ESTATE PLANNING MADE SIMPLE

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Given the vast selection of articles, how-to books, and magazines on investing as well as the emotional waves generated by the ups and downs of the stock market, the fact that over forty percent of our population has no estate plan is shocking. Overlooking the need to secure and properly implement a customized estate plan exposes assets to both federal and state taxes. Without proactive planning, the stocks, bonds, mutual funds, IRAs and 401k plans, life insurance proceeds, and jewelry which took a lifetime to build lay unnecessarily vulnerable to the maximum applicable tax rates, which, under Federal law alone, is currently forty percent.[1]

<u>Documents to Consider</u>

Properly drawn estate planning documents address specific financial, health, and family situations. They protect finances both during life and after death. They ease the administrative burden of managing the assets for the planner and his family. Through certain documents, individuals have the opportunity to make personal and financial decisions which otherwise might require court orders. The following is a list of the documents:

1. <u>Last Will and Testament</u>. A will provides for the legal transfers of assets after death, names a person to settle the estate, names a trustee to administer any trust established, and names a guardian for any minor children.

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[1] As of January 1, 2015, the Federal Estate Tax applies to all estates which exceed a $5,430,000 exemption and the tax rate is 40%.

Individuals who die without wills are considered "intestate." State law controls who administers their estates, who is entitled to become a beneficiary of their estates, and how much each beneficiary is entitled to inherit.

To execute a will, individuals must be at least eighteen years of age and of sound mind. Two witnesses are required to be present at the will signing. Current law also permits individuals to execute self-proving wills, which eliminate the requirement to present at least one of the witnesses to the county surrogate's office to probate the will. Having the will notarized will execute the will as a self-proving document.

Because witnesses often move or are otherwise unavailable to attest to the will signatures, all individuals whose wills are not notarized need to consider re-executing new wills.

2. Trust. Individuals can execute inter vivos (established during life) or testamentary trusts (established through a will). Assets are transferred into the living, or inter vivos, trust at the time of its creation, and the trust operates during the trust creator's lifetime. Testamentary trusts, on the other hand, are created in a will and become operative at the time of death. Pour over trusts are created while a person is alive, but can be funded at death.

A trust can also be considered to be revocable or irrevocable. The differences are as follows:

2.1. Revocable Trusts. With a revocable trust, the person establishing the trust (hereinafter referred to as "the settlor") reserves the right to amend or revoke the trust, change the conditions under which the assets are held, or reclaim the assets for personal use. Revocable trusts are commonly used to avoid probate, which is required when an individual dies with a will.

New Jersey is considered a probate-friendly state and does not require an attorney to administer an estate. Nevertheless, avoiding probate can be useful for certain situations. Because with a revocable living trust, at death, a successor trustee has the authority to distribute all of the trust assets to named beneficiaries without the supervision of the probate court, the process is quicker and more private than probate.

It is also not a matter of public record. Anyone can go to the surrogate's office and read a copy of a will. A living trust is not available to the public, however.

Revocable trusts also allow individuals to avoid ancillary probate for real estate owned outside the state. This saves estates from out-of-state probate costs and attorneys' fees.

Many people operate under the mistaken assumption that revocable living trusts save taxes. They are, essentially, tax neutral. While there are many benefits of revocable trusts, such trusts will not reduce estate tax liability.

2.2. Irrevocable Trusts. Unlike a revocable trust, the person establishing an irrevocable trust relinquishes rights to the assets in the trust. That individual also cannot later alter, amend, or revoke the terms of the trust.

Assets placed into an irrevocable trust not only avoid the jurisdiction of the probate court, but unlike revocable trusts, they are usually excluded from the settlor's estate. An irrevocable trust is recommended for estates exceeding the applicable exemption amount (currently $5,430,000 for Federal and $675,000 for New Jersey).

3. Durable Powers of Attorney. A power of attorney authorizes a designated agent to carry out financial and business transactions for the individual establishing the document. It

grants authority to the agent to access bank accounts and brokerage accounts, sell property, deal with insurance companies, and handle any financial transactions.

