"WILL WEDNESDAYS"

BY ESTATEPLANESQ

January 2, 2019 "New Year's Estate Planning Resolutions"

Happy New Year! With the onset of a new year, often we begin to reflect. Not only backwards on the year that has passed but also forward to things that we want to accomplish. One of those items that is often talked about is estate planning. Often someone says "I know I need to get my things in order" but inaction or procrastination frequently occurs. Since we are at the start of the new year, I am going to make this issue a little longer than usual to hopefully allow some reflection leading to action with respect to handling one's estate planning.

According to the AARP,78 percent of millennials (ages 18-36) and 64 percent of Generation Xers (ages 37-52) do not have a will. A little over half of adults have a health care power of attorney in place, according to the survey, with 83 percent of people over age 72 having this document compared with 41 percent of millennials.

Why do so many people fail to tackle or complete estate planning? The top two reasons of the people surveyed: They "hadn't gotten around to it" (47 percent), and they "don't have enough assets to leave to anyone" (29 percent). These answers may be hiding an aversion to dealing with the topic of death, a concern for the value compared to the perceived legal fees involved or a feeling that one just doesn't "fit the profile".

WHAT IS "ESTATE PLANNING"?

One of the issues is the direct association of "estate planning" with having a will. While having a will is certainly something to be aimed at doing, it is not the first and foremost document to assist someone with lifetime issues as was discussed in the December 26, 2018 issue. Documents like Durable Power of Attorney, Health Care Power of Attorney and Living Wills (sometimes the last two are combined into a form called an "Advance Directive for Health Care" in some states) all provide to address lifetime issues of handling financial and/or heath related decisions.

The second issue is the focus on "estate planning" even being about the documents themselves. The documents will simply execute a plan in the best-case scenario. However, "Estate Planning" is the formulation of the PLAN itself not the documents.

"Estate Planning" is about someone's values and desires for how they want not only their life's issues to be handled if they become unable to handle things themselves (i.e. disabled or incompetent), but also how they may want the lives of those they love handled whether they are alive or passed on. When done holistically, "estate planning" will consider: family dynamics, desired distribution of assets, tax planning to maximize receipts of assets and asset protection to preserve and protect assets.

FAMILY DYNAMICS

Families are usually no longer like those on "I Love Lucy", "Leave it to Beaver", "The Cosby Show", etc. In 2019, more like the "Brady Bunch" or "Modern Family" where there may be children with different parents, divorced individuals, individuals with different sexual orientations, individuals with different religions, etc. The problem is that many of the default state rules are based on historical assumptions (maybe even biases) that may not match the actual desires of the individuals involved.

As discussed in prior issues, most states do not classify stepchildren similarly to naturally born children. However, for a particular individual, he or she may want them to share equally. Also, with a 2015 Supreme Court ruling in Obergfell v. Hodges, there is now same sex marriage allowed throughout all fifty states. Since this is allowed at the federal level, certain estate planning issues come into play with the expanded inclusion of same sex individuals as "spouses". For example, with ERISA based retirement plans such as 401(k)s, the "spouse" must automatically be the beneficiary unless that spouse executes a written waiver in a particular manner. That term "spouse" would now include a same sex spouse and could alter estate planning distributions.

There are many other family dynamic issues to be considered. These were just a few.

DESIRED DISTRIBUTIONS OF ASSETS

Too often people assume what will happen with their assets rather than know what will happen with their assets. There are many rules that will direct property that people are not aware of and they can have tremendous effects on the standard of living of someone's loved ones. A simple example involving real estate is that many times property is owned as "joint tenants with right of survivorship". That means whomever dies first, their 50% interest automatically transfers to the survivor by operation of law. Often this is done for convenience. When this ownership arrangement is present, no probate would have to be done after the passing of the first spouse. This can cause an issue when there are "blended families" where all the property would pass to a stepparent and the stepchildren may get nothing later.

Another example using "blended families" is where the parent may have had beneficiary designations with the children as beneficiaries when he or she was single. Depending on the asset, there may be an automatic change by operation of law when they get married. So, a man getting married would automatically have the wife (i.e. stepmother) moved into first position in an ERISA based retirement plan like a 401(k), 403(b), etc. which could leave his children without those funds as he desired, unless he is able to convince his new wife to do a waiver of her rights. However, the same setup on his beneficiary designations for any IRAs or life insurance contracts would not be affected.

Some of the differences with distributions will depend on the actual nature of the assets themselves. This makes it incredibly important to plan.

