Estate Planning Basics

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Introduction to Estate Planning

Estate Planning involves making decisions regarding (i) issues that will arise upon one's death (ex. gifting property, appointing an executor, etc.) as well as (ii) certain issues that might arise during one's lifetime (ex. management of property during one's incapacity, directions regarding one's medical treatment in certain situations, etc.).

The estate planning process may result in the creation of several legal documents that articulate one's decisions and plans regarding some of these issues. Some of the most common estate planning documents are described below.

Will

A "Will" is a document that sets forth the signer's instructions regarding a variety of issues that will or might arise upon his or her death. Issues that may be addressed in a will include the following:

1. The identification of the persons or organizations to receive one's property. Property may be given directly to a beneficiary or given to a trust to be managed for a period of time by a trustee for the benefit of designated beneficiaries (minor children, for example).

2. The appointment of an Executor who will be responsible for the administration of the estate in accordance with the directions in the will.

3. The appointment of a guardian to care for the signer's minor children in the event no parent is then surviving.

4. Plans to minimize estate taxes that are imposed on larger estates (in 2009, estates of over $3,500,000 in value, but see estate tax discussion within).

Trusts

"Trusts" are flexible and valuable estate planning tools well suited for a variety of tasks. A trust is a three party relationship created when one party (called a "grantor" or "settlor") transfers property to a second party ("trustee") who is directed to hold the property for the benefit of a third party ("beneficiary"). A simple example can arise when parents with minor children direct that if both parents die before all of the children are adults that the parents' property will be held by a designated trustee for the children's benefit until they reach adulthood. During the term of the trust, the trustee will use the trust property for the children's needs. At some designated point in the future (for example, when the youngest child reaches age 25) the trust will terminate and the remaining property will be distributed by the trustee to the children free of the trust.

Second marriages present another situation in which trusts are commonly used. For example, a spouse with children from a prior marriage might wish, at death, to leave certain property to the current spouse for his or her lifetime, but wish after the surviving spouse's death such property pass to the children from an earlier marriage. To accomplish this, a trust may be established to receive one's property at death, with the trustee directed to make the trust property available for the benefit of the second spouse during his or her lifetime. At the second spouse's death, the trustee may be directed to distribute the remaining trust property to the children from the earlier marriage. By contrast, an outright gift of property to the second spouse could not guarantee that, upon the second spouse's death, children from a previous marriage would receive the gifted property. The second spouse would independently control, as a part of his or her estate, the eventual disposition of the gifted property.

Another very common use of trusts is as part of a plan to minimize estate taxes, particularly for married couples. Included in the tax planning section of this booklet is an illustration of how trusts can be used to reduce the estate taxes incurred by married couples.

Power of Attorney

A "Power of Attorney" is a document that appoints another to act as one's agent to handle one's property and financial affairs in the event of one's temporary or permanent incapacity. By executing a power of attorney, one can avoid the necessity of a guardian being appointed by the court to handle one's property in the event of incapacity. Guardianship is often viewed as undesirable because of the expense and delay associated with its establishment and the degree of continuing court involvement in the guardian's activities.

Living Will

A "Living Will" is a document in which the signer states his or her desire that certain types of medical treatment be withdrawn or withheld in certain situations so that death will result more naturally and directly. For example, a living will may direct that certain life-prolonging treatment be withheld if one's condition deteriorates beyond a stipulated point.

Health Care Power of Attorney

A "Health Care Power of Attorney" is a document that appoints an agent to make decisions regarding the signer's medical care in the event of the signer's incapacity to make such decisions.

Related Matters

Estate planning also involves determining whether beneficiary designations on life insurance policies, annuities, retirement accounts, and similar properties are consistent with one's estate planning desires. In addition, some planning goals may be promoted by the transfer of property from one's estate during life. For example, in some cases transfers between spouses or the creation (or dissolution) of joint ownership by both spouses can assist in reducing estate taxes. In other cases, gifts during life to children or others may produce valuable tax savings, or accomplish other desired goals.

The next several pages discuss the basics of the federal estate tax system and how advance planning can, in some circumstances, reduce the impact of this tax on one's estate.

Tax Planning Basics

The Estate Tax

A Federal Estate Tax (the "estate tax") is assessed at death on the value of each person's estate. The assessed tax, if any, is payable as part of the administration of one's estate and is due within nine months of the date of death. However, please note that two important features allow many estates to pay <u>no</u> estate tax.