Most people tend to give their agent broad authority; however, this is not required. An agent's power can be limited to specific acts. A power of attorney can be revoked at any time, assuming the grantor of the power is competent.

Unless the document specifies otherwise, a power of attorney is effective upon execution. However, the document can be designed to have a delayed, or "springing" effect, whereby it only becomes effective upon certain conditions set forth in the power, such as the onset of incapacity for the principal. Couples who are not concerned about each other's trustworthiness may choose to make the powers immediately effective as a matter of convenience.

A general durable power of attorney allows an individual to "step into the shoes" of the person he or she is assisting and perform any function that individual may perform. The person who established the power of attorney is known as the "principal"; the person who is given the authority to act is known as the "agent." The authority is "general" because it allows the agent to undertake any personal or financial decision for the principal. It is "durable" because it will survive any incapacity of the principal and be valid until death, unless modified or revoked by the principal.

To be effective, a power of attorney must be carefully drafted. Traditionally, a power of attorney was merely a one or two page document appointing an agent that stated the agent could do "anything" the principal could do. However, many institutions, ranging from government agencies to insurance companies, do not accept a power of attorney with such broad language.

Due to the mass of litigation and government regulation pervading society, many institutions require that any act to be performed by the agent be delineated in the power of attorney.

Because the basic one to two page power of attorney form is often ineffective when the principal becomes disabled, our firm has designed a document to cover an enormous range of financial and personal matters which may affect the life of the principal. To that end, it is accepted by virtually all institutions that are asked to rely upon it.

If a person becomes disabled or incompetent before establishing a power of attorney, a court will appoint a guardian. A guardianship procedure can be time-consuming, expensive, and a humiliating procedure whereby a person is judged to be "incompetent" in the public forum of a court. It can be avoided by having a power of attorney in place.

4. Health Care Power of Attorney. A health care power of attorney, which is a form of a living will, is designed to:

! Provide instructions for the conditions when life-sustaining procedures should be utilized.

! Designate who will make health care decisions.

! Ensure that the individual chosen to make these decisions has access to the principal's medical records during incapacity.

In the absence of a health care power of attorney, the medical profession sometimes ignores even family members in decision making. Therefore, it is imperative that everyone have a health care power of attorney which designates to what extent life should be prolonged in the event that there is no reasonable hope of recovery or regaining a meaningful quality of life. A health care power of attorney should stipulate what medical treatment should be provided,

whether feeding tubes should be used, and whether organs are to be donated. It should designate a health care representative to make these decisions on behalf of the principal.

Without a living will, there is no authority, outside of a court proceeding, for a doctor to discontinue artificial life sustaining treatment. Assets may be used for unnecessary and costly life support.

Tax Issues

Many people think "estate" only applies to the wealthy, yet an "estate" comes into being whenever any individual (or "decedent") dies owning any property. The manner in which the rules affect a decedent depend on a number of variables: the size (i.e., value) of the estate, whether estate planning documents were in place at the time of death, and the laws of the state having jurisdiction over a decedent's estate. The summary that follows highlights the tax issues that apply at death:

1. Estate and Inheritance Taxes. An estate consists of the property owned at the time of death. This property includes but is not limited to: bank accounts, real estate, stocks, bonds, mutual funds, life insurance policies, the value of retirement accounts, annuities, all personal property (i.e., cars, jewelry, furniture, etc.) and any business interest.

