BERLINER COHEN LLP

ESTATE PLANNING 101:
THE IMPORTANCE OF DEVELOPING AN ESTATE PLAN

Introduction

At some point, most people will contemplate estate planning. Often, this is prior to or shortly after a significant life event, such as marriage, the birth of a child, or the death of a loved one. However, estate planning can have somewhat of a morbid connotation – after all, it is planning for the management of your assets after you cannot, either due to incapacity or death. In addition, many incorrectly believe that estate planning is only necessary for "wealthy" individuals. As a result, it is common for people to delay estate planning (or even avoid it altogether).

The truth is that a proper estate plan can benefit anyone. Put simply, estate planning is the process of getting your affairs in order. An estate plan will appoint guardians to care for your minor children, avoid probate on your estate, minimize or avoid estate taxes upon your death, and make it easier for your family members following your death or incapacity.

This memo summarizes several estate planning concepts and provides some background information to help prepare you for a discussion with your estate planning attorney.

Specifically, this memo addresses the following topics:

- Overview of Estate and Gift Taxes
- Disposition of Your Assets Upon Death
- Revocable Trusts
- Durable Powers of Attorney for Finances
- Advance Health Care Directives

Overview of Estate and Gift Taxes

Estate and gift taxes are taxes imposed by the federal government on property that you own when you die or that you gift to others. California does not currently impose gift or estate taxes. Estate and gift taxes are often referred to as "transfer taxes" because they are taxes imposed on property that you transfer at death (estate taxes) and taxes on property that you transfer during your lifetime (gift taxes).

There are two primary exemptions or deductions from estate and gift taxes: 1) the applicable exclusion; and 2) the marital deduction.

<u>The Applicable Exclusion</u>

Under current law, every individual has an amount of assets that they can own at death or gift during their lifetime without incurring any transfer tax. This is referred to as the applicable exclusion. The applicable exclusion is available to U.S. taxpayers (including U.S. citizens and domiciliaries) but is not available to nonresident aliens. For nonresident aliens, the estate tax exemption continues to be limited to a mere $60,000.

The estate and gift tax applicable exclusion amounts are "unified," meaning that a person can use the exclusion during their lifetime by making taxable gifts to others and any applicable exclusion not applied to lifetime gifts can be applied to property held at death.

Currently (2020), the applicable exclusion is $11.58 million. This means that a person may gift up to $11.58 million in assets during their lifetime or, if they make no taxable gifts, die owning assets totaling $11.58 million and pay no gift or estate taxes. The tax rate on lifetime gifts or estates worth more than $11.58 million is 40%. Under current law, the applicable exclusion is adjusted annually with inflation. Accordingly, it should increase modestly each year.

Notably, there was a substantial increase in the applicable exclusion in 2018. The Tax Cuts and Jobs Act passed in 2017 increased the applicable exclusion from $5.49 million (in 2017) to $11.18 million (in 2018) to $11.4 million (in 2019), and to $11.58 million (in 2020) but this increase is only temporary and, barring Congressional action, the applicable exclusion will return to its 2017 value (plus an increase for inflation) after 2025.

<u>Table 1</u> at the end of this memo shows the applicable exclusion and estate and gift tax rates since 1987.

Marital Deduction

A spouse can transfer an unlimited amount of property to their surviving spouse without paying estate or gift tax so long as the surviving spouse is a U.S. citizen. This is referred to as the "marital deduction." For a married couple, if all of the couple's assets are transferred to the surviving spouse, the marital deduction will avoid the application of estate taxes on the death of the first spouse. However, property escaping estate tax on the death of the first spouse will be subject to estate tax on the death of the surviving spouse.

Portability

Because the applicable exclusion has increased so much, many estates fall below the exclusion amount, resulting in decedents not needing or using all of their available applicable exclusion. Under current law, married couples now have the ability to transfer their unused applicable exclusion amounts to the surviving spouse through what is referred to as "portability."

