Will you Trust Me?

Estate Planning

ELGA Investment & Insurance Services

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After a lifetime of accumulating wealth and enjoying the fruit of your labors, one should turn to the final chapter of a complete financial plan. Passing on wealth to the next generation according to your wishes and in an efficient manor should be a priority. The lack of planning can be extremely costly not only in dollars but also in damaged relationships or hurt feelings. Your estate plan should not solely be concerned with numbers or taxes but also accomplishing your objectives.

This guide is not an exhaustive explanation of estate planning, but merely an outline of possible estate planning tools.

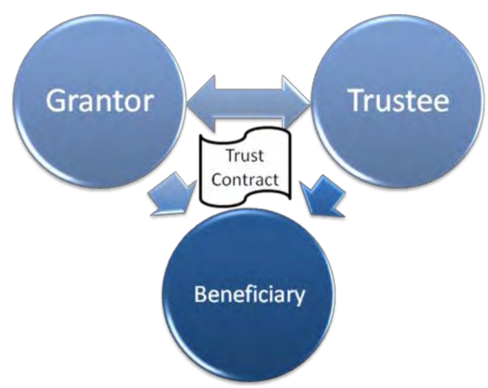
Summary of Contents

Definitions

Your Estate. The sum of all your property; personal, business, joint, etc. owned by an individual prior to their death and prior to the distribution of that property under the terms of a will, trust or inheritance laws. The term "estate" is very broad and encompasses all assets and liabilities of an individual.

Property. Either real or personal. Real property refers only to real estate. Personal property is everything else, all physical and financial assets. Examples: jewelry, antiques, collectibles, bank accounts, IRA's, securities and investments, life insurance, etc.

Trust. Trusts are legal agreements or entities that let you name conditions on how and when your assets will be distributed upon your death. It is a private agreement between two or more parties, the grantor(s) and the trustee(s).



Grantor. The individual(s) who place some or all of their property in a trust. The grantor holds no legal title to the property once it is placed in the trust, and in most cases retains full control over the property's use and maintains exclusive rights as well.

Trustee. A trustee is an individual who holds or manages assets that are in the trust for the benefit of another, usually the beneficiary.

Beneficiaries. The person or persons identified within a trust to receive the assets, income, or rights to the property. The heirs.

Irrevocable Trust. An irrevocable trust is where the grantor gives up the right to revoke the trust once it is established, including the right to change any of the terms or provisions of the trust. Once it becomes effective, an irrevocable trust cannot be amended, changed, revoked, or terminated by the grantor or anyone else.

Probate. Probate is the legal process that includes determining the validity of your will, gathering your assets, paying your debts, taxes, and the expenses of will administration, and then distributing the remaining assets to those persons entitled to them.

Estate Tax. This is a tax that the Federal government levies on the right to transfer property on your death. It takes into consideration everything you own or have certain interests in at the time of your death.

Gift Tax. Is a federal tax on "gifts" given to another individual or entity. You are subject to a gift tax if you give another individual property while receiving nothing or something not of equal value in return.

Power of Attorney. Provides powers to an individual or an organization that you appoint to act as your agent. You can specify the powers given to the agent or give them "general" power of attorney which includes a very broad and extensive scope of powers.

Health Care Power of Attorney. A type of specialized power of attorney in which you elect a person to act as your agent specifically for any medical related decisions in the case that you become unconscious, mentally incompetent, or otherwise unable to make a decision.

Durable Power of Attorney. Is a provision put within your power of attorney that allows the power of attorney to stay in effect in event of mental incapacitation or initiates the power of attorney if you become mentally incapacitated.

Living Will. A legal document that is used to declare your wishes regarding life prolonging medical treatments.

Guardianship. A legal guardian is a person appointed legal authority and power to care for the another individual, usually for the personal well-being and financial interests of the individual.

Keys to Successful Estate Planning

Essential elements of an estate plan include a will and/or trust, financial (durable) and medical power of attorneys, guardianship designations for minor children, and a living will (life support issues). In this article, we will not go into detail about the assignments of power of attorney and living wills, but keep in mind that a properly established estate plan includes all these elements.

When considering a will or trust there are four main components:

1. **Life-Focused.** What are your goals for your wealth? What are your desires for your heirs? Do you have special needs or does someone need more help than another? Estate planning is more than just tax planning, it is planning the future path of your wealth.
2. **Liquidity.** We cannot control how long we live or how the economy or markets will affect the value of our assets, but we can control when and how. Providing the necessary liquidity to allow for income and or estate taxes to be paid, funeral arrangements to be made, and bills addressed are all aspects of liquidity. Unexpected financial needs may arise and being prepared for them means your heirs will not have to make tough decisions or lose out on opportunities.
3. **Flexibility.** It may be necessary to include provisions within the trusts that give the trustee more discretion if situations change in the future. Tax laws change, personal needs change, after all, how can we be certain 20 years from now the same goals are valid?
4. **Revisit Regularly.** Estate planning is dynamic. Legal and tax laws change which may affect your current strategy. Regularly reviewing and adjusting your plan will make it more consistent with your goals.