First, the estate tax does not apply to property transferred from one spouse to another. Therefore, when the first spouse dies, he or she can give all of his or her property to the surviving spouse, regardless of the amount, without any estate tax being assessed.

Second, each estate is granted an exemption that allows a specified dollar value of property to pass to beneficiaries other than a surviving spouse free of the estate tax (remember that <u>all</u> gifts between spouses are free of estate tax, as well as gifts to many charities). This exemption allows most people with estates valued at less than the exemption amount to be unconcerned with the federal estate tax.

For people dying in 2009 the estate tax exemption amount is $3,500,000 (assuming the exemption has not been previously used to shield taxable gifts during life*). Fortunately, this large exemption amount means most people don't have to worry about the federal estate tax. The Federal estate tax rate applicable to property in excess of the exemption amount is significant (approximately 45%), which means that people who may be subject to the tax generally wish to take active steps to minimize or avoid the tax.

The 2001 Tax Act — Recent History

On June 7, 2001, The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") was signed into law. Beginning in 2002, this Act made a number of substantial changes to the federal estate tax, many of which have been beneficial to taxpayers. However, certain features of the 2001 Tax Act, discussed in more detail below, make uncertain whether the changes provided by this Act will be permanent or whether the

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* In any year, a taxpayer may make gifts to others in amounts not exceeding the applicable annual gift tax exemption ($13,000 per recipient in 2009) and such gifts will not be subject to the federal gift tax. Gifts that exceed the annual exemption amount will use up portions of the estate tax exemption that would otherwise be available to shield gifts at death from the estate tax.

tax law will undergo additional changes in future years. This uncertainty regarding the future of the estate tax laws means that all taxpayers should review their estate plans from time to time over the next few years to determine whether changes phased-in pursuant to the 2001 Tax Act or other changes resulting from subsequent tax acts necessitate revision.

Of particular benefit, the 2001 Tax Act significantly increased the estate tax exemption amount (the amount of property that can pass free of the estate tax) for people dying in the years 2002 through 2009. These increases have been phased-in over several years as follows:

In 2002 the exemption amount increased to $1,000,000 per estate.

In 2004 the exemption amount increased to $1,500,000 per estate.*

In 2006 the exemption amount increased to $2,000,000 per estate.

In 2009 the exemption amount increased to $3,500,000 per estate.

In addition, the 2001 Tax Act gradually reduced the maximum estate tax rate from a top rate of 55% in 2001 to a maximum rate of 45% in 2007.

Interestingly, the 2001 Tax Act fully eliminates the federal estate tax for people dying after 2009.** This repeal provision attracted significant media attention when the legislation was debated and passed in 2001. However, it is important to note that the repeal lasts for only one year (2010), and beginning in 2011 the estate tax rules revert to the law in effect in 2001, except that the tax exempt amount then will be $1,000,000 per estate rather than the $675,000 amount that was in effect in 2001. As strange as it may sound, the estate tax repeal provided by the 2001 Tax Act applies <u>only</u> for those dying in 2010, and after 2010 the estate tax rules will revert substantially to the 2001 rules.

Many people believe that the one-year estate tax repeal in 2010 followed by a reversion in 2011 to the 2001 rules cannot reasonably be left in place, and that further debate and change regarding these tax laws is inevitable. Many possibilities exist as to when additional change may occur and what that change may be. A short-term solution may be to extend the 2009 exemption amount of $3,500,000 for an additional year until the matter is

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* It should be noted that the exemption amount that one can use to shield large gifts during life from the federal gift tax is limited to a total of $1,000,000, even though the exemption amount available to shield gifts at death from the estate tax increased beyond $1,000,000 beginning in 2004.

** Tied to the estate tax repeal is an important change in the basis step-up rules presently in effect. The existing basis step-up rules essentially allow estate beneficiaries to incur less capital gains tax when they sell inherited property. Because of the change in the basis rules (effective in 2010), planning will continue to be necessary after the estate tax repeal to deal with the asset basis issue.

considered more comprehensively. Longer-term solutions may include full repeal of the estate tax, freezing the exemption amount at a set dollar value (possibly indexed for future inflation), reverting to something similar to the 2001 rules, or an entirely new version of the estate tax. Therefore, estate tax planning must be viewed as an ongoing process that requires regular review and appropriate response to any changes that may be made to the tax laws.

