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Estate Planning Outline

This complimentary summary is provided by the firm of Brad Borncamp, CPA, LLC. Please note this brief summary only explains some of the aspects of estate planning and the related laws put in place on January 2, 2013 which apply for 2013 and future years. This summary is not intended to be all inclusive and since tax laws are subject to change, this summary cannot be relied upon as professional advice. Each person's estate is unique and you are strongly encouraged to consult with qualified professional advisors about your situation before taking any steps that may affect your estate planning goals.

Why Planning is Important

Planning is vital to achieving financial goals. It involves more than just working hard, paying your annual income tax returns, and saving for retirement. It is essential to get assistance from professional advisors, such as CPA's, attorneys, investment advisors, insurance professionals, etc. The following are some typical goals which you may want to discuss with these professional advisors:

* Reduce income, estate, and gift taxes
* Choose and use retirement accounts
* Set up tax savings college accounts
* Build net worth and protect assets
* Carry out specific wishes and desires
* Protect family members from creditors
* Provide for an orderly transfer of assets
* Manage cash flows and investment risks

Reasons for Estate Planning

Under the federal tax law passed January 2, 2013 Congress managed to avert a potential financial crisis and made many changes to the tax laws affecting individuals, businesses, estates, and trusts. This article deals with some of the changes affecting the estate and gift tax laws and offers a simplified explanation of how these laws may affect you and your family.

The law passed on January 2, 2013 makes permanent (until it changes) certain tax laws that affect estate and gift taxes for 2013 and future years. The previous tax law passed in December of 2010 was temporary and had a sunset provision which would have made many pre- 2001 tax laws go into effect starting in 2013. This new tax law prevented this from happening and allows for a $5,000,000 (before indexing) estate and gift tax exclusion, unlimited step up in basis, and a maximum 40% tax. This exclusion amount when indexed for inflation becomes $5,340,000 for 2014 and $5,430,000 for 2015, but estate planning is still very important. There are good reasons to do estate planning even for smaller estates.

* Name a guardian for your dependents
* Transfer property to specific heirs
* Keep the estate private
* Avoid probate
* Provide security from creditors and predators
* Simplify administration of your estate
* Direct your own medical treatment
* Minimize estate and income taxes

Estate Planning Terminology

To understand estate planning, it really helps to learn the meaning of several key words. For example, did you know that **any person could have several different "estates"**.

* You may own parcels of ***real* estate**
* If married, you have a ***marital* estate**
* If broke, you may have a ***bankruptcy* estate**
* Upon each person's death, ***two* other estates** are created on that day:
    * a ***probate* estate** (for transferring assets held directly by the decedent)
    * a ***taxable* estate** (for valuing and taxing assets)

Understanding these key words is essential to learning the basics of estate planning. You must also know how the word "estate" is being used in any given context or you may misinterpret what is being said and become very confused.

The **probate estate** is limited to the assets you hold title to in your own name which do not have designated beneficiaries. These assets transfer upon death by the terms of your **will** document, or by state statute if you die (intestate) with no will. The probate estate usually does NOT include any assets which have a designated beneficiary (such as retirement accounts, life insurance policies, annuities, etc.), assets titled jointly with rights of survivorship (such as a house or bank accounts), or assets you hold in the name of a trust (either revocable or irrevocable) of which you may be a trustee.

The **taxable estate** is used as a basis to determine if the estate is required to file Federal and state estate tax returns and to assess estate taxes. It includes everything you own or have control over, either directly or indirectly. This includes all the assets in your probate estate plus any other assets that you control, including those assets with designated beneficiaries, such as your retirement accounts, the death benefit of your life insurance policies, assets in your revocable living trusts, etc. The taxable estate may include many more assets than the probate estate. If estate planning is done correctly, it is very common to have a large taxable estate and have little, if any, of these assets included in your probate estate. This is because the probate estate usually does not include assets that have designated beneficiaries or assets held in the name of a revocable trust, but the taxable estate does include these assets. These rules are complicated so get professional help with this area.

Trusts are often used in estate planning, both to reduce potential estate taxes and to achieve other goals such as transferring and protecting assets and keeping the estate private. There are basically two types of trusts, those you can change, called "**Revocable**" and those you can NOT change, called "**Irrevocable**". Attorneys often refer to two types of trusts as those formed while the creator (grantor) is alive, called **"intervivos"** trusts and those trusts formed upon the creator's death, called **"testamentary"** trusts. This can be confusing since both revocable and irrevocable trusts can be established while the creator is still alive. It helps to understand that revocable trusts can only be formed or changed while the creator is alive, and that every revocable trust becomes irrevocable upon the death of the creator. Irrevocable trusts can be formed and funded either while the creator is still alive or upon their death. Neither trust can be changed after the creator's death, except for certain actions allowed by the trust document or upon a court order.

