



# Preserving Your Estate



## Chapter 15

# Learning Goals

**LG1**

Describe the role of estate planning in personal financial planning, and identify the seven steps involved in the process.

**LG2**

Recognize the importance of preparing a will and other documents to protect you and your estate.

**LG3**

Explain how trusts are used in estate planning.

**LG4**

Determine whether a gift will be taxable and use planned gifts to reduce estate taxes.

**LG5**

Calculate federal taxes due on an estate.

**LG6**

Use effective estate planning techniques to minimize estate taxes.



# How Will This Affect Me?

No, you can't take it with you . But there's a next best thing: **A carefully designed estate plan will allow your loved ones and family to keep as much of your accumulated wealth as possible.** This chapter explains the role of estate planning and the importance of a will. It discusses the use and design of living wills, advance medical directives, and trusts. It also explains how federal estate taxes are calculated. After reading this chapter you should understand the key elements in handling and preserving your estate for your loved ones.

# ***Financial Facts or Fantasies?***

- Estate planning is one of the key elements of personal financial planning.
- The wealthy are the only ones who need to make out wills.
- Due to recent changes in the law, a person no longer has to be mentally competent in order to draw up a valid will.
- Once a will is drawn up, it is relatively simple to make minor changes.
- In order for a living trust to be legally enforceable, it must be irrevocable.
- There are no federal estate taxes on estates of up to \$5,430,000 for individuals.



# Principles of Estate Planning

- The process of developing a plan to administer and distribute assets in a manner consistent with your wishes and needs of survivors while minimizing taxes
- Without planning, chances are your heirs will only receive part of your estate. The rest will be consumed by poorly timed sales, sales at less-than-optimum prices, taxes and various administrative costs.
- After you have spent a lifetime accumulating your assets, your final step is planning what to do with your stuff.



# Two parts to Estate Planning

- **People Planning:** Anticipating the psychological and financial needs of those people you love and providing income or capital to ensure a continuation of their way of life. All kids are not the same; they have different needs and you need to plan how to use your stuff to address their needs.
- **Asset Planning:** What are you going to do with your stuff? Are you going to sell your house, your ceramic collection, your jewelry, your investments, and all your other stuff? How you own your property will impact where it goes at your death. You may need to change the form of ownership.



# Why do Estate Break Up?

- Death-related costs; Some may be avoidable
- Inflation
- Lack of liquidity
- Improper use of vehicles of transfer (such as trusts, form of ownership, beneficiaries)
- Disabilities: If you wait long enough, you will not be able to be a part of the planning. Or a long-term illness may eliminate your estate.
- See Exhibit 15.1 for additional problems.



# Seven Steps in Estate Planning

1. Assess your family situation and set estate planning goals
2. Gather comprehensive and accurate data
3. List all assets and determine the ownership and value of your estate.
4. Designate beneficiaries of your estate's assets
5. Estimate estate transfer costs
6. Formulate and implement your plan
7. Review the plan periodically and revise it as necessary.





# Your Estate

- **Gross Estate:** All property you own at your death
- **Probate Estate:** The part of your gross estate that will be transferred by will, or if no will, under intestate laws of your state. The government oversees the probate estate through the probate judge and collects a probate tax to cover its costs.
- The balance of your gross estate will be transferred to your named beneficiaries by contract, or will be transferred by property law to your joint owner.

# Wills

- A written and legally enforceable document expressing how a person's property should be distributed on his or her death. The will transfers your probate estate.
- If you do not have a Will, your state laws provide **rules of intestacy** that will “draw the will the decedent failed to make”. If the value of your probate estate is over a minimum amount [\$50,000 in many states] the probate court will appoint an executor or administrator to distribute your property and provide a fee of about 4% of the value of your estate. See Exhibit 15.4 for a typical intestate distribution of your estate.



# Three requirements for a Will

- Provide a plan for distributing your assets according to your wishes and to plan for related taxes
- Consider the changes in family circumstances that might occur in future
- Be concise and complete in describing your desires.

Should not be attempted by a layperson, but you need to understand your will



# Common Features of a Will

- Introductory Clause
- Direction of payments
- Disposition of property
- Appointment Clause
- Tax Clause
- Simultaneous Death Clause
- Execution and Attestation Clause
- Witness Clause



# Requirements of a Will

- Mental Capacity: You must be of “sound mind”
- Freedom of choice
- Proper Execution, may provide for a “self-proving will”



# Codicils to a Will

- Codicil: A **codicil** is a simple, often single-page document that provides a convenient legal means of **making minor changes** in a will. It reaffirms all the existing provisions in the will except the one to be changed, and it should be executed and witnessed in the same formal manner as a will.
- Revoking the will requires a complete rewriting of the will.

