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Estate Planning Outline

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This complimentary summary is provided by the firm of Brad Borncamp, CPA, LLC. It explains some of the aspects of estate planning and the federal tax law put in place December 22, 2017 under the Tax Cuts and Jobs Act. This summary is intended to offer general guidance and is not all inclusive, accordingly, it cannot be relied upon as professional advice. Also note every state has their own laws which are not covered in this outline. Each person's estate is unique and you are strongly encouraged to consult qualified professional advisors before taking steps to achieve your estate planning goals.

Why Planning is Important

Planning is vital to achieving financial goals. It involves more than just working hard, filing your annual income tax returns, and saving for retirement. It is essential to get assistance from professional advisors, such as Certified Public Accountants (CPA's), attorneys, investment advisors, insurance professionals, and relatives to help design and implement your estate plan. The following are some goals you should consider:

- * 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 December 22, 2017 Congress 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 impact of the Tax Cuts and Jobs Act on estate and gift taxes is temporary. It is effective January 1, 2018 through December 31, 2025 (unless Congress changes it) at which time the previous law goes back into effect. The previous law is from 2010 and allowed an estate and gift tax lifetime exclusion of \$5,000,000 before indexing, this was \$5,490,000 for 2017. The new law increases the 2018 estate and gift tax exclusion amount to \$11,180,000 and will continue to be indexed for inflation. It continues to allow unlimited step up in basis, and the maximum 40% estate and gift tax rate above the exclusion amount. This higher exclusion amount will exempt most estates from tax, but estate planning is still very important even for smaller estates, especially given that the new law is temporary. The following are some of the reasons to do estate planning.

- * 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 you must 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 assets titled to the decedent with no named beneficiaries)
 - * a **taxable estate** (to value all assets and debts which may be subject to estate tax)

Understanding these key words is essential to learning the basics of estate planning. You must 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 your death according to the terms of your **will** document, or by state statute if you die (intestate) with no will. The probate estate does NOT include any assets which have a designated beneficiary (such as bank accounts with TOD/POD, retirement accounts, life insurance policies, annuities, etc.), or assets titled jointly with rights of survivorship (such as a house or investment accounts), or assets you hold in the name of a trust (either revocable or irrevocable) even if you are the trustee of that trust.

The **taxable estate** includes everything you own or have control over, either directly or indirectly. It is used as a basis to determine if the estate is required to file federal and state estate tax returns and owe estate tax. This includes all the assets in your probate estate plus any other assets that you control, including those assets with designated beneficiaries, such as TOD/POD accounts, retirement accounts, the death benefit of your life insurance policies, your share of assets held jointly, all assets titled to your revocable living trust(s), but usually excludes any assets held in irrevocable trust(s). If estate planning is done correctly your taxable estate usually includes many more assets than your probate estate. In which case, it is common to have a relatively large taxable estate and have little, if any, of these assets included in your probate estate. 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 personal goals such as transferring and protecting trust assets and to keep 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 while the creator is alive or upon their death, but cannot be changed even while the creator is alive. Neither type of 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 refers to how title to an asset is held. It can be

held in the name of one individual (with or without designated beneficiaries), or held jointly with two or more owners either as tenants in common or with rights of survivorship. It can also be held in the name of a trust, in which case the trustee has control over the asset. Titling has a direct effect on the transfer of each asset.

Assets can be almost anything. Assets typically include your car, house, bank accounts, life insurance benefits, investment and retirement accounts, rental and royalty property, an ownership interest in a business, etc. The term asset also includes personal items (such as clothes, collectibles, etc.) and intangible property (such as intellectual property rights, and the right to use property). Mortgages, debts, and other liabilities must also be taken into account as these reduce the total value of the estate assets. It is important to identify and value all assets, net of any debts, and to title each correctly before death, in order to develop and implement an estate plan so that things turn out as you intended.

Personal representative (PR) is also known as an estate administrator, or an executor (if a man) or an executrix (if a woman). This is the **person named in your will** who is responsible for administering the estate and transferring the probate assets controlled by your will. If there is no will, the probate court will assign a personal representative to administer the estate according to state law. The PR is also the person who makes funeral arrangements, gathers information about estate assets, and arranges the sale of the house or other property. They also manage and direct the transfer of assets held jointly and with designated beneficiaries. However, they do not deal with assets held in your trust(s) unless they are also named separately as trustee in the trust document(s).

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, which usually includes managing or transferring the trust 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 the probate estate. The term beneficiary applies to those receiving distributions from trusts or as designated beneficiaries of estate assets. There may also be contingent beneficiaries (who may not get anything), income beneficiaries (who only get current income), and remainder beneficiaries (who get the assets that transfer to them at some time in the future).

The Basic Estate Planning Strategy

Estate planning takes into account each person's goals and desires while taking advantage of their lifetime exclusion. The lifetime exclusion amount for a person dying in 2017 was \$5,490,000 and for 2018 it is \$11,180,000. However, this exclusion amount must be reduced for any prior taxable gifts. The federal estate tax rate of 40% applies to the value of the taxable estate, net of any debts, over the exclusion amount. In addition to federal estate tax, there may be state level estate or inheritance taxes. State tax law applies for the state in which a person is a resident at the time of their death and other state(s) law may apply if the person owns property located in another state.