General Estate Tax Planning Issues

Individuals with taxable estates in excess of the current estate tax exemption amount should consider what planning steps can be taken to minimize the tax on their estates.

Married couples with total assets between them exceeding the current exemption amount should consider the possible impact of estate taxes on their estates, even if neither spouse alone has an estate exceeding the exemption amount. This is because, without appropriate planning, the last surviving spouse could be left with all the property now owned by both spouses (more than the exemption amount) and the ability to shelter only a portion of the total estate with his or her single exemption. The unused exemption of a spouse who leaves his or her property to the surviving spouse is lost; the unused exemption is not carried over to the surviving spouse for his or her later use.

A planning strategy that insures the full use of both spouses' estate tax exemptions is described beginning on the following page.

Presently, Kentucky imposes its own inheritance and estate tax. However, because the federal estate tax rate is substantially higher than the Kentucky tax rate, estate planning decisions are often driven primarily by efforts to minimize the federal tax. Fortunately, steps taken to minimize the federal estate tax often have a similar effect on the Kentucky tax.

The Taxable Estate

At this point it is important to understand what property is included in a person's estate subject to the estate tax. Simply stated, the taxable estate includes all property in which the decedent had an interest (generally meaning ownership rights or other rights similar to ownership) at the time of his or her death. Among the types of property included in one's taxable estate are tangible personal property, real estate, cash and investments, retirement accounts, life insurance policies, annuities, etc. Property owned jointly by the decedent with another is usually included in the percentage owned by the decedent.

Generally, properties included in the taxable estate are reported at their value as of the date of the owner's death. It is important to note that life insurance owned by the decedent on his or her own life is valued at the amount of the death benefit payable to the beneficiaries, not the cash value of the policy.

Many people underestimate the size of their estates (and the possible estate tax impact) until they carefully review their assets and their value. The value of life insurance is particularly overlooked, but careful attention needs also to be given to other assets, including retirement accounts, business interests, and equity in real estate.

Separate information gathering forms are available to help you identify your assets and gather much of the other information that will be needed for a review of your circumstances and to discuss your estate planning goals and objectives.

Basic Estate Tax Planning for Married Couples

As discussed above, every estate is granted an exemption shielding from the estate tax a stipulated value of property passing to beneficiaries other than the surviving spouse (assuming the exemption has not been previously used by the making of large gifts during life). However, if the exemption is not used at one's death, for example by a decedent who leaves property exclusively to his or her surviving spouse, the opportunity to use that exemption is lost. For married couples with total assets in excess of one exemption amount, the failure to use the exemptions available to both spouses' estates can be very costly.

Although the current exemption amount is $3,500,000 per estate, we are uncertain how this may change in the future. To illustrate the impact of effective tax planning for married couples, we're assuming for the purpose of this illustration an exemption amount of $2,000,000 per estate. The future exemption amount may be higher or lower.

In our hypothetical situation we have a husband and wife with a total joint estate valued at $4,000,000. This couple wishes to leave everything to their children upon the death of the second spouse. If the first to die leaves all of his or her property to the surviving spouse, the survivor will then own the entire $4,000,000. Upon the second spouse's death, when all of the property passes to the couple's children, only one estate tax exemption is available. If the exemption is only $2,000,000, the remaining $2,000,000 remains subject to the federal estate tax. At current rates, the estate tax on the second spouse's estate would be approximately $900,000. As a result, the children would receive only about $3,100,000 of their parent's $4,000,000 estate.

Alternatively, had the first spouse to die left $2,000,000 in assets to someone other than the surviving spouse (such as to the children, for example), those assets would have passed free of estate tax by virtue of the estate tax exemption applicable to his or her estate. The surviving spouse would then have property valued at only $2,000,000, which, using our assumption of a $2,000,000 exemption, could pass to the children free of estate tax by virtue of the exemption available to the surviving spouse's estate. This plan allows the parents to transfer to their children the full $4,000,000 estate with none of the property being consumed by estate taxes.

The weakness of this alternative approach is that the surviving spouse does not get for his or her remaining lifetime the use and benefit of the $2,000,000 in property given to the children by the spouse who died first. This result is not satisfactory to many people.