Historically, the Federal Government has had an estate tax. In 2009, the estate tax applied to all estates which exceeded $3,500,000. The estate tax rate for that year was forty-five percent (45%). Furthermore, the federal government exempts any assets passing from one spouse to another, provided that both spouses are United States citizens. The exemption is referred to as an Applicable Exemption Amount. The federal estate tax was repealed for the year 2010. However, on December 17, 2010, legislation was signed into law which reinstated the

federal estate tax (retroactive to January 1, 2010) through December 31, 2012. For years 2010 through 2012, the federal estate tax exemption amount was $5,000,000 (this amount was increased to $5,120,000 in 2012) and the rate of tax on all assets over such amount was thirty-five percent (35%). Additionally, assets passing from one spouse to another, provided that both spouses are United States citizens are exempt from the federal estate tax. Even more favorable to the married taxpayer was a "portability" provision in the tax code which allowed a surviving spouse to carryover and utilize any unused portion of the deceased spouse's exemption amount. This was accomplished simply by filing a federal estate tax return on the death of the first spouse and making an election on that return. This allowed a married couple to shield up to $10,240,000 worth of assets from the federal estate tax without any tax planning. This portability provision was set to expire on December 31, 2012.

However, on January 1, 2013 Congress passed the American Taxpayer Relief Act (hereinafter "the Act"). The Act applies to all persons dying and all persons making gifts for years 2013 and beyond (unlike prior amendments to the estate tax provisions in the Code, there is no "sunset" provision in the Act). The Act increased the Applicable Exemption Amount to $5,250,000 (this has been increased for 2014 to $5,340,000) and continued the portability provision, discussed above. The Act also permanently increases the top estate and gift rates from 35% to 40%. The Act has no affect on the New Jersey Estate tax which still provides for only a $675,000 exemption amount.

Accordingly, for married clients with estates in excess of the Applicable Exemption Amount (for federal or New Jersey purposes), it is important to take advantage of both spouse's exemptions. As state above, if you are married, the Internal Revenue Service exempts from tax

any property transferred outright to a surviving spouse. Furthermore, under the portability rules the surviving spouse is given credit for any unused exemption amount belonging to the first spouse to die. Therefore, under Federal law a married couple can protect a combined $10,680,000.

However, under New Jersey law if a spouse leaves his or her estate outright to a surviving spouse then all assets would be included in the estate of the surviving spouse and taxed on the second death to the extent the assets then exceed the New Jersey Exemption Amount. Usually, this is an undesirable result. Consequently, married couples should attempt to take advantage of each spouse's Applicable Exemption Amounts for New Jersey purposes. Language in each spouse's estate planning documents can be used so that, upon the first spouse's death, the maximum amount allowable by New Jersey law passes into a Trust for the benefit of the surviving spouse. This type of trust is known as a "New Jersey Credit Shelter Trust."

By establishing a New Jersey Credit Shelter Trust, the first spouse will leave his or her assets in trust for the surviving spouse, allowing the surviving spouse to utilize the assets in the trust during the surviving spouse's lifetime, but precluding such assets from tax when the surviving spouse dies. The trust usually provides that the spouse has the right to the income generated off of the trust assets as well as any amount of principal to maintain the health, education, maintenance, and support of the surviving spouse. This latter right can be extended for the needs of the decedent's children. In addition, the client can choose to include the right of the surviving spouse to invade 5% or $5,000 of the trust corpus, whichever amount is greater, on a non-cumulative annual basis without restriction as to how the funds are used. This right is commonly known as a "5 and 5 power".

In cases where New Jersey Credit Shelter Trusts are established, careful consideration should also be given to how the assets are titled. Any jointly owned property will pass to the surviving spouse with rights of survivorship. Furthermore, any accounts which designate beneficiaries, (i.e., retirement accounts, life insurance policies, annuities and other payable on death accounts) will pass directly to the named beneficiaries. Accordingly, married couples must pay attention to how accounts are titled and how beneficiaries are designated. It is important not only to prepare a proper trust for the client, but to also make sure that there are sufficient assets to fund the trust upon the client's death.