Titling assets is an essential part of estate planning. The estate plan can only work if the assets you own are titled correctly. Titling simply refers to how title to an asset is held. It can be held in the name of one individual, or held jointly with two or more owners either as tenants in common or with rights of survivorship. It can also be titled in the name of a trust, in which case the trustee has control over the asset.

Assets can be almost anything. Typically, assets include your house, bank accounts, insurance policies, investment and retirement accounts, rental and royalty property, an ownership interest in a business, etc. However, it is important to know that the term asset also includes personal items, such as cars, clothes, collectibles, and intangible things such as intellectual property and the right to use property. It is essential to identify and value all assets of an estate, and to title them correctly before death, in order to implement and execute an effective estate plan so that things turn out the way everyone expects.

Personal representative, also known as an estate administrator, is the **person named in your will** to carry out the directions stated in your will document. If there is no will, the probate court will assign a personal representative. This person is also called an executor (if a man) or an executrix (if a woman). This person is responsible for administrating the estate and transferring the probate assets controlled by your will. They also direct the transfer of assets with designated beneficiaries, but they do not deal with assets held in your trust(s) unless they are also named separately as trustee in the trust document.

Trustee may be natural persons or institutions like a bank or trust company and are **named in the trust document** or they can be assigned by the court. They are responsible for carrying out the directions stated in the trust document and transferring the related assets. The trustee does not deal with assets in the probate estate unless they are also named separately as a personal representative in the will or by the court.

Heirs and beneficiaries may be natural persons or they can be trusts and charities. The term heir applies to those receiving an inheritance from an estate. The term beneficiary applies to those receiving distributions from trusts or as designated beneficiaries on other accounts. There can also be contingent beneficiaries (who may not get anything), income beneficiaries (who only get current income), or remainder beneficiaries (who get the assets that are left at some time in the future).

The Basic Estate Planning Strategy

Estate planning strategy takes into account the family's goals and desires while taking advantage of each person's lifetime exclusion. For example, after indexing the estate tax exclusion for a person dying in 2015 is $5,430,000 (if not reduced for prior taxable gifts) and the maximum federal estate tax rate of 40% applies to the value of their estate over this exclusion amount. In addition, there may also be a state level estate tax on top of the federal estate tax. The tax law passed on January 2, 2013 also made permanent (until it changes) the portability of the estate exclusion unused at the death of the first spouse. The balance of the first spouse's unused estate tax exclusion is allowed to transfer to their surviving spouse and this increases the amount of the surviving spouse's exclusion which will be applied upon the surviving spouse's death. It is important to note that an estate tax return (Form 706) must be timely filed after the death of the first spouse in order to elect to have the unused exclusion apply to their surviving spouse. This is the case even if the value of the first spouse's estate is below the exclusion amount and the Personal Representative would not otherwise be required to file an estate tax return.

This means that for 2015 a married couple with a basic estate plan can exempt a total of $10,860,000 (2 x $5,430,000) of assets from estate and gift taxes. However, to utilize their combined exclusion, they must either title assets in their separate taxable estates or change their estate plan to include filing an estate tax return upon the first spouse's death to elect portability. Keep in mind the value of the surviving spouse's assets may increase significantly by the time of their death and they may need this additional exclusion.

There are generally two planning strategies available to get the benefit of the combined exclusion amounts depending on the size of the total estate. In either case, spouses (including same sex couples) must be married under state law. Larger estates will have more complicated plans to protect assets and achieve the family's goals and desires.

A conventional estate plan involves each spouse utilizing their exclusion by creating a separate taxable estate as a result of titling various assets to each spouse before death. Each spouse can hold assets directly or in a revocable trust, or by titling joint assets as tenants in common, NOT with rights of survivorship. Assets of the first spouse to die typically transfer to a family trust where the surviving spouse is the primary beneficiary and this utilizes some of the first spouse's exclusion for the benefit of the surviving spouse. Assets with designated beneficiaries or held jointly with rights of survivorship that transfer directly to other (nonspouse) beneficiaries also utilize some of the first spouse's exclusion but do not benefit the surviving spouse. Assets passing directly to their surviving spouse do not utilize any of the first spouse's exclusion, which allows for portability as discussed in the following paragraphs. However, there may be good reasons for the conventional approach in order to achieve the family's goals.

A portability plan allows spouses with estates whose combined value is not expected to exceed $10,860,000 (2 x $5,430,000 in 2015) to pass assets directly to their surviving spouse without using trusts. This plan anticipates that an estate tax return will be filed upon the first spouse's death to elect to transfer the unused portion of the first spouse's exclusion to the surviving spouse. Both approaches should be discussed with your professional advisors and a plan developed that considers the activity in your estate, the future income taxes, and your personal goals.

