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THE PLANNER

A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.

From: Louis Lepore

Louis Lepore is an attorney admitted to practice law in the states of New York, New Jersey, and Florida. He has dedicated his practice of law to providing quality legal representation and personal attention to all of his clients on Estate Planning, Elder Law issues, Probate, Business Succession Planning, Asset Protection, Tax and Business Planning.

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Estate Planning: Overview

Our clients expect their estate planning will cause their property to go to whom they want, the way they want, when they want and that it will minimize the impact of taxes, professional fees and court costs. They also expect their estate planning will help them keep control of their property while they are alive and well and provide for themselves and their loved ones if they become disabled.

Traditional estate planning often falls short of some of these goals. In this issue of The Planner we will examine the traditional estate planning process, some of its shortfalls, how modern estate planning overcomes them, and the pros and cons of modern versus traditional estate planning.

The advisor who understands the advantages and disadvantages of various modern and traditional estate planning techniques will be able to influence not just their client, but their client's family for generations to come, bringing considerable value to both their client and to the advisory team.

Traditional Estate Planning

Traditional estate planning is focused on the transfer of ownership of assets at their owner's death. Its cornerstone is the will. Too often traditional estate planners treated the creation of an estate plan as a transaction. They would also often ignore the client's assets that are not usually subject to probate and focus only on the assets that, with traditional estate planning, must go through the probate process before they can pass to the heirs. It relied on the durable power of attorney to protect the client from having an expensive court ordered and administered guardianship in case of incapacity.

In today's world, with a proliferation of non-probate assets, a more mobile society, and increased longevity, traditional estate planning often falls short of your clients' goals. It does not provide for your client's disability; it does not necessarily give what they have to whom they want, the way they want, and when they want; it will not avoid probate; and it too often ignores or inadequately deals with non-probate assets.

Non-Probate Assets

"Non-probate" assets are those that pass on death in accordance with some contract and thus without being involved in the probate process. In the traditional estate planning days, pretty much the only non-probate asset one ever saw was life insurance. In modern times, the portion of the typical estate that is non-probate assets has dramatically increased.

Where once defined benefit retirement plans for the worker and the worker's spouse were the norm, today the norm is the defined contribution plan, which passes by beneficiary designation. Today's planners must also deal with right of survivorship property, IRAs, and all sorts of annuities. Moreover, non-probate assets are typically a much larger portion of today's client's total wealth than they were in the days of traditional estate planning.

The proliferation of the types of no-probate assets, especially accounts with transfer on death or right of survivorship provisions, have likely led many of your clients to the false conclusion that they do not need to invest their time and money in estate planning to avoid probate and meet their estate planning goals. Nothing could be further from the truth.

Reliance on the most typical non-probate account provision, joint ownership with right of survival, for example, creates risks for the asset owner that are seldom considered.

Adding a joint or co-owner exposes the affected asset to the joint or co-owner's liabilities, increasing the owner's risk of being named in a lawsuit or losing the asset to a creditor of the joint or co-owner. There is also the risk that the joint or co-owner will not be able to resist the temptation to take or use the property while its original owner is still living.

With some assets, especially real estate, all owners must sign to transact business. If a co-owner (including an owner's spouse) is unable to do so because of incapacity, a guardianship may be required to have someone able to act for the incapacitated owner.

With right of survivorship property, when one owner dies, full ownership usually does transfer to the surviving owner without probate; but what if that owner dies without adding a new joint owner, or if both owners die at the same time? Then the asset must pass through probate before it can go to the heirs. And because a will does not control most jointly owned assets, someone in your client's family could become unintentionally disinherited when the property transfers automatically on death.

Planning Tip: Joint ownership with right of survivorship is often relied upon as a probate-avoidance mechanism, but its risks are often not even considered.

Moreover, avoidance of probate is not guaranteed with non-probate transfers. If "my estate" is listed as the beneficiary, or if a valid beneficiary is not named, the affected non-probate assets will have to go through probate, which will determine who gets what part of the estate. So, too, if a minor is the beneficiary, the asset holder will probably insist on there being a court-appointed and supervised guardian to receive the assets and manage them for the minor.