The surviving spouse can transfer or "port" any unused portion of the deceased spouse's applicable exclusion amount to be applied to the survivor's transfer taxes. By using portability, a married couple may shield up to $23.16 million from estate tax in 2020 ($11.58 million from each spouse).

Prior to portability, in order to utilize the deceased spouse's exemption, estate planners often created trusts requiring the surviving spouse to split the couple's assets into an irrevocable "bypass" or "exemption" trust on the death of the first spouse. This is more fully discussed below. With portability, that may no longer be necessary for tax purposes. All of the couple's assets may be passed to the surviving spouse, and the surviving spouse may elect portability and maintain complete control of all the assets during his or her lifetime. With portability, many people are able to simplify their estate plans and still fully-utilize both spouses' exclusions.

Annual Exclusion

Another gift tax exclusion worth mentioning is the annual exclusion. A person can exclude gifts of up to $15,000 per person per calendar year – this is referred to as the "annual exclusion." A married couple can combine their annual exclusions and gift of up to $30,000 per person per year. As long as the gifts to each individual remain within the exclusion amount, there is no gift tax reporting requirement and the gifts won't use any of the applicable exclusion amount. As a result, annual exclusion gifts are a very popular (and efficient) way to transfer assets.

Disposition of Your Assets upon Death

Often, one of the most important estate planning issues for a client is how their property will be distributed after they die.

Probate

Probate, quite simply, is a court proceeding which clears title to property passing from the decedent (the person who died) to those persons named in the decedent's will, or if there was no will, to the decedent's heirs under the California laws of intestate succession.

There are major disadvantages to probate. First, probate fees are based on the gross value of property in the estate at the time of the decedent's death. None of the decedent's debts are taken into account. Probate fees are automatically determined and awarded by law. To add insult to injury, the fee, once calculated, is paid twice – once to the attorney and then again to the executor or administrator. In addition, any "extra events" in a probate, such as litigation and selling real property produce "extraordinary" fees for the attorney and the executor.

For example, if an estate's only asset is a house with a fair market value of $1,000,000 with a mortgage of $800,000, the probate fees will be calculated based upon the entire $1 million, despite the estate only having $200,000 in equity. A $1 million estate will produce $46,000 in fees, not including any extraordinary fees which may be due for selling the house.

Table 2 at the end of this memo illustrates how the fees are calculated and provides examples of executor and attorney fees.

Second, the average length of a probate proceeding is between 12 and 24 months (a minimum of two months for a spousal property proceeding). During this time, the beneficiaries of the estate do not have legal title to the assets they ultimately are to inherit, and simple tasks involving property become unnecessarily cumbersome. For instance, refinancing a loan, selling property, exchanging property, or running a business, may require court approval, resulting in delays (and additional costs).

Avoiding Probate

Many people have the misconception that if they have a will, all of their property will avoid probate; however, this is not the case. Rather, probate carries out the purposes of the will for property that does not pass outside of probate.

There are various forms of holding title to property which will determine whether an asset is to be "probated." Generally, all assets owned by the decedent will be included in the probate estate, except property passing: 1) by operation of law or contract; and 2) property titled in the name of an inter vivos revocable living trust (see discussion below).

Property Passing by Operation of Law or Contract

Certain types of assets are transferred immediately upon death and are not subject to probate, examples of these assets are as follows:

- Joint Tenancy: When a person holds an asset in joint tenancy, their interest in the asset passes automatically to the surviving joint tenant(s) when they die.

- Community Property with Right of Survivorship: This is a form of community property which, like joint tenancy, automatically passes to the surviving spouse.

* Retirement Accounts, Annuity Contracts or Life Insurance pass to the named beneficiary(ies) of the assets upon the death of the owner.

Revocable Trusts

Creating and funding an inter vivos revocable living trust is a method of avoiding probate, and, often times will be the most important part of an estate plan. The trust will set forth a clear and complete plan for the management of your assets upon your incapacity or death and avoid the need for probate. Unlike probate, a revocable living trust provides for private administration, outside of the courts, and there are no statutory fees, allowing for the administration of the trust upon the death of the decedent to generally be more efficient and less costly than probate.