TAX PLANNING TO MAXIMIZE RECEIPTS OF ASSETS

Of course, the stereotypical phrase is "Death and Taxes". Yes, they do interplay with each other, however, with the Tax Reform there is an altered viewpoint of it. Often in the estate planning area, there are three taxes involved with which many people are not familiar. They are the estate tax, the gift tax and the generation skipping tax ("GST"). They are very complicated taxes.

With the income tax that everyone is familiar with, the calculation is based upon a period (i.e. usually calendar year) where you report income on the form 1040 (or your business entities on forms 1120 or 1065). However, the estate, gift and GST are more like snapshots at the point of death (or six months later for a date called the "alternate valuation date"). Essentially it is like the accounting equivalent of a balance sheet and the tax would be based upon your total assets contained at the time of that snapshot. The rate for the estate, gift and GST taxes is a flat rate of 40%. The good news is that there is a high hurdle for the number of assets that you need to have before that 40% tax applies. Currently in 2018 that amount was $11.18 million for each person.

Due to that high hurdle, many people will never have any estate, gift or GST tax liabilities. So, the shift has moved over to income tax planning in the estate planning arena for lawyers, CPAs, Enrolled Agents and financial advisors. This income tax planning is centered around "basis".

Basis is essentially the tracker that the IRS (and states) utilize to determine how much of a sale is taxable. Usually your starting basis is your cost paid. So, if I purchased a stock for $10000 (i.e. 1000 shares at $10 per share) and sold it for $40,000, I would have generally have capital gain of $30,000 (i.e. the fair market value of my sale at $40,000 minus $10,000 cost basis).

In estate planning, where the income tax planning comes into play is that the Internal Revenue Code section 1014 provides that basis adjusts to the fair market value upon death. So, in the same example, if I died when the stock was worth $40,000 and then left the stock to my children as their inheritance, they would take the fair market value at the time (i.e. $40,000) as their basis. As a result, if they sell the stock for $40,000, they would have no income tax, because there would be no gain ($40,000 fair market value minus $40,000 basis).

Often this type of income tax planning is done using trusts and certain trust powers to ensure inclusion of particular property within the estate at death. It is something that requires the expertise of an experienced estate planning attorney and possibly coordination with a CPA and/or financial advisor.

ASSET PROTECTION TO PRESERVE AND PROTECT ASSETS

Someone can only give during life or death what they owned. Asset protection planning seeks to help with having the most protection and retention of assets from threats to those assets. Some examples of threats are lawsuits, divorce, substance abuse, excessive spending and long-term care costs.

Two ways to protect against these threats are business entities and trusts.

<u>Business Entities</u>

Certain business entities are usually compared based upon their tax planning benefits (i.e. "C" corporations vs "S" corporation's vs Limited Liability Companies (LLCs)). However, a very important aspect of business entity selection should be asset protection. Some aspects of protection can be lost using a corporation if detailed procedures are not followed. In addition, certain entities like LLCs in many states have a special protection called a "charging order" that is not available to either "C" or "S" corporations.

Depending on the type of liability exposure, there is still a risk with corporations of losing the actual stock itself in the corporation. With LLCs, the "Charging Order" protection is that you cannot lose the membership interest in the LLC itself but rather the creditor just steps into your shoes to receive your distributions. Of course, that could also be potentially debilitating, however, it may also provide some excellent leverage for settlement negotiations if the creditor does not want to wait for payment over an extended period.

<u>Trusts</u>

Trusts are arrangements where someone (i.e. the grantor or settlor) creates a relationship where someone manages the property (i.e. the trustee) for someone else that has the equitable and beneficial ownership in the property (i.e. the beneficiaries). As an example, in the long-term care context, many older people will face the prospect of an extended medical issue that could drain their financial resources. If that happened, without any further planning, those individuals would have to spend down their life long savings until they were nearly all gone and then apply for federal and state aid in the form of a program called Medicaid.

To avoid any giving away of assets in anticipation of applying for Medicaid the federal and state governments, currently utilize a 60-month period where they "look back" from the date of the Medicaid application to see if someone has given up any assets. If so, there is a penalty for doing so. However, if amounts are given away prior to the 60-month period, the government is not allowed to take that gift into consideration. That is where trusts (in an irrevocable format so that the "gift" is completed) could be utilized to avoid outright giving away of property yet having provisions that could potentially benefit the grantor that setup the trust until certain conditions happen.

MAIN TAKEAWAY

Too often important estate planning matters are not being handled ahead of time with a coordinated plan.

The main reasons are that people just do not understand 1) what issues “estate planning” is addressing and 2) how important the issues are.

When done holistically, “estate planning” will consider: family dynamics, desired distribution of assets, tax planning to maximize receipts of assets and asset protection to preserve and protect assets.

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