There is, however, one kind of non-probate asset system that has been demonstrated to work exceedingly well to meet all of the client's estate planning goals. That is the revocable living trust. Property that is held in a client's revocable living trust will bypass probate and can be used by the trustee to care for the incapacitated owner without court involvement or interference. Other non-probate assets that name the client's revocable living trust as the beneficiary will also bypass probate.

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Modern Estate Planning

Modern estate planning is not a transaction; it is a process. It involves not only your client but many generations. It allows your client to care for their loved ones with resources, love and wisdom. It truly is "wealth counseling." Modern estate planning is not just something done to plan for death – it is planning for life, and life involves changes and uncertainties.

Typically the cornerstone of a modern estate plan is a revocable living trust, because a properly funded revocable living trust can avoid both the huge expense of guardianship if the client becomes incapacitated and the expense and delays of probate when the client dies. But a revocable living trust plan is not a Ronco appliance – your client can't just "set it and forget it." Over time your client's assets change, their family members' circumstances change, and the law changes. There is truth in the saying, "There is nothing as certain as change." Failure to fund a revocable living trust and keep it properly maintained is an almost sure fire way to get to a probate court.

The modern estate planning process, therefore, includes education, design, drafting of the documents, and implementation. Like traditional estate planning, modern estate planning includes medical directives. Today those include a health care power of attorney, a living will, and a HIPAA authorization. For asset management if the client becomes incapacitated, modern estate planning uses a revocable living trust, backed up by a durable power of attorney.

Planning Tip: A living will lets physicians know the kind of life support treatment your client would want in case of a terminal illness or injury. But its scope is limited, and in some states physicians are under no legal obligation to follow it. A health care power of attorney is broader; it lets your client give legal authority to another person in advance to make any health care decisions for your client—including the use of life support—should your client become unable to make them.

Revocable Living Trust

A living trust-centered estate plan is more likely to achieve your client's goals in today's world. It plans for your client's disability, provides for your client's loved ones, contains your client's caring instructions, addresses your client's fears, and reflects your client's love and values. It can also avoid probate, is valid in every state, and is more private and confidential than a will. For all these reasons, a living trust-centered plan has become the plan most preferred by estate planning professionals and clients alike.

Planning for Disability

Planning for disability with a living trust is superior to relying solely on a durable power of attorney. Today, many financial institutions and other third parties will not accept a durable power of attorney unless it is recently signed and on their own form. But they will, and indeed must, accept the instructions of a trustee (or successor trustee) named in a revocable living trust concerning the trust assets. This makes it less likely that a guardianship/conservatorship will be needed for your client. (Note: A will has no effect at disability because it can only go into effect after your client dies.)

Planning Tip: Usually, several successor trustees are named in a trust, in the order in which the grantor wants them to serve. It is a good idea for your client to also have a durable power of attorney with the same successors named, in the same order, for even more ease of acceptance.

Why a Revocable Living Trust Works

The concept is simple. When a revocable living trust is established, the name on the titles to the client's assets is changed to the trustee of the trust. Legally, the individual no longer owns the assets; the trustee of the trust owns them. Thus, when the individual becomes disabled or dies, there is no reason for the court to become involved. The trustee (or successor trustee) already has the legal authority to transact business with the assets. The trust is made revocable so the client retains the power to change his or her mind as well as adapt their plan to changes in their assets, their family, and the law.

Planning Tip: Most people name themselves as trustee of their revocable living trust so they can keep control of their assets, naming a successor to step in when they can no longer conduct business due to incapacity or death. Many include a corporate trustee as co-trustee for professional asset management.

Avoiding Probate

Probate administration is very state specific; procedures and costs vary greatly from state to state. Wills do not avoid probate. Assets titled in the client's name at death and assets that are directed by a will must go through the probate process before they can be distributed to the heirs. If a client dies intestate (without a will), their assets will be distributed according to the probate laws in that state, which will almost certainly not be what the client would want. If a client owns out-of-state real property, probate is usually required in each state in which the client owned real property at death.

