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ESTATE PLANNING

What is Estate Planning? Estate Planning is controlling your own destiny by deciding today how your affairs will be handled in the future in the event of death or disability.

Why should an individual have Estate Planning? Estate Planning is utilized by an individual to minimize the taxes and costs associated with the administration of his or her estate, thereby maximizing the amount which may be received by his or her heirs, and to control how and by whom his or her estate is administered.

How is Estate Planning achieved? Through the use of Wills, Trusts, Powers of Attorney and Living Wills. However, you should also realize that you do basic estate planning every time you open a joint bank account or purchase an asset in joint name.

ESTATE PLANNING VEHICLES

I. LAST WILL AND TESTAMENT - Document that states what you want to happen with your property upon death and who is to handle your affairs.

A. Reasons for having a Will.
   1) Direct who is to receive your assets, and how.
   2) Appoint who you want as fiduciaries to handle your affairs (i.e., Executor to administer your estate, Trustees to administer any testamentary trusts, and Guardians to care for minor or disabled dependents).
   3) Provides for opportunity to do tax planning upon your death via certain testamentary trusts such as a credit shelter trust or a marital trust.

B. What if you don’t have a Will?
   1) Assets will be distributed in accordance with Pennsylvania intestate law. This law favors surviving spouse and children. However, this statutory distribution scheme may not coincide with the way you would want your assets distributed.
   2) Fiduciaries (administrators/trustees/guardians) appointed through court proceedings.

C. Non-Probate Assets - pass by law and are not subject to probate. Examples are joint bank accounts, certain jointly held property, and beneficiary designations (i.e., life insurance/pensions). But some non-probate assets still subject to PA Inheritance Tax. Also may cause problems if try to save inheritance tax by putting assets in joint name with person other than a spouse.
   1) Joint owner may die first and you would end up paying inheritance tax on own property.
   2) Joint owner may take the money and run!
   3) Other heirs left out if you don't specify that joint assets are to be split between all heirs.

II. **<u>LIVING TRUST</u>** - Document created during life that manages your assets and provides for plan of distribution in future. A trust is a mechanism whereby property is given to one person ("Trustee") who holds the property for the benefit of another person ("Beneficiary").

A. Advantages of Living Trust
   1) Reduces cost and delays of probate.
   2) Provides maximum privacy because trust is not probated and therefore not public record, but Inheritance Tax Return will be available to public
   3) Allows for management of assets if incapacitated.

B. Types of Living Trust
   1) Revocable - grantor can revoke, alter or amend.
   2) Irrevocable - grantor can not revoke, alter or amend, therefore lose all control over the assets placed in an irrevocable trust.

C. Disadvantages of Living Trusts
   1) Does not save inheritance or estate tax if trust revocable because you still own and control.
   2) May still need a Will to "pour over" any assets that are outside of the Trust into the Trust.
   3) Has no affect on non-probate assets (joint property).
   4) Have burden of transferring assets to trust when trust established - requires time and money today. Assets may have to be distributed from Trust upon death of creator, which will create extra cost of transferring assets twice.

D. When are Living Trusts Useful?
   1) When you have substantial assets that are difficult to dispose of through probate process. For example, owning real property in several different states requires the probate of an estate in each such state to pass the real estate to your heirs. This could be avoided if the real estate was held by a Living Trust.
   2) When you don't want to manage your own property.
   3) Certain Medicaid planning. Can use Living Trusts to provide for elderly or disabled beneficiaries and, to a lesser extent, to protect own assets from hindering Medicaid eligibility. But if marital residence is owned by a

Revocable Trust, will not be afforded same protection from Medicaid attachment to spouse who is still residing in the marital residence.

4) Irrevocable Trust used to remove value of life insurance from estate for federal estate tax purposes.

III. POWERS OF ATTORNEY - Document whereby you appoint another ("Agent") to handle your affairs as if you were present.

A. Financial Power of Attorney - This document is needed in the event of a physical or mental incapacity which renders you incapable of effectuating financial or legal matters. By use of this document, you appoint an agent to act on your behalf with respect to such financial matters in the event you are unable to do so.

B. Health Power of Attorney - Similar to the Financial Power of Attorney, this document is used to appoint an agent or attorney-in-fact to act on your behalf with respect to medical decisions in the event you are unable to act due to physical or mental incapacity. Examples of the powers granted under a Healthcare Power of Attorney include having your agent or attorney-in-fact consent to your medical treatment, sign medical authorizations, employ physicians and provide access to your medical records.

C. Types of Powers of Attorney

1) Durable vs. Non-durable - Durable power of attorney is not affected by subsequent incapacity of principal whereas non-durable power of attorney ceases to be effective upon principal's incapacity.

2) Springing vs. Non-springing - Springing power of attorney only becomes effective upon the occurrence of some event, generally the incapacity of principal, whereas a non-springing power of attorney is effective immediately upon execution.