# Checklist for Executors -- Worksheet 15.1

- Marriage certificates
- Your will and trust agreements
- Life insurance policies
- Your Social Security number
- Military discharge papers
- Bonds, stocks and securities
- Location and passwords for computer files
- Real estate deeds
- Businesses agreements
- Automobile titles and insurance policies
- Property insurance policies
- Tax information
- Letter of last instructions



# Letters of Last Instructions

- An informal [that is not legally enforceable] memorandum that is separate from a will and contains suggestions or recommendations for carrying out a decedent's wishes.
- Contains location of will, funeral and burial instructions, suggestions on disposition of some assets, personal matters about the family, suggested legal and accounting professionals, explanation of some will provisions, suggestion how to divide some property, and other items you feel will be useful to the executor or family.





# Other Estate Planning Documents

- Power of Attorney
- Living will, may include a durable power of attorney for health care
- Ethical Will, decedent last words of advice based upon their life experiences. May be video or written



# Ownership of property

- Joint Ownership takes three forms:
- Joint owners with right of survivorship – at death of one owner, title passes to other owner(s) with no additional action required
- Tenants by the entirety – Ownership between husband and wife, at death of one, title passes to other by property law. Also provides some liability protection since property can not be divided
- Tenants in common – Joint owners have no right of survivorship, thus share of ownership subject to will and probate



# Community Property

- All marital property is co-owned equally by both spouses while living in a community property state. Community property states are found in southwestern part of country, states that had a Spanish or French influence.
- Couple may designate some property as separate property



# Trusts

- A legal relationship created when one party transfers property to an second party for the benefit of third parties. All parties may be the same person. Trust is a legal entity, subject to federal income tax
- Grantor – person who creates trust
- Trustee – person who administers the trust property in accordance to written trust agreement
- Beneficiary – person who receives the income and/or property of the trust



# Primary Use of Trusts

- Manage and Conserve property for benefit of named beneficiary. Used when beneficiary is not able (or does not desire) to manage property.
- Helpful when beneficiary is disabled, not responsible (in view of grantor), or there is a need for privacy. Trust agreements are not public records.
- Selection of trustee is important. The person (may be a corporation like a bank) must possess sound business and investment knowledge and judgement, know the grantor, be good manager, and available to beneficiaries.



# Terms and Special Uses of Trusts

- **Revocable v Irrevocable:** If the grantor can change their mind and take back the property, the trust is revocable. If grantor cannot change trust, it is irrevocable.
- **Living Trust** – typically revocable, grantor transfers all of their property to the trust. The grantor is also the beneficiary and may be the trustee. For income tax, the trust is ignored and all income of trust taxed to grantor. But at death, the grantor does not own the property in the trust [the trust does], so none of the property is included in the probate estate. Typically such property will still be a part of the gross estate.

# Primary Use of Trusts

- ▶ **Testamentary trust** will be set up at grantor's death as provided in the grantor's will.
- ▶ **Irrevocable Life Insurance Trust** – Trust formed to own life insurance policy on life of grantor. At death, the proceeds of life insurance come to the trust and the trust is the owner of the life insurance policy. Thus, the policy and its benefits are not part of the gross estate.

# Federal Unified Transfer Tax

- Tax on the value of property transferred to another. Applies to two types of transfers:
- **Transfer by Gift**, referred to as Gift Tax, during donor's life. Amount of gift is value of property less value of any consideration given. Thus, a bargain sale is part gift.
- **Transfer through the gross estate** at death. Amount taxable is the fair market value of all interests in property owned at decedent's death plus any amount of taxable gifts since 1976. Referred to as the estate tax.



# Federal Unified Transfer Tax

- Rate schedule is same for gifts and gross estate.
- Both are subject to the **Federal Unified Transfer Tax Credit**. The credit for 2015 is \$2,117,800 which will eliminate tax on \$5,430,000 of transfers. This amount is referred as the **Applicable Exclusion Amount**. Thus, there is no transfer tax on the first \$5,430,000 of transfers. The amount is adjusted annually for inflation. See Exhibit 15.8 for past years credit.
- See Exhibit 15.7 for rate schedule. Note the top rate is 40% and applies to estates over \$1,000,000. This means that **any amount over the applicable exclusion amount will be taxed at 40%**.

# Federal Unified Transfer Tax -- Gifts

- ▶ Gifts are subject to an **annual exclusion of \$14,000** [in 2015] per donee. For example if a grandparent gave each of three grandchildren \$5,000 at Easter, Thanksgiving and Christmas, that is a total of \$15,000 to each of the three. The annual exclusion would be \$14,000 per grandchild, for a total of \$42,000. The taxable gifts would be a total of \$3,000 [\$45,000 - \$42,000], the tentative tax would be \$540 [18% \* \$3,000]; after applying the credit of \$2,117,800, there would be no tax due.