As explained earlier, many assets (survivorship and pay-on-death property, life insurance, IRAs, defined contribution retirement plans, and annuities) are designed to pass outside of probate. That can result in an uncoordinated estate plan. Moreover, many clients—and even attorneys and professionals—fail to understand the importance of asset titling and beneficiary designations, and it is not unusual for a non-probate asset to become a probate asset because of a title or beneficiary designation that is incorrect or out of date.

Living trusts can avoid the need for probate altogether if the titles of all assets have been vested in the trustee and all beneficiary designations have been changed to the trustee of the trust. However, probate avoidance requires rigorous maintenance of titling and beneficiary designations. All it takes to require probate is for your client to open a bank or brokerage account in their individual name instead of as trustee. Also, because living trusts are valid in all states, the need for multiple probates can be eliminated.

Planning Tip: It is important to avoid any asset or beneficiary designation not being changed to the trust. If one is forgotten, or the valid reason for not putting it into the trust to begin with no longer exists, probate may become necessary. If that happens, the client's "pour-over" will, a standard accompanying document to a living trust, will redirect the asset into the client's trust. The asset may have to go through probate first, but it can then be distributed according to the client's instructions in the trust.

Planning Tip: It is usually advisable to transfer a client's home and all their other valuable assets to their trust to make sure they all become part of the unified trust-based estate plan.

Privacy and Confidentiality

Once filed for probate, a will becomes a public document. Moreover, many states have a statutory requirement to file a decedent's will even if there is no probate. With rare exceptions, probate files are open to the public, and private information has become a commodity. Do clients really want the planning they have put in place for their loved ones and what their loved ones will inherit to become public information?

Living trusts are not a matter of public record. While some states now do require some notices, a living trust provides more privacy than any other estate planning mechanism.

How to Distribute Assets to Heirs

Distributions made outright to your client's heirs have no protection from the variety of risks to which personally-held assets are exposed. Once distributed, the heirs can use those assets however they choose and the assets can be subject to their creditors' claims. However, bequests that are kept "in trust" for the benefit of the heirs enjoy protection from creditors, predators (including ex-spouses), irresponsible spending (protection from "self") and future estate taxes. Assets kept in trust can also provide for individuals with special needs without affecting their entitlement to valuable government benefits.

Basic Estate and Gift Tax Rules

Proper estate planning should always consider estate and gift tax rules. The estate and gift taxes are transfer taxes. They apply to everything your client owns unless their transfer falls under a tax exclusion. Here are the rules for federal transfer taxes that, unless changed, will be in effect until the end of 2012:

- Estate transfers and gifts are taxed at a flat 35%.

- There is a $13,000 annual exclusion for present interest gifts to each individual. (Amount is indexed for inflation.)

- There is an unlimited marital deduction applicable to gifts to a U.S. citizen spouse.

- There is a $5,120,000 unified exclusion for gifts and death transfers not covered by annual exclusions or a marital or charitable deduction. Under current legislation, it becomes $1 million in 2013.

- There is an unlimited charitable deduction.

Of course, any exemptions that are not used in planning are lost when the client dies or tax laws change. Speaking of change, there is a major change scheduled for December 31, 2012.

Under current law, on January 1, 2013, the maximum transfer rate will increase from 35% to 55% and the unified exclusion will be reduced from $5,120,000 to $1,000,000.

What can we expect between now and 2013? This is definitely a political issue, and one that the House Democrats have targeted. Possibilities bandied about include a $5 million unified exclusion and 35% tax rate; $3.5 million unified exclusion and 45% tax rate; permanent repeal; the end of the unified exclusion; and a $1 million exclusion with graduated rates up to 55%.

Planning Tip: Some states have their own death/inheritance tax in addition to the federal transfer taxes. Often they begin at a much lower level than the current unified exclusions. So, while a client could be exempt from federal taxes, their estate may have to pay state transfer taxes. Make sure you know your state's laws.