Note: Powers of Attorney cease upon the death of the principal.

IV. LIVING WILL - Document allows you to control your medical care in the event you are in a "terminal condition" or state of "permanent unconsciousness". You specify which treatment you do or do not want when in such a condition, such as:

- cardiac resuscitation
- mechanical respiration
- tube feeding
- blood or blood products
- surgery
- dialysis
- antibiotics

A Living Will becomes operative when given to physician. If physician does not follow living will on ethical or moral grounds, statute requires physician to make an effort to transfer you to a physician who will. *Note:* A Living Will does not condone euthanasia or assisted suicide.

FEDERAL TRANSFER TAX OVERVIEW

I. ESTATE TAX – The American Taxpayer Relief Act of 2012 (the "Act") was signed into law on January 2013. The Act continues the estate tax exemption of $5 million, indexed for inflation (from 2011). With the inflation adjustment, the 2013 exemption is $5.25 million. At this level, a married couple may shield up to $10.5 million from federal estate tax. The Act also provides for a maximum estate tax rate of 40%.

II. GIFT TAX – The Act also continues the gift tax exemption of $5 million, also indexed for inflation ($5.25 million for 2013). Under the Act, a married couple may make lifetime gifts having a value of up to $10.5 million without incurring any federal gift tax. The Act also provides for a maximum gift tax rate of 40%.

III. GENERATION SKIPPING TRANSFER (GST) TAX – The GST tax is a tax assessed on transfers during lifetime or upon death to or for the benefit of grandchildren or more remote descendants. It is in addition to any gift or estate tax that may apply. The Act continues the GST tax exemption of $5 million, also indexed for inflation ($5.25 million for 2013). Under the Act, a married couple may shield up to $10.5 million from GST tax during their lifetimes and at death. The Act also provides for a maximum GST tax rate of 40%.

IV. PORTABILITY – The Act extends spousal portability which allows the executor of a deceased spouse to elect to give that spouse's unused federal estate and gift tax exemption to the surviving spouse. Portability does not extend to the GST tax exemption.

V. UNLIMITED MARITAL DEDUCTION - Assets pass between spouses during life and at death free of any federal estate or gift tax consequences. Federal legislation creates a "deferral mechanism" upon the death of the first spouse, assuming he or she is a U.S. citizen, which is known as the unlimited marital deduction. To the extent one passes assets to his or her spouse without restriction (called a general power of appointment), there is no estate tax upon the death of the first spouse. However, upon the survivor's death, the entire estate can be taxed at a high marginal tax rate. Therefore, careful planning is needed if you want to keep the size of your estate in a lower tax bracket.

Qualified Terminable Interest Property (QTIP) - One problem with the marital deduction provisions is that it forces one to convey large sums of money to the surviving spouse. For a number of reasons, this can leave the surviving spouse and the children vulnerable. Congress recognized this, and in 1981 wrote in the "QTIP" Section 2056(b)(7) to the Internal Revenue Code. Use of a QTIP trust creates a good result by conveying the following powers to the surviving spouse:

- Lifetime income interests to surviving spouse
- At trustee discretion, liberal corpus invasion for what are called "Ascertainable Standards", i.e., Health, maintenance, and support
- May give surviving spouse additional withdrawal powers

One disadvantage with a QTIP Trust is that it limits the surviving spouse's ability to pass assets at death. Generally, these trusts compel the surviving spouse to pass the assets to the children. Typically, these trusts are written into documents to protect their family's financial interest rather than placing restrictions on their spouse.

VI. HOW TO LESSEN FEDERAL ESTATE TAXES:

A. Gifting - each person may gift up to $14,000.00 per year per donee without consequence. Gifts over this amount cut into unified tax credit and gift tax return must be filed (But no tax may be due).

B. Place life insurance into irrevocable trust to remove from estate.

C. Credit Shelter Trust can be used in Last Will and Testament or Living Trust to utilize both spouses' unified credits.

PENNSYLVANIA INHERITANCE AND ESTATE TAX OVERVIEW

I. TAX RATES

A. Property inherited from a spouse or owned jointly between husband and wife is taxed at a zero percent rate.

B. 4.5 percent for transfers to direct descendants (lineal heirs).

C. 12 percent for transfers to siblings.

D. 15 percent for transfers to other heirs (except charitable organizations, exempt institutions, and government entities which are exempt from tax).