Because the future of the federal estate tax is uncertain, clients may also consider the use of a "Disclaimer Trust." With Disclaimer Trusts, each spouse's Will leaves all of his/her assets outright to the surviving spouse. However, if the surviving spouse so chooses, he or she can disclaim any portion (including, all) of the deceased spouse's estate into a Trust. The provisions of the Disclaimer Trust state that the surviving spouse has access to the income and any principal to maintain his or her standard of living. This is an excellent option for clients who want flexibility in case the estate tax is repealed or the applicable exemption amount exceeds the assets of their estate. The Disclaimer Trust would give the surviving spouse the option to pick and choose what, if anything, goes into the Trust upon the first spouse's death. Obviously, there are some drawbacks to a Disclaimer Trust. Clients who are concerned with controlling the ultimate beneficiary of their assets may not want to allow the surviving spouse to have the option as to whether or not to make a disclaimer. (For example, in cases involving second marriages or situations in which one spouse is concerned with the second spouse remarrying and leaving assets to new spouse, a Disclaimer Trust may not be desirable).

All married individuals with assets in excess of $675,000 should consider establishing a New Jersey credit shelter trust. In addition to these types of death tax sheltered trusts, for those individuals who are married and have combined assets over $1,350,000 or are single and have assets over $675,000, some commonly used tax planning techniques are as follows:

2. Gifting. The federal gift tax rules allow each person to gift $14,000 per calendar year to an unlimited amount of individuals. Such gifts are referred to as “annual exclusion gifts.” For a married couple, each husband and wife can gift $14,000 per calendar year to an unlimited amount of individuals. Gifts made within these limits are not subject to tax either by the person receiving the proceeds or the person making the gift.

The Internal Revenue Code also provides that only married couples can transfer an unlimited amount of assets back and forth between each other without any gift tax consequences. Accordingly, if someone makes a gift to a person other than a spouse which exceeds the $14,000 exclusion, a gift tax return must be filed. Although usually no tax will be due, the excess amount of the gift will reduce the exemption allowed at death. For example, if a single individual gave $50,000 during the course of a year to one person, the receiver would not have to pay any tax on the proceeds. The person making the gift would not have to pay any tax either, but a gift tax return would have to be filed indicating that $36,000 over the exclusion was given during the year. This $36,000 would be taken off the individual's $5,340,000 estate tax exemption.

Annual exclusion gifts can serve to reduce your estate over time and thus, your estate tax.

3. Irrevocable Life Insurance Trust. Life insurance can provide ready cash for estate taxes. However, life insurance is included in the policy owner's estate. The majority of our clients’ life insurance policies designate the insured as owner and the surviving spouse as

beneficiary. As such, the death benefit of the policy is included in the survivor's estate. Some clients try to circumvent this problem by naming their children as both owners and beneficiaries of the policies. However, problems can arise if a child gets into financial trouble or dies before the parent. Furthermore, the surviving spouse would not have access to any of the life insurance proceeds. This is generally not consistent with our clients' intent.

To avoid these problems, yet still shield the life insurance proceeds from estate tax, individuals should consider placing life insurance policies into an irrevocable trust. The trust becomes both the owner and the beneficiary of the policy. When the insured dies, the trustee collects the insurance proceeds on behalf of the trust and reinvests or distributes the money in accordance with the terms of the trust. The trust can remain in effect after death. Typically, the surviving spouse is given the right to income and principal during his or her lifetime. At the surviving spouse's death, the remaining assets pass to the beneficiaries. Provisions can be made to continue the trust even after the surviving spouse's death by establishing successive trusts for children or grandchildren. This maintains the assets beyond the reach of creditors and limits the beneficiaries' ability to spend the proceeds immediately.

Although a life insurance trust saves estate taxes, it has certain drawbacks. For instance, the life insurance trust is irrevocable. The terms cannot be altered or amended once executed. Second, the previous owner of the policy must relinquish control over the insurance. That means that the insured cannot be the trustee. We typically recommend that a family member, bank or trust company be named trustee.

4. Qualified Personal Residence Trust. A qualified personal residence trust can be used to reduce estate taxes on a primary or secondary residence, or both. To establish a qualified

personal residence trust, a homeowner must transfer title of a residence to a trust, the terms of which provide that the trust grantor retains the use of the residence for a specified period of years. Thereafter, the residence will pass to designated beneficiaries (usually the children). For a qualified personal residence trust to work, the person establishing the trust must outlive the term of the trust, or the house will be included in that person's estate.