Settlor Maintains Control of Assets During Lifetime

Essentially, when creating the trust, you transfer assets to a trust reserving, for your lifetime, all of the beneficial right of the trust, including the right to amend and revoke it. In other words, it is your trust and all of your assets are still under your control. Legal title to the assets in the trust is held by the trustee of the trust, rather than you individually, which causes the assets in the trust to avoid probate at the time of your death.

Although the trustee of the revocable living trust holds legal title to the assets of the trust, you are the trustee of the trust and you have the power to amend or revoke the trust during your lifetime. Accordingly, you retain the same control and power of the assets in the trust as if you had continued to be the individual owner. You will be treated as if you owned all the assets of the trust for income tax purposes. In addition, the trust uses your social security number, and all tax reporting is on your individual return. Basically, the only difference between the trust owning the assets and you owning the assets, individually, is a fiction of title.

Funding of Revocable Living Trust and Pour-Over Wills

In order to avoid probate through the use of a revocable living trust, the assets must be retitled from you to the trust before you die. This is

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often referred to as "trust funding." Many people will form a revocable living trust, but then do not properly fund it. As a result, assets not properly transferred to the trust will be subject to probate.

Because any assets which are held by you as an individual may be subject to probate upon your death, a Will is typically created in conjunction with your revocable living trust. A Will provides that those assets will be transferred (or "poured-over") to the trust upon your death. Although those assets being "poured-over" to the trust will not avoid probate, the Will ensures that the ultimate distribution is in accordance with your wishes, as you provided in the trust instrument.

Additionally, the Will also sets forth the guardians you nominate for any minor children living at the time of your death.

<u>Joint Revocable Living Trusts for Married Couples</u>

In California, married couples generally create joint revocable living trusts for their assets. During your lifetimes, generally, you and your spouse will serve as co-trustees of the trust. You and your spouse will designate both who will serve as trustee if you are unable to serve and how the trust assets will be distributed after the death of the first of you (for example, to your spouse in trust for life, then to your children in equal shares).

Upon the death of the first spouse, the trust may be allocated to the surviving spouse or divided into separate trust shares for the benefit of the surviving spouse.

Traditional estate planning often focused on utilizing the applicable exclusions of both spouses. This was accomplished by creating an irrevocable exemption or bypass trust with the decedent's portion of the trust assets. These types of trusts, often referred to as "A-B" Trusts are discussed below.

However, because of portability and because the applicable exclusion has increased so much, that type of planning may no longer be necessary. All of the trust assets may pass to the surviving spouse, and the surviving spouse may maintain complete control of all the assets during his or her lifetime and still exclude $23.16 million from estate tax by electing portability.

Note, individuals often have reasons (other than estate tax) to allocate a portion of the trust assets to irrevocable sub-trusts on the death of the first spouse. For example, many people who divorce and remarry desire that their children receive their ultimate assets, as opposed to the new spouse or new spouse's children from a prior or subsequent marriage. What is important to them is that the ultimate distribution of the trust assets is directed by the first spouse and not the surviving spouse. In those cases, an "A-B" or QTIP Trust might be more appropriate. These trusts are more fully discussed below.

"A-B" Trust

The "A-B" Trust provides for the creation of two trusts upon the death of the first spouse, an A Trust and a B Trust.

The surviving spouse's share of the couple's assets will be allocated to the A Trust (often called the "Survivor's Trust").

The deceased spouse's share of the couple's assets - up to the applicable exclusion amount ($11.58 million for 2020) will be allocated to the B Trust (often called an "Exemption Trust"). If the deceased spouse's share of the couples' assets exceeds the applicable exclusion amount, then the excess will be allocated to the A Trust.

Assets in the B Trust, however, will be subject to the protection under the applicable exclusion since assets up to $11.58 million (in 2020) will not be subject to the estate tax – even at the death of the surviving spouse.

