated a much larger amount than originally anticipated and the marital share a proportionately smaller one. For example, consider a married Arizona couple with a \$2.5 million estate, all of which is community property. Assume the decedent had children from a former marriage. When the trust was drafted, the exclusion amount was \$600,000 and the trust had an allocation formula similar to that given above. Upon the first death, the decedent's estate would be \$1.25 million, which under the former law would be split \$600,000 to the bypass trust to benefit the deceased's children and \$625,000 to the marital trust for the spouse. With the exclusion amount at \$2,000,000, the typical funding formula will allocate zero to the spouse's trust because this is the "minimum amount allowable as a marital deduction . . . necessary to reduce the amount of federal estate tax . . . to the smallest possible amount."

2. Possible Solutions to the Over-funded Bypass.

i. *Cap the Bypass.* The bypass trust could be drafted with language that subjects it to an overall cap of either a dollar amount or a percentage of the estate. The obvious drawback of this approach is that it is difficult or impossible to determine at the planning stage, what the right dollar or percentage cap should be.

ii. *Provide for alternative distribution schemes depending on the law at the time of death.* While susceptible of innumerable variations, this technique will provide a standard A-B split, perhaps with the above cap on the non-marital share, but provide an alternative disposition in the event the estate tax is repealed or the exclusion amount is above a certain percentage of the estate.

iii. *Use Disclaimers.* The amount to be set aside in the bypass trust could be left entirely contingent upon a qualified disclaimer being made by the surviving spouse. This technique must be used cautiously. First, it may be inappropriate unless the heirs of the survivor are the same as the heirs of the decedent as otherwise the survivor may be disinclined to relinquish any of her inheritance for the benefit of the late husband's family. Second, the disclaimer must be made within nine months of the date of death and the disclaimant may not accept any benefits prior to making the disclaimer. The surviving spouse may fail one or both of these requirements unless she consults with an attorney soon after her husband's death.

iv. *Make Entire Trust "QTIP-able."* This technique would provide for a distribution of all of the decedent's property into a single trust, which would contain provisions allowing it to qualify as QTIP. Thus, all of the income would be paid for life,

at least annually, exclusively to the surviving spouse; no one but the surviving spouse may appoint any part of the trust during her life; and the surviving spouse would have the authority to require the trustee to invest in productive property. The trustee would be given the authority to make a QTIP election for all or a part of the trust. If made for part of the trust, the trust would be divided into QTIP and non-QTIP portions, with the non-QTIP portion serving as the bypass trust. To accomplish this aim, it will also be necessary to restrict the surviving spouse's access to principal to an ascertainable standard or make distributions discretionary with an independent trustee. While this idea is simple, it obviously will not be suitable unless the clients wish to benefit the survivor exclusively during her lifetime.

v. Allow the Personal Representative to make the decision. This technique would leave the entire estate to a QTIP and a bypass trust in the discretion of the trustee or personal representative. The power to make an effective election has been upheld by the courts (*Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5 Cir. 1992)) and is now sanctioned by the regulations. This plan has great flexibility, however it also has drawbacks. The identity of the trustee or personal representative is obviously extremely important, and it cannot be the surviving spouse.

V. BEWARE THE RESIDUARY DEVISE

Most wills have a clause devising the residue of the estate, very often to the surviving spouse or children (i.e., the principal beneficiaries of the estate). Most wills also have a clause directing that expenses and taxes be paid by the administrator from estate assets; revocable trusts usually have a similar clause. For example, here is a clause from a will form produced by Attorneys Computer Network Inc.:

I direct that the expenses of my last illness and funeral, the expenses of the administration of my estate, and all estate, inheritance and similar taxes payable with respect to property included in my estate, whether or not passing under this will, and any interest or penalties thereon, shall be paid out of my residuary estate, without apportionment and with no right of reimbursement from any recipient of any such property.

This clause is by no means atypical and the curious thing about it specifically states that equitable apportionment, which is the doctrine stating that items which cause or increase taxes and expenses should bear the cost of them, is not applicable. In many states equitable apportionment is the default rule but in Arizona it is not. However, if equitable apportionment is not provided for, severe and unexpected problems could result when an asset not thought by the drafter to be in the estate becomes part of it, or when an estate tax must be paid from the residuary marital devise, reducing the marital deduction and resulting in an increase in estate tax. These problems could come about in a number of ways:

- A life insurance policy of which the drafter was unaware, providing beneficiaries other than the residuary beneficiaries.¹⁰

¹⁰ See *Estate of Fogelman*, 197 Ariz. 252 (App. 2000).

- An asset of significant value which the client keeps hidden from the attorney or which unexpectedly goes not to the spouse but to another person.¹¹
- Items of significant value which the planner erroneously believed were not includible in the decedent's gross estate but which turned out to be includible.¹²

Another way the problem surfaces is where assets pass outside of the will and the will is silent on apportionment of taxes.