E. Property inherited from a child twenty-one (21) years old or younger by a parent is taxed at a rate of zero percent.

F. 5 percent discount on actual tax paid if paid within three (3) calendar months of the decedent's death

II. PENNSYLVANIA ESTATE TAX - The Pennsylvania Estate Tax applies only when the size of the estate requires filing of a federal estate tax return. Prior to 2005, the IRS allowed a state death tax credit against the federal estate tax based on the value of the estate. If the allowable state death tax credit was greater than the amount of the Pennsylvania Inheritance Tax, the Department of Revenue imposed a Pennsylvania Estate Tax on the difference. This is called a "make-up" or "pick-up" tax, because it picked up revenue for the state without increasing the total amount of estate taxes. However, the Taxpayer Relief Act of 2005 phased out the state death tax entirely in 2005, and replaced the credit with a deduction for state death taxes in 2005. The Act extends the deduction of state death taxes for federal estate tax purposes. Because the Pennsylvania Estate Tax is based on the state death tax credit (and not on a state death tax deduction), unless and until Congress reestablishes a state death credit against federal estate tax, there is effectively no Pennsylvania Estate Tax for decedents dying after 2004.

III. TAXABLE PROPERTY - All real property and all tangible personal property located within the Commonwealth of Pennsylvania is taxable, as is all intangible personal property of a resident decedent regardless of where it is located. The various types of taxable assets and the required method of valuation of the same are as follows:

A. Real Property located within the Commonwealth of Pennsylvania: Must be valued at its Fair Market Value as determined by an appraisal or the actual sales price of the real property. Although the use of the county assessment figure and the "common level ratio" as determined by the State Tax Equalization Board may be used, there is no statutory requirement that the Department of Revenue accept this method for valuation of the real property for inheritance or estate tax purposes. Land devoted to agricultural use, agricultural reserve or forest reserve may also be eligible for preferential assessment measured by particular use, rather than by fair market value, under the Pennsylvania Farmland and Forest Land Assessment Act of 1974, 72 P.S. §5490.1, et. seq.

B. Stocks and Bonds owned individually by decedent or as tenants in common: valued as the mean of the highest and lowest quoted selling prices on the decedent's date of death. If death occurs on a weekend or holiday, the average of

the means for the most recent preceding and subsequent trading days is to be used as the valuation.

C. Closely held Corporation, Partnership or Sole-Proprietorship: Must provide detailed calculations used in valuation of decedent's interest, including tax returns and financial statements for year of death and four (4) preceding years.

D. Mortgages and Notes Receivable: Must state face value and remaining unpaid balance due. However, should be valued as the present discounted value of the expected payment stream utilizing the current applicable federal rate for the corresponding remaining term of the loan if not being paid in full upon decedent's death.

E. Cash, Bank Deposits, and other miscellaneous personal property: Includes all tangible personal property (automobiles, boats, furniture, household items, collectibles, etc.) and other assets, such as cash on hand, bank deposits, wages, rents due, royalties, patents, payments or debts due to the decedent, such as refunds, required IRA distributions not yet received, or litigation proceeds to be received. If an article is worth more than $3,000, or if any collection of articles in one category is valued at more than $10,000, include an appraisal by an expert and that appraiser's statement concerning his or her qualifications.

F. Non-Pennsylvania lottery winnings.

G. Certain retirement benefits, Individual Retirement Accounts, or qualified annuities: Are included in the taxable estate if decedent had right to receive distributions that would not be subject to a ten percent (10%) withdrawal penalty. Generally, if the decedent was older than 59½ years of age at date of death or was considered disabled at any age, then such accounts will be subject to PA Inheritance Tax.

H. Transfers made within one (1) year of decedent's death are taxable to the extent that such transfers exceed $3,000 per transferee during any calendar year.

Example: $3,000 gift made to A on December 30th
$3,000 gift made to A on January 2nd
Decedent dies on January 10th
Both gifts, although made within one year of decedent's death, are exempt because of differing calendar years.

*Note: Joint tenancies, including those between husband and wife, created within one year of the decedent's death, are considered to be transfers made within one year of decedent's death.

I. Bank accounts held "in trust for" or "payable on death" avoid probate, are transferred upon the death of the decedent, but are still fully subject to PA Inheritance Tax.

J. Retained Reversionary Interests: Are subject to PA Inheritance Tax if, immediately preceding death, the decedent had a reversionary interest in the transferred property that is greater than five percent (5%) of its value.

K. Transfers in which the decedent retained a life interest are fully taxable on the value of the property as of the decedent's date of death.

L. Revocable or Living trusts. Must include all assets owned by the Revocable or Living Trust including current valuations of the same.

Jointly-owned assets are included in the taxable estate to the extent of the decedent's taxable interest in the asset at the time of his or her death. Determine the decedent's taxable interest by dividing the full value of the property (as determined in accordance with the foregoing valuation requirements) by the number of joint owners. Only the fractional ownership interest of the decedent at the date of death is subject to PA Inheritance Tax, unless the joint ownership was created within one year of the decedent's death. See *Note above.

However, life insurance proceeds from policies owned by the decedent are not subject to PA Inheritance tax.

Property over which the decedent had a power of appointment is taxable in the estate of the donor, not the decedent who has the power of appointment.