The surviving spouse can retain substantial rights and benefits over the B Trust and can even act as trustee. However, in order for the B Trust to qualify for the tax savings, the surviving spouse may not control the ultimate disposition of the B Trust, and it becomes irrevocable upon the death of the first spouse. The ultimate beneficiaries are predetermined by the trust instrument while both spouses are alive. The predetermined distribution of the trust assets while both spouses are alive may also protect future beneficiaries from being removed after the first spouse's death and maintain the deceased spouse's intentions of who the estate should ultimately be distributed.

The surviving spouse will retain full control over the A Trust and has the unlimited right to withdraw principal at any time during his or her life. The surviving spouse has, upon his or her death, a general testamentary power of appointment over assets in the A Trust (i.e., he or she can change the beneficiaries or give the property away as he or she sees fit).

The portion of the total estate going into the A Trust will not be subject to estate tax on the first spouse's death since this portion of the estate will qualify for the marital deduction (assuming the surviving spouse is a U.S. citizen). The assets remaining in the A Trust on the surviving spouse's death will be included in his or her own estate since the surviving spouse is deemed the owner of these assets.

QTIP Trust

If the deceased spouse's share of the couple's assets may exceed the applicable exclusion amount and either spouse is concerned about giving the surviving spouse an unrestricted right to withdraw assets as provided for in the A Trust, the trust can be divided into three shares: the A Trust (the "Survivor's Trust"); the B Trust (the "Exemption Trust"); and the C Trust (the Qualified Terminable Interest Property Trust – "QTIP Trust") upon the death of the first spouse.

The A Trust will be made up of the surviving spouse's separate property (if any) and his or her one-half share of the community property. The surviving spouse will have the unrestricted power over the income and principal of the A Trust, including the right to revoke the A Trust at any time. The surviving spouse may change the ultimate beneficiary of the assets of the trust upon his or her death at any time. The property in the A Trust is included in the taxable estate of the second spouse to die.

The remaining trust estate is made up of the deceased spouse's separate property (if any) and his or her one-half share of the community property and will be allocated between the B Trust and the C Trust.

The deceased spouse's share of the couple's assets - up to the applicable exclusion amount ($11.58 million for 2020) will be allocated to the B Trust. The terms of the B Trust are identical to the B Trust discussed above.

If the deceased spouse's share of the couple's assets exceeds the applicable exclusion amount, then the excess will be allocated to the C Trust. The tax laws provide that as long as the surviving spouse retains the right to receive all income from the trust, payable at least annually for life, the marital deduction will still be applicable.

Like the B Trust, the C Trust becomes irrevocable upon the death of the first spouse, and the surviving spouse will not retain any control over the ultimate distribution of the assets.

Traditionally, A-B Trusts and QTIP Trusts were used because use of a deceased spouse's applicable exclusion amount was not automatically transferred to the surviving spouse without this advanced tax planning. Now with portability, these trusts may no longer be needed for estate tax purposes; however, these trust structures still provide creditor protection of the B Trust and QTIP Trust and allow for income tax planning for the surviving spouse, in addition to the benefits described above.

Note, because the marital deduction is only available to U.S. citizens, a special type of QTIP Trust (called a Qualified Domestic Trust – "QDOT") is created for surviving spouses who are not U.S. citizens. A QDOT is similar to a QTIP Trust, except for a few minor differences. For example, the trustee of the QDOT must be a U.S. citizen. Also, if the amount of trust assets exceeds $2 million, one of the trustees must be a U.S. bank.

Incapacity Planning

Durable Powers of Attorney for Finances

The Durable Power of Attorney for Finance appoints an agent to act on your behalf for your financial affairs, such as paying your bills, accessing your bank accounts and filing your income taxes. When a client becomes disabled and is no longer able to handle their day-to-day financial decisions, many financial institutions want a Durable Power of Attorney for Finance, even when the assets of the client are in a trust, which clearly states who the successor trustee would be in case of disability. Because of this, clients will also sign Durable Powers of Attorney for Finance (DPA for Finance) in addition to a trust. In some circumstances, a client may also need to fill out the DPA for Finance for their specific financial institution to be sure that there will be no push back from the financial institution if a disability should occur.