The effective solution to this problem is to use a trust as a substitute, intermediate recipient of $2,000,000 in property upon the first spouse's death. In other words, the first spouse to die leaves $2,000,000 in property to a trust rather than to the surviving spouse or the children. The $2,000,000 in property transferred to the trust passes tax free due to the estate tax exemption available to the estate of the first to die. The trust terms provide that the surviving spouse is the primary beneficiary of the trust assets for his or her lifetime and the children are secondary beneficiaries. Because the children are included as beneficiaries of the trust in addition to the surviving spouse, the spouse is not considered the owner of the trust property. This is important because we do not want the trust property to be included in the surviving spouse's taxable estate at his or her death.

The benefit of this plan is that the surviving spouse, as primary beneficiary of the trust, has the use of the trust property for the remainder of his or her life (slightly restricted by necessary terms of the trust), but the trust property is not included in the surviving spouse's taxable estate. At the surviving spouse's later death, the trust property is distributed to the children pursuant to the terms of the trust with no estate tax then being assessed. At that same time, the surviving spouse's separate estate also passes to the children free of estate tax due to the estate tax exemption available to his or her estate.

Through the use of this plan, these parents can transfer to their children their entire $4,000,000 estate, undiminished by estate taxes, and the longer living spouse can retain the use of the full estate until his or her death.

If the exemption amount available to each spouse is larger than out $2,000,000 assumption, this same plan can shield even larger joint estates from estates taxes (in the right circumstances, up to whatever amount is two times the individual exemption amount).

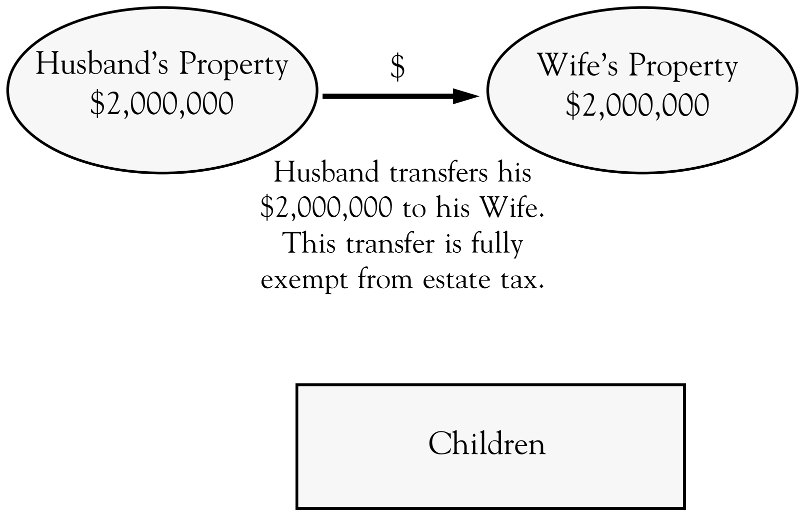
The following two pages show graphically the difference in the estate tax cost for a $4,000,000 joint estate between (i) a simple estate plan that neglects the issue of estate taxes (see page 9) and (ii) a plan designed to save estate taxes by using a trust to receive certain property upon the first spouse's death (see page 10). Note that this illustration uses a hypothetical $2,000,000 estate tax exemption amount, and that the actual tax savings will depend on the exemption amounts in effect when the spouses die.

Example of a Simple Estate Plan for a Married Couple
<u>That Does Not Address Estate Tax Issues!</u>

Situation:

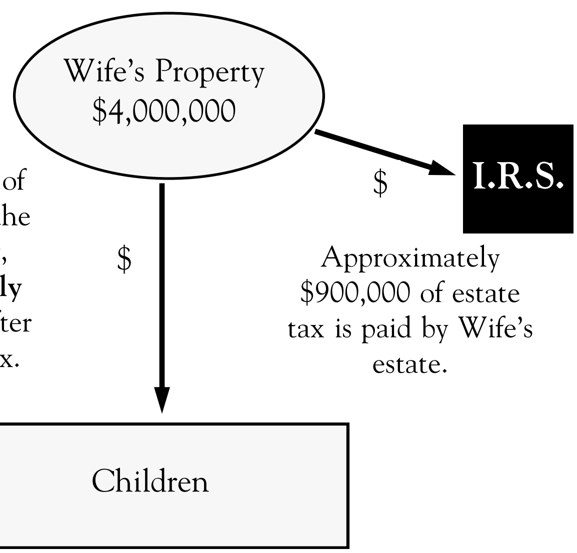
- Husband and Wife have total assets of $4,000,000; $2,000,000 is in each spouse's name.
- They desire the entire estate be available to the surviving spouse after death of first spouse.
- They desire that all assets pass to their children following death of second spouse.
- In this hypothetical, husband dies first and wife survives him for a period of time.
- A $2,000,000 per estate federal estate tax exemption is in effect.