An important aspect of the new federal law is that it continues to allow married couples portability of the exclusion amount unused by the first spouse to die. Portability increases the amount of the lifetime exclusion available to the surviving spouse by the unused exclusion amount of the first spouse. It is important to note that a federal estate

tax return (Form 706) must be filed within nine months from the date of death of the first spouse in order to elect portability and apply their unused exclusion to the surviving spouse, even if the estate would not otherwise be required to file or to pay estate tax.

This means that for 2018 through 2025 a married couple can exempt up to \$22,360,000 (2 x \$11,180,000) of net asset value from federal estate and gift taxes. However, to utilize their combined lifetime exclusion, the estate of the first spouse must file an estate tax return to elect portability or it does not apply. Keep in mind the value of the assets in the surviving spouse's estate may increase significantly by the time of their death and they may need the additional unused exclusion from the first spouse's estate to avoid tax.

There are generally two planning strategies available to get the benefit of the combined exclusion amounts for both spouses. In either case, spouses (including same sex couples) must be married under state law at the time of the first spouse's death. Both approaches should be discussed with your professional advisors to develop a plan that considers the value of your current and future estates, the potential income taxes, and your goals.

A conventional estate plan involves each spouse utilizing their lifetime exclusion by creating separate taxable estates and carefully titling assets before the death of either spouse. In this case, each spouse holds assets directly or in a revocable trust, or by titling joint assets as tenants in common, NOT with rights of survivorship. This method allows most, if not all, of the assets of the first spouse to die to transfer into an irrevocable family trust which utilizes the some or all of the exclusion amount from the first spouse. The surviving spouse may be the primary beneficiary of this family trust but the assets held in this trust are not part of the surviving spouse's taxable estate. Any assets with designated beneficiaries that transfer directly to nonspouse beneficiaries (such as kids) also utilize some of the first spouse's exclusion amount. There may be good reasons to use the conventional approach in order to achieve the family's goals and protect the assets or to benefit the kids from previous marriages. This also allows portability of the unused portion of the first spouse's exclusion to transfer to the surviving spouse.

A portability estate plan is simpler and may be considered by married couples with small estates whose combined total asset value is expected to stay well below the \$22,360,000 (2 x \$11,180,000 in 2018) combined exclusion amount. The portability approach titles most, if not all, of the assets so they pass directly to the surviving spouse, without using trusts, which may avoid probate all together. Note that assets passing to a surviving spouse do not use the first spouse's exclusion amount, accordingly, this approach does not utilize much, if any, of the first spouse's exclusion. This plan requires a federal estate tax return (Form 706) be timely filed upon the first spouse's death to elect portability and the transfer the unused portion of the first spouse's exclusion to the surviving spouse.

Despite the benefits of a conventional estate plan, using a family trust could result in significant income taxes related to future sales of assets held in the trust if these assets appreciate (increase) in value. This is because the assets transferred to the first spouse's family trust get a stepped up basis equal to their fair market value at the date of death of the first spouse. These trust assets retain this basis and do not get a second step up in basis at the time of the surviving spouse's death. Planning should be done to analyze the potential income taxes on the appreciation of estate assets and determine if a conventional or a portability plan should be used. A portability plan transfers most, if not all, of the first spouse's assets to the surviving spouse, which then get another step up in basis upon the surviving spouse's death. The portability plan may significantly reduce the gains realized and the related income taxes resulting from the sales of appreciated assets which are sold by the surviving spouse's estate, or by their heirs.

The tax law allows a married couple a total combined estate and gift tax exclusion of \$22,360,000 (but only through 2025), 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 plan and many states have estate tax laws which are different from federal laws. In addition, there are many non-tax reasons to do estate planning.

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 do basic estate planning. This process usually involves the following information.

- * Document what medical treatments you want to endure
- * Note certain funeral arrangements you may want
- * Identify the person(s) to manage your estate and trust
- * Identify the person(s) to be guardian of minor children or disabled dependents
- * Identify who will inherit the assets in your estate and when or at what age
- * Draft and review your will and trust documents
- * Make a list of all your assets, investments, debts, etc.
- * Document how each asset is titled and note designated beneficiaries, if any
- * Describe how to deal with special needs of your heirs, beneficiaries, and pets
- * Indicate what amounts (if any) go to certain charities

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, identify all estate assets, and gain an understanding of estate and trust administration. 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) for each spouse
- * Revocable Living trust for each spouse, if applicable
- * Durable power of attorney, in case you become incapacitated
- * Medical power of attorney, to authorize or limit medical treatments
- * Medical directive (living will), to direct the extent of life sustaining procedures

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 each asset transfers according to your plan. You should enlist the assistance of an attorney, a CPA, and other professionals to assist you with 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 or trust. As time goes by, it may be necessary to update the plan for changes in your family, your assets, or the tax laws.

Estate Administration

Administration of an estate starts at death and involves, among other things, the will and trust 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 guardian of certain dependents. The personal representative and trustee carry out your directions by following the instructions of your will and trust 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 accounts. 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 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 income taxes, especially since the 2018 top tax rate of 37% plus the additional 3.8% Net Investment tax apply to trusts and estates with undistributed taxable income over \$12,500 (for 2018). Form 1041 is the federal income tax return filed for trusts and estates.
- * **Gift tax** applies to the value of property, or rights to such property, transferred while you are alive. Knowing how to use the annual gift 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 to be filed by the donor.
- * **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 (GST)** applies to the value of property transferred directly to more than one generation below you and is in addition to the federal estate tax.
- * **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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