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Conclusion

Many clients put off estate planning, thinking they have plenty of time to do it before they die. But the truth is that none of us knows how long we have. We only have to watch the nightly news to be reminded of that. And, estate planning should be a process, not a transaction. The advisor who understands this, as well as the advantages and disadvantages of the various estate planning mechanisms, will be able to provide an invaluable service to their clients and their families.

Uncovering Charitable Planning Opportunities

Charitable giving is discretionary spending. It is affected by both the economy and the income tax rates. Not surprisingly, charitable giving has been down in recent years, but this does not mean clients are less charitably inclined. Many just need to be pointed in the right direction. With the $5.12 million transfer tax exemption ending on December 31st and higher income tax rates looming for 2013, now is an excellent time to begin discussing charitable planning solutions.

Choice of a charitable planning technique is mostly driven by the type of client and asset involved. Therefore, in this issue of The Planner, we will focus on the types of clients who might benefit from charitable planning and for each the kinds of charitable planning that can work for them, and some pitfalls to avoid.

Charitable planning is most beneficial to those clients who already have some interest in charity or have other non-tax reasons for doing charitable planning.

Client Category: Young Professionals

These clients are usually still building their assets and may have some outstanding student loans and probably have mortgage debt. Their current estate planning goals are more likely to be centered on taking care of a surviving spouse and minor children, but they may still like to benefit their favorite charities (a college or church, for example) if they were to pass away unexpectedly. For these busy professionals, simple is usually best. Flexibility is also important because their estate plan will need to change several times over their lifetimes.

For these reasons, a simple bequest in a will or trust may be the solution. It's not complicated, it's revocable, and it can be drafted to take effect after the death of the second spouse.

Planning Tip: If there will be significant restrictions on the gift, the client should talk to their charity first and make sure the gift will be acceptable. For example, some charities have minimum requirements on gifts to be used for specific purposes.

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Tax Issues

Assuming the beneficiary is a qualified domestic or foreign charity, the bequest should generate an estate tax charitable deduction. Note the difference with income tax deductions, which do not apply to gifts to foreign charities. Gifts to certain ESOPs and to fraternal benefit organizations (lodges) can qualify for the estate tax charitable deduction, but those to sororities and fraternities usually do not.

Client Category: Has a Large IRA or Retirement Plan Account

Doctors, business executives and other clients may have large IRAs, sometimes with few other liquid assets. The problem is that, because of the combined effects of income and estate taxes, dying while owning a large IRA can create a large tax liability—with as much as 70% of the IRA going to taxes. For clients with large IRAs, especially those who are not married, charitable IRA planning is often very attractive.

Potential strategies include:

1) Naming a qualified charity as the beneficiary of all or part of the IRA. This is easily accomplished by naming the charity as a beneficiary on a beneficiary designation form obtained from the IRA administer. The designation should be revocable to preserve flexibility.

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2) If it comes back, taking advantage of the Charitable IRA Rollover. The Charitable IRA Rollover opportunity ended on December

If it comes back, taking advantage of the Charitable IRA Rollover. The Charitable IRA Rollover opportunity ended on December 31, 2011. However, there is a chance that it might be extended retroactively through December 31, 2013. (Such an extension is part of the proposed Family and Business Tax Cut Certainty Act of 2012, which passed the Senate Finance Committee on August 2, 2012.) Stay tuned for post-election developments.

The Charitable IRA Rollover allowed up to $100,000 to be paid by the IRA administrator to a qualified charity if the IRA owner had attained age 70½. Distributions counted toward the individual's annual mandatory IRA withdrawal amount but were not included in the IRA owner's taxable income.

Tax Issues

Funds held at the time of death in an IRA, 401(k), 403(b) or other deferred income account are called, in tax jargon, "income in respect of a decedent" or "IRD." IRD includes all amounts earned during the decedent's lifetime that have not yet been subject to income tax. Code Section 691 states that a recipient of IRD is treated as the recipient of the income and so must pay income tax on it.

Because a charity is tax-exempt, it can receive items of IRD without paying income tax on those items. Also, because the donor receives an estate tax deduction for the gift, IRD assets passing to a charity are unreduced by estate taxes.