Questions to ask yourself:

? **State Taxes:** Does my state have inheritance taxes? If so, how much? When are they due?

? **Debts:** Are any of my debts joint with another person? Are there certain debts or loans I have that I want/should pay off? Would my family incur debt as a result of my own?

? **Final/Funeral expenses:** What will my funeral expenses be? Do I have any medical bills? Do I want my family to shoulder these costs at such a vulnerable time?

? **Business transition, buyout, or shutdown:** Will my business stay in my family? Who should run it in my absence? Do my successors have sufficient capital to keep the business going? Could one of my heirs buy the business from my spouse?

- ? **Special Needs:** How can I make sure my disabled or special needs child, spouse, or sibling is cared for? Would a large sum on money help or hurt their benefits? Will my other family members be burdened in order to take care of a disabled family member?
- ? **Blended Families:** How can I make sure my children from my prior marriage receive an inheritance without disinheriting my spouse?
- ? **Unmarried partners:** How can I make sure that my unmarried partner is taken care of after my death?
- ? **Incentives:** How Do I pass on my values and traditions? Can I control how funds are used?
- ? **Giving Beforehand:** Should I take advantage of the $13,000 per year tax-free gift allowance?

Current Tax Laws: How it can affect You

One thing that is constant is change. Due to economic and political uncertainty, the 111th congress passed a 2-year extension on the Bush Tax Cuts in December of 2010. This means that the current tax code will most likely change in another two years. A long-term tax code would be convenient but it may also look very different to what we have now.

The current estate/gift tax is as follows:

Year	Estate Tax Rate	Estate Tax Exclusion Amount (single)	Estate Tax Exclusion Amount (married)	Gift Tax Exclusion Amount
2011	35%	$5 million	$10 Million	$1 Million
2012	35%	$5 million	$10 Million	$1 Million
2013-	?	?	?	?

Understanding the tax code is an essential element to estate planning. Along with estate and gift taxes, other tax considerations such as IRA eligibility, income tax rates, capital gains, and generation skipping taxes are all relevant.

The Section 7520 rate is also important in estate planning. The Section 7520 rate is used to value certain charitable interests in trusts. This is an important factor for those considering gifting monies at their death. These rates found on the IRS website are currently historically low. And are subject to change like all other rates.

Understanding Probate

As previously defined, probate is the legal process that includes determining the validity of your will, gathering your assets, paying your debts, taxes, and the expenses of will administration, and then distributing the remaining assets to those persons entitled to them. It is often misunderstood and left unaccounted for. We will take a quick look at the different aspects of probate to further understand the reasons for avoiding it. ***Remember, a will gets you into probate not out of it!***

Living Probate

Most people think probate is only something that happens when you the owner of the estate dies. Unfortunately, probate can also happen while you are alive and is called a conservatorship or guardianship proceeding but often referred to as "living probate". In the event of the owner of the estate becoming mentally incapacitated, then probate court will appoint someone to take control of all of your assets and affairs. These court appointed agents must file strict annual accountings with the court. The entire proceeding may be expensive, time consuming, and potentially humiliating.

Death Probate

At the time of your death, your assets need to be distributed to your heirs, your debts need to be paid, and any loose ends need to be taken care of. Because you are unable to sign deeds, write checks, or handle any business or family affairs, probate court assumes these duties on your behalf. Again, the process can be long, expensive, and frustrating to most families.

The Costs of Probate

- **Financial**

Probate can be very costly financially. Statistics show that the average cost is between five and seven percent of the gross value of the estate. One legal scholar who urges a reform in the probate system remarked that, *"the cost of probate expands to consume the money available."* Small estates are particularly vulnerable because even reasonable fees can eat up a large percentage of an estate's assets. There just is not that much to go around. Remember, every dollar that goes to pay probate costs is a dollar that could benefit your loved ones.

State law sets the probate fees that attorney's and personal representatives can charge. Many states allow attorney's to charge any fee that the court considers reasonable, without any limitations. Other states limit the fees to a fixed percentage of the estate. Under either method, the fees can range from four to ten percent of your family's gross estate.

Remember, probate fees can be levied at each spouse's death. Depending on how title was held on the date of death, a married couple could pay some form of probate fees on the death of each spouse.

Not only are the fees excessive, but the manner in which they arrive at the size of your estate bears little resemblance to its actual value. In states that use the percentage of the estate method, probate fees are calculated on your estate's gross value without deductions for liens or encumbrances. This means that if you have property worth $100,000 but owe $90,000 to a bank or financial institution, your probate fees will be based on the full value, not just on the equity you own, the full $100,000.