I. Events that Occur Upon Husband's Death



II. Events that Occur Upon Wife's Later Death

Wife directs that all of her property pass to the children. However, **Children receive only about $3,100,000** after payment of estate tax.



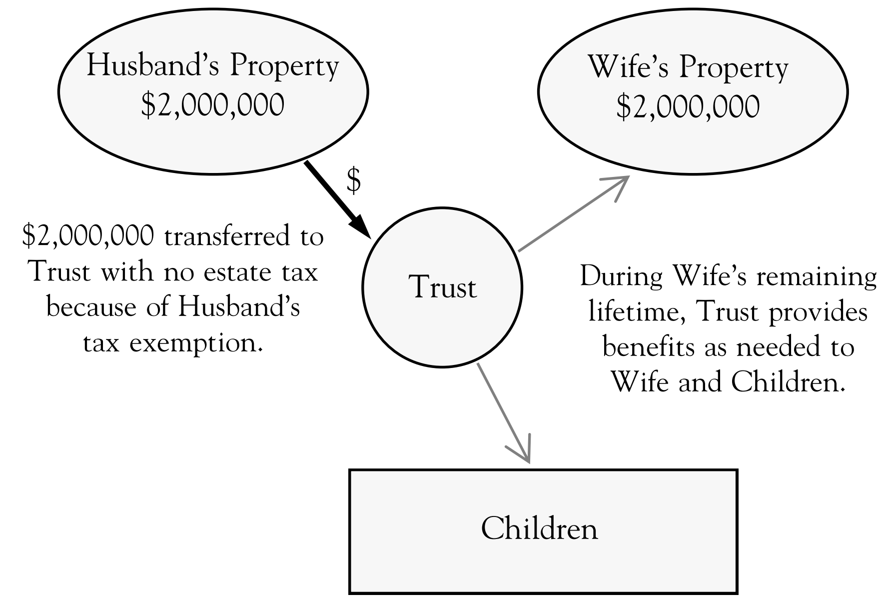
Result: Husband's estate tax exemption is lost when he gives all of his property to his Wife.
Wife can shelter from estate tax only $2,000,000 of her $4,000,000 estate by the use of her exemption.
Children's inheritance is substantially diminished by estate taxes assessed on Wife's estate.
Children receive $3,100,000; Approximate estate tax = $900,000.

Example of an Estate Tax Savings Plan for the same Married Couple

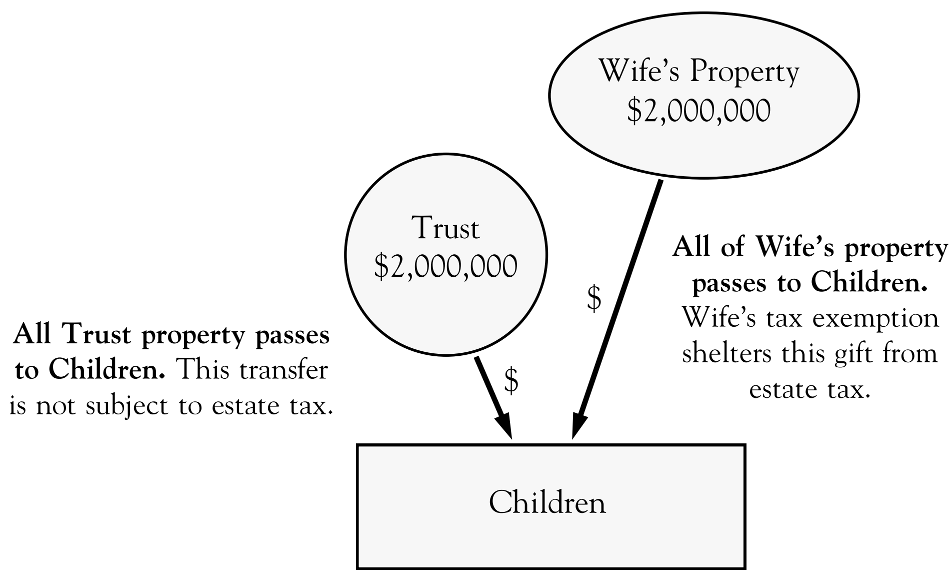
Situation (same as previous example):