By comparison, if IRD is inherited by an individual, that beneficiary would pay state and local income taxes on the IRD and the decedent's estate would be liable for any state and Federal estate taxes.

Client Category: Has Low Basis Assets

Many clients have stocks and other investments with a low cost basis that they have held onto for a very long time. Low basis assets can also exist with younger clients, for example those who were involved in successful start-ups. This client may want to make a larger gift to a charity—endow a chair at their alma mater, set up a scholarship fund, or help to renovate their church—but needs an income stream. Charitable planning can minimize the client's capital gain burden while monetizing the asset to provide the income stream.

Two strategies that will extend the recognition of gain over time are:

1) Charitable Gift Annuity (CGA). With a CGA, the donor transfers an asset or assets to a charity in return for the charity's issuing an annuity contract to the donor. To the extent that this annuity does not provide the same value of benefit that a commercial annuity would provide; the difference is a gift to the charity. If the annuity is exchanged for appreciated property, it may be possible to recognize the gain on the transaction over the life of the annuity.

With a CGA, the donor receives a current deduction for the charitable portion of the transaction. The annuity payments continue for the agreed term, which may be the life of the donor(s). With a life annuity, the cumulative amount of the annuity paid may be more or less than the value of the original property transferred; depending on whether the donor(s) die prematurely or later than an actuary would predict. The annuity payment is a general debt of the charity so it is important to work with a charity that is credit worthy. Administrative costs are low, so a CGA can be done for fairly small amounts as long as the charity is willing.

Planning Tip: State law may limit the ability to use real estate or other very illiquid assets to purchase the CGA.

2) Charitable Remainder Trust (CRT). As with the CGA, the donor transfers appreciated property and receives a stream of payments over a defined term. With a CRT, the CRT Trustee sells the assets and pays the donor an annuity or "unitrust" amount (a set percentage of the fair market value of the trust's assets revalued annually), depending on the terms of the CRT. Capital gain is recognized as the donor receives the annuity/unitrust payment. At the end of the trust term, the designated charity receives whatever is left in the trust. If the principal of the trust is exhausted in the payment of the annuity or unitrust amount to the donor, the income stream stops and the charity gets nothing.

Upon creation of the CRT, the donor receives a charitable income tax deduction for the actuarial present value of that remainder interest in the trust.

A CRT can benefit any charity, and is generally not limited in the type or amount of assets that can be used (with a general exception that a CRT should not hold an asset that produces unrelated business taxable income, such as S Corporation shares). Because a CRT is a separate, private trust, administrative costs are higher than is typical with a CGA, so a CRT is more often used for larger donation amounts.

Planning Tip: Current low interest rates used in the residual interest valuation (1.2% for November) disfavor the use of the CRT.

Note that neither the CGA nor the CRT erases the capital gain from the disposition of the appreciated asset. Instead, both defer the recognition of the gain over the life of the annuity or unitrust payment. As a result, some gain may not be recognized until the death of the donor if the annuity or unitrust is for life. Also, depending on the transaction structure, the donor may be able to plan the timing of some income.

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Client Category: Has Income Producing Assets

This client may have equity in a small business or real estate that is producing a good amount of income. He does not want to permanently part with the asset and wants for it ultimately to go to his children. A Charitable Lead Trust (CLT) can be the answer for the charitably inclined client. A CLT can be designed to give an income stream to a charity, reduce the client's estate and gift tax bill and preserve the asset for future generations.

A CLT is almost the opposite of a CRT. During the term of the CLT, the trust pays an annuity or unitrust amount to the charity. At the end of the trust's term, the remaining assets can return to the donor or, more commonly, pass to family members. If the assets in the trust grow at a rate that is greater than the actuarial rate of growth, all of that appreciation passes free from estate or gift tax.

Planning Tip: In a low interest rate environment, when the government assumes a very low rate of actuarial growth, it is much easier for the CLT to outperform these assumptions and pass appreciation tax-free to the donor's children or other beneficiaries.

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