- **Time**

Probate in some cases can last eighteen months or more. If everything goes completely smoothly and there are no issues, it is possible to complete probate in one month. Most people assume that their estates are simple and will glide through the system. Regardless of how simple an estate may appear, it is very difficult to close a full probate in less than a year. All steps must be completed to full satisfaction of the court.

- **Loss of Control**

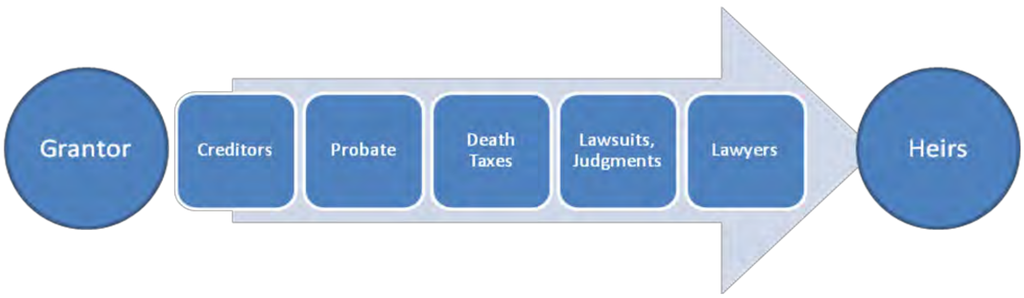
One of the biggest disadvantages is that your family potentially loses control of the estate. During probate, your family may not be able to sell assets without court approval even if they need the money. Opportunities can be lost because the system moves so slowly.

- **Loss of Privacy**

All probate proceedings are open to the public. Anyone who has an interest can pull your probate file and examine every detail of your financial life. The file will disclose an inventory and appraisal of every asset you owned at death. It reveals the name of all your creditors and amounts owed to each. It lays out the names of all your beneficiaries and the amounts and conditions of their inheritances. This information is often compiled and sold to those who use the information to sell products and services to vulnerable surviving family members. It can be particularly damaging if you owned a business. Your competitors will have a treasure trove of confidential business information at their fingertips.

Trusts

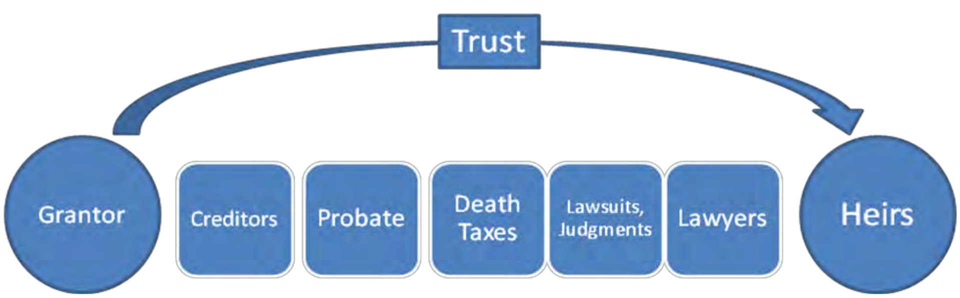
As previously covered, a trust is a legal agreement between the grantor and trustee for the benefit of the beneficiaries or heirs. The conditions you create within the trust ensures your wealth goes to whom you want it to, when you want it to, and how you want it to. Without a trust, your estate becomes vulnerable to creditors, probate, death taxes, lawsuits, and disgruntled friends or family members.



Reasons to establish a trust might be:

- To put conditions on how and when your assets are distributed after you die
- Protect minor children who cannot own property or be influenced into poor decisions
- Reduce estate and gift taxes
- Distribute assets to heirs efficiently without the cost, delay and publicity of probate court.
    - *Probate can cost between 5% to 7% of your estate*
- Better protect your assets from creditors and lawsuits
- Name a successor trustee, who not only manages your trust after you die, but is empowered to manage the trust assets if you become unable to do so.

There are many different variations of trusts; each uniquely designed to maximize wealth transfer for different situations and purposes. Each trust has specific requirements and/or parameters and you should discuss in-depth with your attorney to decide which trust fits you and your needs.



Grantor Retained Annuity Trusts (GRATS)

A GRAT is an irrevocable trust to which an individual transfers property to or into the trust but retains a fixed amount of interest or payment like an annuity from the trust for a specified term. The assets that remain in the GRAT (Trust) during the payout period are then distributed at the end of the term to the GRAT beneficiaries free of estate tax so long as the grantor (giftor) outlives the GRAT term.