- Husband and Wife have total assets of $4,000,000; $2,000,000 in each spouse's name.
- They desire the entire estate be available to the surviving spouse after death of first spouse.
- They desire that all assets pass to their children following death of second spouse.
- In this hypothetical, husband dies first and wife survives him for a period of time.
- A $2,000,000 per estate federal estate tax exemption is in effect.

I. Events that Occur Upon Husband's Death



II. Events that Occur Upon Wife's Later Death



Result: Using the Trust as an intermediate recipient of property upon the first spouse's death, the entire $4,000,000 joint estate passes to the children undiminished by federal estate taxes.
Children receive $4,000,000; Estate tax = $0.

Wrap Up

As the foregoing illustrations make clear, this simple estate planning strategy can result in substantial estate tax savings in the situation of a married couple with a joint taxable estate exceeding one estate tax exemption amount.

To receive the benefit of these tax savings, part of the joint estate must pass to a trust (or to someone other than the surviving spouse) upon the death of the first spouse to die. This imposes a minor inconvenience upon the surviving spouse in that the surviving spouse does not have fully unrestricted access to the property held by the trust. However, because the surviving spouse is the primary trust beneficiary for the remainder of his or her life, his or her well being is the trustee's foremost concern. The trustee is charged with using the trust assets to promote the beneficiaries' interests, and, as a result, the surviving spouse's financial needs will be funded by the trustee. Furthermore, the appointed trustee is generally either a trusted individual or a professional trust organization with experience in serving in this role. When compared to the benefit of saving significant estate taxes, the minor inconveniences of using this trust are generally considered acceptable.

When married couples have assets exceeding two tax exemption amounts in value, additional tax planning strategies may be appropriate. These other strategies, which are beyond the scope of this booklet, generally seek either to (1) reduce the value of the taxable estate (and thereby reduce or eliminate the estate tax) or (2) provide for the payment of an unavoidable estate tax in the cheapest way possible. Single persons with taxable estates exceeding one exemption amount may find these additional strategies attactive also, since the plan illustrated on the preceding pages has application only to married couples who have two estate tax exemptions available to them.

The information gathering forms that are available separately should assist you in identifying and gathering the various pieces of information needed for your estate planning. In addition to helping you collect and document personal information, the forms include schedules to help you calculate the value of your taxable estate.

Note . . .

This material is intended to provide a very basic overview of some of the most commonly used estate planning tools and strategies. This is not intended to serve as legal advice. This material is necessarily brief. It is by no means a comprehensive review of the issues that may be presented by any particular estate situation nor is it a comprehensive review of the strategies available to address such issues. As a result, no final conclusion should be drawn on the topics covered herein. If you have questions or concerns regarding your estate situation, you should obtain professional assistance.

John D. Meyers, Jr. - Profile

John Meyers is an attorney in Lexington, Kentucky, focusing primarily on estate and business matters. In his estate practice, John regularly works with individuals and couples to help them determine estate planning goals and take the appropriate actions to accomplish these goals. [Click here to return to the estate planning attorney services page at www.johndmeyers.com/eplaw.html.]

In his business practice, John assists business owners with business formations, business purchases and sales, joint ventures, contracts, transactions, business succession, and many other matters related to the operation and development of small and medium-sized businesses. [Click here to visit the hope page for John Meyers, business and estate planning attorney, at www.johndmeyers.com.]

John is a graduate of the University of Kentucky (B.S. in Accounting, 1983) and the University of North Carolina School of Law (J.D., 1986). After graduating from law school, John briefly practiced tax accounting with Arthur Andersen & Co. in Raleigh, NC and has since then practiced business and estate planning law for more than 20 years in Charlotte, NC and Lexington, KY.