During the trust term, so long as the trust is structured as a "grantor trust," the grantor is entitled to the same income tax deductions as if he held the property individually. For instance, the grantor should be entitled to the income tax deduction for real estate taxes and mortgage interest, and he should be entitled to exempt up to $250,000 ($500,000 if married filing jointly) of gain upon the sale of the property.

If during the term of the trust the residence is sold and a new house is purchased for less, the sale proceeds must be invested in the new house itself. If proceeds from the sale of a residence are not reinvested in a residence within a certain period of time, the trust converts to an annuity trust for the benefit of the person establishing the trust for the remainder of the term of years specified. At the end of the trust term, the donor has to move out or enter into a lease to pay rent at the market rate. Of course, an individual might not mind paying rent to children if the estate planning strategy to reduce taxes is to transfer money to the next generation anyway. Furthermore, this might not be an issue with a secondary residence, like a beach house.

The trust establishes a means to leverage the applicable exemption amount and remove all future appreciation from the estate. Since the beneficiary of the trust does not receive the property immediately, the I.R.S. discounts the value and reduces the amount of the gift. The amount of the discount depends on the owner's life expectancy, the terms of the trust, and the

current interest rate. If the value of the property increases from the inception date of the trust, the appreciation is removed from the estate.

5. Family Limited Partnership. A Family Limited Partnership can be an attractive method of shifting wealth to younger generation family members to reduce federal estate taxes. Transferring assets to a Family Limited Partnership permits older family members to retain management and control of assets while making tax-free gifts of equity in the asset to intended beneficiaries. Typically, assets that are placed into a Family Limited Partnership include stock in a family owned business, rental real estate, or liquid investments such as stocks and bonds. The partnership creates two classes of partners: general and limited.

The general partner makes all decisions relating to the partnership, while the limited partner has no voice. In a typical Family Limited Partnership, the husband and wife are the general partners. In some partnerships, however, they are the limited partners. The children, grandchildren, or other family members can also be limited partners.

Each year, the parents amend the partnership agreement to decrease the share of their limited partners' interest and increase the share of the other family members. If the partnership is properly structured, the family can also obtain valuation discounts for having a minority interest and a lack of marketability. Since children are limited partners and the parent is the general partner, the children, initially, would not have any control over the partnership assets. In addition, a properly drafted partnership agreement would provide that the children could not dispose of their interest without first offering it to either the remaining partners or the partnership.

These restrictions placed upon the limited partners' interest allow a discount to be taken for the value of the partnership interest transferred. Therefore, it may be possible to transfer in excess of $13,000 to each of the beneficiary children without triggering any gift or estate tax consequences. Also, while maintaining control of the assets, the general partners, are removing the partnership assets from their estates.

6. Charitable Remainder Trust. Individuals with assets that have a low cost basis should consider gifting to charity. Due to its nonprofit status, the charity would then be able to sell the assets without paying any capital gains tax. Out of the proceeds, the charity would then pay the trust grantor an income stream based on a market rate of interest for the full value of assets which were initially transferred.

The charitable remainder trust setup routinely saves clients on income taxes because they receive a substantial charitable gift income tax deduction which can be spread over five years. Furthermore, the value of the property that will pass to charity will be excluded from the trust grantor's estate.

Because with this planning technique, the donated assets will not be distributed to children, it is recommended that a life insurance policy be used to replace the value of the investment. The insurance policy should be of an amount at least equal to the value of the transferred assets. Premiums may be paid out of the income stream from the charity. Moreover, the value of the life insurance policy can be excluded from the estate as well through an irrevocable life insurance trust.

Conclusion

Estate planning potentially preserves hundreds of thousands of dollars for children, relatives, close friends, and other beneficiaries. Regardless of age or financial status, everyone should have a will, living will or health care power of attorney, and general durable power of attorney. The documents should reflect the personal and economic circumstances surrounding the individual for whom they are created. Careful examination of individualized needs results in the implementation of an estate plan that not only protects, but advances personal and financial goals.