When the GRAT is established, the IRS levies a gift tax on the remainder value of the GRAT (the projected value of what will eventually be left to the trust beneficiaries). The value of the gift is the difference between the amount contributed and the present value of the annuity payments that the grantor will receive.

This irrevocable living trust is only effective as long as the grantor does not die before the end of the GRAT term. If the grantor does not outlive the term then the assets revert back to grantors taxable estate.

Qualified Personal Residence Trusts (QPRTs)

A qualified personal residence trust (QPRT) is useful if particular parts of your estate are likely to appreciate in value, such as a home or an investment property. It is designed to reduce the value of a personal residence for federal estate tax purposes upon the death of the grantor. It allows you to give your home as a gift, while retaining control of it based on a specified number of years defined within the trust. During the specified period, say 10 years, you may retain full control of the home and may continue living in it.

The QPRT allows the gifted house to be valued at less than the present day value because the beneficiaries will not take possession for several years. (Note: The longer the term of the trust, the less the value of the gift.) The IRS makes calculations that take into account current interest rates, your life expectancy, and other factors, which they use to assume a “devalued” worth of the gift.

Let’s say you establish a 10-year QPRT and put in a $700,000 home. After the IRS calculations, they will assume the value to be (for example) $500,000. Even though the house may go up in value during this time, the gift will still be valued at $500,000.

An important fact to note is that, like a GRAT, you must outlive the trust. If you do not outlive the QPRT then the full market value at the time of your death will be counted in your estate. In order for the trust to work you must outlive the specified term.

At the end of the trust, you either must move out of the house or pay fair market rent in order to continue living there.

Installment Sales to Intentionally Defective Irrevocable Trusts (IDIT Sale)

The IDIT allows individuals to sell assets, property, etc. to an IDIT benefiting their heirs. This technique can remove the appreciation on the sold property from the individual's taxable estate, thereby avoiding taxes. By structuring the transfer as a sale rather than as a gift, this technique allows individuals to remove assets from their estate at a minimal gift tax cost. Any income that the trust produces is taxable to the grantor, or person giving /selling the asset. However, gifts that you make into this trust stay in this trust and cannot ever be accessed by you again and in the event of a beneficiaries death do not automatically revert back to you.

The IDIT can be very complicated and designed in many different ways. An IDIT can be extremely effective for real estate or business owner or if you own highly appreciating stock. It allows you to make a "gift" to your beneficiaries above and beyond what the normal gift tax excludes and reduces the drag of taxation on these assets.

Charitable Lead Annuity Trusts (CLATs)

This trust is designed for those individuals who do not necessarily need the current income from some specific property but would like to retain control of it for either themselves or their heirs.

The property or investment inside the CLAT provides income to a designated charity or qualifying organization and then transfers the property to the heirs at a designated time. When establishing the CLAT the grantor transfers property into an irrevocable trust that then pays the designated charity an annuity payment for a specified time period. At the end of the term, the property then passes to the beneficiaries.

Given that the remainder of the CLAT passes to someone other than the grantor, a gift tax is levied upon the transfer of the asset into the CLAT. The value for gift tax purposes is the present value of the remainder interest. The present value of the remainder interest, like the present value of the GRAT, is calculated using an assumed rate of return equal to the section 7520 rate. Similar to the GRAT, the objective is to set the annuity payments to the charity equal to the present value of the remainder interest in order to zero out the gift tax cost value of the remainder. A lower section 7520 rate translates into a lower annuity payment to the charity and a larger amount left for the grantors beneficiaries.

Different variations of charitable lead trusts can be used depending on whether the individual wants the asset to revert back to him or her or go to his or her heirs and depending on the client's other objectives, such as income tax deduction.

Charitable Remainder Annuity Trusts (CRATs)

A CRAT allows the grantor(s) to live off a fixed income for the remainder of their lives, and upon the death of the grantor(s) the balance left is donated to a designated charity. The fixed payment to the grantor(s) is based on a percentage of the total property value placed within the trust. The payment of the annuity to the grantor is received annually either for life or for a specified number of years and the payout ratio or percentage is selected by the grantor at the establishment of the trust.

Notice that the payment is calculated on the value of the property when placed within the trust. Thus, if the value of the property increases the payment remains the same and there is more left over for the beneficiaries.

Let's say you place $500,000 into a CRAT and select a 5% payout. You as the grantor would receive 5% of the initial balance invested annually until the end of the term that you specified. If the value of the property within the trust increases to (as an example) $700,000 the $200,000 increase will not be added to the value that the 5% payout is based upon. Thus, any increase in value of the estate is not taxed and passes to the beneficiary.

If set up correctly, you can use a portion of the annuity payments or tax savings from the charitable deductions to fund life insurance placed within an irrevocable trust that are not included in your estate.

For more information please call Nathan Sealey at 248-330-8707 or nsealey@nextfinancial.com

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