In the *Lurie* case (see footnote 12) just decided, the decedent left an estate valued at nearly \$90 million, plus another \$47 million of assets in certain trusts to benefit his children. His estate planners apparently thought the children's trusts were not includible in his estate, but the IRS disagreed. When the trusts were included in the *Lurie* estate, they increased the estate tax by about \$25 million, which had to be disbursed from funds otherwise going to the spouse. Consequently this tax reduced the marital deduction causing a *further* increase in estate tax of \$12 million – a wholly unnecessary increase if only the decedent had a better drafted residual clause! The 7th circuit began its opinion in this case with this language:

This case is an example of how the best laid plans of mice and men can often go awry. Prior to his passing, the decedent, Robert H. Lurie, planned for the bulk of his wealth to be excluded from federal estate taxes and passed through various trust instruments set up for the benefit of his wife and children. The IRS, however, determined that the trusts Lurie formed for the benefit of his children, valued at approximately \$40,471,059, should be included in Lurie's gross estate for tax purposes.

In *Lurie*, the taxpayer argued that under Illinois law, the doctrine of equitable apportionment would apply if the will were silent on apportionment. Under that doctrine, contrary to the common-law rule, all assets which passed from the decedent, whether or not probate assets, must bear an equitable portion of the estate tax. The court, however, thought the language the will did contain on apportionment, similar to that given above, was sufficient to override the equitable apportionment rule and cause all the taxes to be paid from the residuary, which was to go to the QTIP trust.

Note that in Arizona, the equitable apportionment rule is not observed.¹³ Consequently, the *only* way assets passing outside the will will bear a portion of the estate tax they caused is by including a properly drafted tax apportionment clause.

VI. RECENT DEVELOPMENTS

1. New Disclaimer Statute. Chapter 195 of the last legislative session repeals the former disclaimer statute 14-2801 and enacts a new regime at 14-10001, *et. seq.* The prior requirement that the disclaimer be made within nine months of death is removed.¹⁴ The new regime requires a written notice signed by the person disclaiming

¹¹ See *Estate of Kuralt*, 294 Mont. 354, 981 P.2d 662 (1999), and its progeny.

¹² *Ann Lurie v. Commissioner of Internal Revenue*, No. 04-3800, 7th Circuit decided 9/30/05.

¹³ *Matter of Estate of Mason*, 190 Ariz. 312, 947 P.2d 886 (App. 1997).

¹⁴ Note, however, that the nine-month rule remains part of federal law. IRC § 2518.

and delivered to the appropriate person. The statute describes who that person is, depending on the nature of the proceeding. The service of the notice can be by mail.

2. Witness to a Will. The court of appeals held that, contrary to prior case law, a witness to a will may sign the will after the death of the testator, if the period of time between the witnessing of the will and the signing of the witness was “reasonable.” *In the Matter of the Estate of Jung*, 109 P.3d 97, 448 Ariz. Adv. Rep. 20 (App. 3/31/2005).

3. Pay on Death Designation Trumps Declaration of Trust. Where a settlor listed a schedule of assets she was transferring to a revocable trust, which schedule included “all bank accounts”, the trust instrument did not govern the account where the account had a “pay on death” designation and no written notice had been given to the bank. *In the Matter of the Estate of Moore*, supra, footnote 9.

4. Divorce Revokes Beneficiary Designation. The Arizona statute will automatically revoke the designation of a spouse as beneficiary effective upon a divorce. The only way to prevent this is to specifically reaffirm the designation after the divorce. *Lamparella v. Lamparella*, 109 P.3d 959, 454 Ariz. Adv. Rep. 3 (App. 3/29/2005).

5. Undue Influence. The testator, who had two grandsons, died with a will which left the bulk of the estate to one of the grandsons (Chris) to the exclusion of the other (Andrew). The testator had been seriously ill and hospitalized. Andrew was unaware of his grandfather’s illness; Chris, on the other hand, stayed at the hospital with his grandfather and oversaw his care. The father had previously executed a will and a trust leaving his estate to his grandsons in substantially equal shares. There was evidence that just prior to the grandfather’s death, Chris requested his grandfather’s attorney to prepare a new will and trust which left most of the estate to himself. This was a rush job which the attorney finished the same day he was asked to do it because the testator was seriously ill at the time. The trial court instructed the jury that, under Arizona law, the presumption of undue influence shifts the burden of proof to the proponent of the will (Chris). The Court of Appeals agreed, and held that in *In the Matter of Shumway*, 3 P.3d 1062, 198 Ariz. 323 (2000), the Supreme Court had implicitly overruled a prior line of cases (even though the decision in *Shumway* did not explicitly state this) and changed Arizona’s position to align with the majority view. This view holds that when the presumption of undue influence arises, it shifts the burden of proof to the proponent of the will. The minority view, which prior Arizona case law embraced, holds that the presumption vanishes as soon as the will proponent comes forth with evidence to support the will. *Mullin v. Brown*, supra, footnote 3.