The DPA for Finance also allows you to nominate conservators of your estate and of your person in the event there is a formal conservatorship proceeding over you in court.

Advance Health Care Directives

In the last several years, the appropriate use of life support systems to keep hospitalized patients alive has become an integral part of estate planning considerations. Lawyers and their clients have focused their attention on these issues as health care providers have become increasingly unwilling to make health care decisions on behalf of their patients.

When considering an overall estate plan, it is important to consider who will make decisions regarding life-sustaining treatments. More and more clients are interested in making sure their health care decisions are well documented.

The Advance Health Care Directive appoints an agent to make health care decisions on your behalf. Health care decision-making powers include authorizing or withholding life support, depending on your preferences. Most health care providers are familiar with the California Medical Association's form for health care directives. Although this form allows our clients to determine who will make their health care decisions for them if they cannot, what their intent is as to life support and whether they intend to be organ donors, the form is not a DNR (Do Not Resuscitate) nor is it a POLST (Physician Orders for Life Sustaining Treatment).

The POLST is intended to compliment the Advance Health Care directive particularly for those who are seriously ill or have been diagnosed with a terminal illness. The POLST is virtually a physician's order that has been signed by both the physician and the client and describes very specific methods of life support.

Conclusion

This memo has set out to explain and simplify some of the basic concepts of estate planning. Note, however, that this memo only touches the tip of the iceberg and is by no means a comprehensive overview of estate planning. We hope that this memo has enlightened you and has encouraged you to think seriously about your own estate plan. Please do not hesitate to contact Berliner Cohen with any questions or comments you might have.

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Table 1
Applicable exclusion and estate and gift tax rates since 1987.

Year	Estate Tax Applicable Exclusion	Gift Tax Applicable Exclusion	Maximum Gift and Estate Tax Rate
1987-1997	$600,000	$600,000	55%
1998	$625,000	$625,000	55%
1999	$650,000	$650,000	55%
2000	$675,000	$675,000	55%
2001	$675,000	$675,000	55%
2002	$1,000,000	$1,000,000	50%
2003	$1,000,000	$1,000,000	49%
2004	$1,500,000	$1,000,000	48%
2005	$1,500,000	$1,000,000	47%
2006	$2,000,000	$1,000,000	46%
2007	$2,000,000	$1,000,000	45%
2008	$2,000,000	$1,000,000	45%
2009	$3,500,000	$1,000,000	45%
2010*	$5,000,000 or $0	$1,000,000	35% or 0%
2011	$5,000,000	$5,000,000	35%
2012	$5,120,000	$5,120,000	35%
2013	$5,250,000	$5,250,000	40%
2014	$5,340,000	$5,340,000	40%
2015	$5,430,000	$5,430,000	40%
2016	$5,450,000	$5,450,000	40%
2017	$5,490,000	$5,490,000	40%

2018**	$11,180,000	$11,180,000	40%
2019**	$11,400,000	$11,400,000	40%
2020**	$11,580,000	$11,580,000	40%

* For decedents that died in 2010, the estates had a choice to use a $5,000,000 estate exclusion/35% estate tax rate or $0 estate tax exclusion/0% estate tax rate coupled with use of the modified carryover basis rules.

** The Tax Cuts and Jobs Act significantly increased the applicable exclusion for the years 2018-2025. Without Congressional extension, this number is set to return to the 2017 value (plus an increase for inflation) after 2025.

Table 2
Executor and Attorney Fees

Value of Estate Accounted For		Rate	Total Executor and Attorney Fees
First	$ 100,000	4 %	Up to 4,000 x 2 = $8,000
Next	100,000	3 %	Up to 7,000 x 2 = $14,000
Next	800,000	2 %	Up to 23,000 x 2 = $46,000
Next	9,000,000	1 %	Up to 113,000 x 2 = $226,000
Next	15,000,000	0.5 %	Up to 188,000 x 2 = $376,000
More than	25,000,000	Reasonable Fee	

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