# Federal Unified Transfer Tax -- Gifts

- One restriction on the annual exclusion is that the gift must be of a **present interest**. So if the grandparent above, made contributions to a trust for the benefit of the grandchildren when they are 35 years old, the annual exclusion would be zero. The gifts would be future interests, not present interests.
- **Gift Splitting** – A couple may elect to split gifts made by one, with the other. So if the husband made a gift of \$20,000 and the wife elects, it will be considered a gift of \$10,000 by each. Since each has an annual exclusion of \$14,000 per donee, the gift would not be a taxable gift.



# Federal Unified Transfer Tax -- Gifts

- Gifts to public charities, 501(c)(3) organizations, are deductible as charitable contributions. Thus, such gifts are not taxable gifts.
- Gifts between spouse are also not taxable due to the marital deduction. That is, they are included and then deducted out.



# Federal Unified Transfer Tax -- Gifts

- Gift giving is a major estate planning tool. By giving a gift now, rather than through the estate later, any appreciation in value between now and later is not taxed. The amount of taxable gifts that is added to the gross estate in determining taxable estate is the amount that was subject to tax when the gift was made in the past.
- If in fact a tax must be paid, then the funds used to pay the gift tax will not be in the estate since they were paid to the government.
- Of course, the annual exclusion eliminates the first \$14,000 per donee from taxable gifts.



# Federal Unified Transfer Tax – Estate Tax

- The federal unified transfer tax is based upon the fair market value of all property owned by the decedent on the date of death, the gross estate.
- Note if the decedent's life insurance is owned by a trust, it is not in their estate—they do not own the policy.
- The fair market value as of the one day, date of death, makes some discounts applicable. For example, if the decedent owned ten different real estate properties and had to sell all ten on the same day, it would be a fire sale and the value would be depressed. This is called a marketability discount.



# Federal Unified Transfer Tax – Estate Tax

- Any debts and end of life expenses paid will be deductible in arriving to taxable estate.
- All taxable gifts [in excess of the annual exclusion] will be added to the gross estate in determining taxable estate.
- The unified transfer tax credit will be subtracted from the tentative tax to arrive at the tax due.

# Computing the Estate Tax-Worksheet 15.2

Line	Computation	Item	Amount	Total Amount
1		Gross Estate		\$7,850,000
2	Subtract sum of	a) Funeral Expenses	\$16,800	
		b)Administrative Expenses	75,000	
		c)Debts	125,000	
		Total		(216,800)
3	Result	Adjusted Gross Estate		\$7,633,200
4	Subtract:	a) Marital deduction		
		b) Charitable deduction	180,000	
		Total		(180,000)
5	Result	Taxable estate		\$7,453,200
6	Add	Post-1976 taxable gifts		0
7	Result	Estate Tax Base		\$7,453,200
8	Compute Tax	Tentative tax on estate tax base		\$2,927,080
9	Subtract sum of	a) Gift Tax paid on post 1976 gifts	0	
		b) Unified Tax Credit--2015 credit	2,117,800	2,117,800
10	Result			\$809,280
11	Subtract	Other Credits		0
12	Result:	Federal estate Tax Due		\$809,280

**Use Exhibit 15.7 to calculate the tentative tax.**

**Use Exhibit 15.8 to determine the appropriate unified tax credit.**



# Federal Unified Transfer Tax -- Planning

- Note that if an estate tax is due, the applicable rate is 40%. On top of that, many states have a state estate tax. Thus, the tax has a large impact on a decedent's ability to transfer property to their heirs.
- Major planning tool: **Making lifetime gifts** reduces the estate tax by keeping the appreciation and the funds used to pay the tax out of the estate. [There is a three-year rule that adds to the taxable estate gift tax paid within three years of death of the decedent.]

# Federal Unified Transfer Tax -- Planning

- Use a life insurance trust to keep the insurance benefits out of the estate. [Again, there is a three year rule that adds the life insurance benefits to the taxable estate if the trust is established within three years of death.]
- Elect the Portability election on the return of the first spouse-to-die, so the second to die will be able to use any transfer tax credit not used by the first. That way a couple will be able to use the entire applicable exclusion amount of \$10,860,000 on their combined estate.

# Federal Unified Transfer Tax -- Planning

- ▶ Charitable contributions made during life will reduce both the **income tax and the future estate tax** since the property will not be in the estate. So better to give now rather than later.
- ▶ Property transferred to a irrevocable trust where the grantor is not one of the beneficiaries will not be included in the gross estate of the grantor since the trust owns the property. Transferring the property will be a taxable gift, but the property is not in the hands of the donee who may not be able to manage the property.

# Federal Unified Transfer Tax -- Future

- In 2010, the estate tax was eliminated for one year, it came back in 2011.
- Some have proposed reducing the credit so that the applicable exclusion amount would be \$3,500,000. Doing so would increase the number of estates subject to the tax.
- Some have proposed eliminating the tax entirely—again. Not likely, even though the revenue generated is less than 1% [0.6% in 2014] of total federal revenue.