It should be noted that conventional planning techniques using family trusts could result in significant income taxes on the gains related to future sales of the assets held in the family trust. This is because the assets transferred to the first spouse's family trust get a (stepped up) basis equal to the fair market value at the first spouse's date of death. The assets held in this family trust retain this basis and do not get a second step up in basis to the value at the time of the surviving spouse's death in the future. Careful planning should be done to analyze if this difference will be significant and if the conventional planning techniques should be retained or if you should revise your estate plan to transfer assets between spouses (instead of using a family trust) and plan to use portability at the second spouse's subsequent death so the assets get a higher step up in basis that will reduce income taxes to the heirs.

The January 2013 tax law allows for a total combined estate and gift tax exclusion of $5,000,000 which is expected to increase each year, a 40% maximum federal estate and gift tax rate, and portability of the unused estate exclusion to the surviving spouse. This may give people the impression that estate planning is no longer necessary. However, as this article points out there may be significant income tax differences as a result of keeping your conventional (old) planning strategy and there are many non-tax reasons to do estate planning. Not to mention, many states have their own version of an estate tax which may differ greatly from the federal laws.

What Information is Needed For Estate Planning

Your estate planning can be simple or complicated, depending on the complexity of your situation and your desires. Significant benefits can usually be gained even if you only do basic estate planning. This process usually involves the following information.

* Draft and/or review your will and trust documents
* List of all assets, investments, debts, etc.
* Document how each asset is titled
* Identify who should inherit the assets in your estate
* Describe any special needs of your heirs or beneficiaries
* Identify the person(s) to manage your affairs
* What amounts (if any) go to certain charities
* What medical treatments you want to endure
* What funeral arrangements you may want

Steps Involved

There are basically two steps involved in establishing your estate plan, documentation and implementation. Each step involves various activities which may require the services of a CPA, attorney, trustee, insurance agent, investment advisor, and others.

Documentation occurs as you establish your estate planning goals and gain an understanding of how to implement them. Then the related legal documents are drafted with the appropriate language to achieve these goals. Estate planning documentation typically involves the following legal documents.

* Last will and testament (a will)
* Living (revocable) trust, or other forms of trusts
* Durable power of attorney
* Medical power of attorney
* Medical directive (living will)

Implementation occurs over time and involves titling assets and monitoring events to see if changes to the documents may become necessary. This starts before the death of the first spouse (if married) by titling assets to assure the proper transfer of each asset to your spouse or your trust(s). You should enlist the assistance of an attorney and other estate planning professionals to assist you in understanding how to title your assets and to designate beneficiaries in order to make sure this step is carried out correctly. It is advisable to discuss your estate plan and related documents with family members, especially the people who will administer your estate. As time goes by, it may be necessary to update the plan for events affecting your family or your assets.

Estate Administration

Administration of your estate starts at death and involves, among other things, the documents you created and the transfer of your assets. These documents tell your personal representative and trustee how and when to transfer your assets and who should be the custodian of any dependents. The personal representative and trustee carry out your directions by following the instructions of your will and trust(s) documents. They usually need to inform any banks, retirement and investment accounts, insurance companies, and others of your death in order to distribute the related assets. Estate administration usually involves, either directly or indirectly, the following people.

* The personal representative to make funeral arrangements and execute your will.
* The trustee(s) to manage and direct assets held in, or transferred to, your trust(s).
* The attorney to assist with the probate process and any legal issues.
* The CPA to prepare estate and income tax returns and offer tax planning advice.
* The investment advisor to help manage investments and make distributions to heirs.
* The banker, insurance agent, and others who help with transferring assets.

Taxes Involved With An Estate

There are **five separate** types of taxes that may impact your estate: income taxes, gift tax, estate tax, generation skipping tax, and state estate or inheritance tax.

* ***Income taxes*** (federal and state) apply to the net taxable income of trusts and estates starting at much higher tax rates than for individuals. Knowing when a trust or estate should distribute income may significantly reduce the income taxes especially since the 39.6% tax rate and the additional 3.8% Medicare tax apply to trusts and estates with undistributed taxable income over $12,300 (for 2015). Form 1041 is the trust and estate income tax return.
* ***Gift tax*** applies to the value of property, or rights to such property, transferred while you are alive. Knowing how to use the annual allowance and lifetime exclusion amounts and applicable discounts may significantly reduce the gift taxes. Planning for the gifting of appreciated assets may significantly reduce the related income taxes. Form 709 is the federal gift tax return.
* ***Estate taxes*** (federal and state) apply to the value of all property in your taxable estate at the time of your death. Planning strategies, such as those discussed in this article, may save significant amounts of both federal and state estate taxes. Form 706 is used to report taxable estates, calculate the federal estate tax, or elect portability.
* ***Generation skipping tax*** applies to the value of property transferred to more than one generation below you. This tax is in addition to the federal estate tax on form 706.
* ***State inheritance tax*** applies to the heirs who inherit assets from residents of those states that have an inheritance tax, based on the value of property transferred.

Get Professional Help

In summary, even with the somewhat liberalized estate tax law now in effect, planning is as important as ever, regardless of the size of your estate.

Call to discuss your situation and how we may ***"help you keep more of what you make"***.

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