

Estate Planning 101

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Introduction

The term “estate planning” tends to conjure up images of a practice that only pertains to wealthy individuals. But this simply isn’t true. What will happen to your assets when you pass away? Even if the amount of assets you own isn’t impressive, it’s still important to go through the process of planning your estate so that it passes to those you desire.

If you don’t plan your estate, then the government will decide for you who gets what. Plus, if you do have considerable assets and don’t use estate planning techniques to avoid estate taxes, then the government gets a hefty chunk of it as well. Is that what you want?

Your estate plan might be as simple as a will that denotes the beneficiary of your retirement account. It might be very complicated and include several trusts for varying purposes plus your will.

The Basics of Estate Planning

Your estate plan simply describes how you wish to have your property distributed after your death.

There are several goals of estate planning:

1. Providing for your own needs as well as your loved ones. It also entails being prepared for the possibility that your ability to provide for everyone may be compromised at some point.
2. Ensuring that your assets will be distributed to your loved ones as you see fit. You might want certain assets to go to certain people. Maybe there is a charity you would like to see get part of your estate.
3. Minimizing taxes. For most of us, the government is the last entity we want to receive our assets.
4. Deciding guardianship for any minor children. If you don't decide, the state is likely to make that decision for you. It might be your ex-sister in-law.
5. Avoiding or using probate to your advantage. Probate is the process used by the courts to determine the distribution of certain assets.

“Planning is bringing the future into the present so that you can do something about it now.”

- Alan Lakein

Dying without a will is referred to as “intestate.” In this case, your state of residence will follow its inheritance laws for the disposition of your assets. In many cases, certain loved ones would receive nothing from your estate. Even worse, it’s possible in some circumstances that the state would keep everything!

Estate planning is particularly important if your relationship is non-traditional or there are other complicating situations. Are you certain that your current spouse would share your assets with your children from a previous relationship?

Are you living with someone but not married? That person would be unlikely to receive anything under the laws of most states. Avoid unintentionally disinheriting someone you love.

Estate Planning Terms

Estate planning has a unique vocabulary.

The following terms are worth knowing and understanding:

1. Beneficiary – This is anyone that inherits property from a grantor. There can be a single or multiple beneficiaries.
2. Grantor – The grantor transfers his or her property to the beneficiaries.
3. Estate – Your estate is all the property that you own at the time of your death. It also includes all of your assets and debts.
4. Real property includes the land, permanent structures, and any assets within the land itself. These additional assets would include things like oil and minerals.
5. Personal property is everything else. It can include household items, bank accounts, automobiles, insurance policies, stocks, bonds, loans, and more.
6. Heir – When no will has been created, an heir is someone with a legal right to inherit property. When there is a will, heirs are named in the will.
7. Trustee – The trustee is the party that handles the administrative aspects of executing the will and distributing the property. Sometimes the trustee is referred to as a fiduciary.

8. Probate – This is the legal process followed by the court system in your state to determine your heirs and distribute the property to them.

“Long range planning does not deal with future decisions, but with the future of present decisions.”

- Peter F Drucker

Understanding Wills

Everyone with property or children should have a will. It is especially important if you have children, since a will can provide instruction of your wishes regarding who will take care of your children.

A will must meet several requirements in order to be considered legally valid:

1. There must be testamentary intent. This is fancy way of saying that the will was created with the intention of acting as a will and this fact is understood by the testator.
2. The testator is required to have testamentary capacity at the time of signing the will. That means the extent and nature of the property in the will must be understood. The distribution of the property must also be understood.
3. The will must be executed freely. This means the testator cannot be under undue influence, duress, or fraud.

4. It must be signed. Depending on the state, this may include a notary or witnesses.

Just as with estate planning in general, wills also have their own terminology that the average person isn't exposed to on a regular basis. Understanding these terms will greatly increase your understanding of wills in general.

"A good plan violently executed now is better than a perfect plan next week."

- General George S Patton

Add these words to your legal vocabulary:

Testator: The testator is the person that died and had a will.

Executor: This is the person named by the testator to execute the terms of the will. This would include distributing the assets and dealing with any debts of the estate.

Guardian: This person is designated in the will or appointed by a judge to care for an adult with special needs or to care for minor children. In many cases, the executor and the guardian are the same individual, but it

is not required.

While a will is a powerful tool for distributing your assets and avoiding probate with certain assets, there are things that cannot be accomplished with a will.

Some of the things a will cannot do:

- ❖ Disinherit your spouse. Spouses are protected under a variety of laws in every state.
- ❖ Distribute property that is in a living trust.
- ❖ Change the beneficiary of a life insurance policy.
- ❖ Leave an excessive amount to a charity when there are surviving children or a spouse. The government wants you to care for your dependents first.
- ❖ Avoid probate. While certain assets are excluded from probate, others are not.
- ❖ Transfer property that is owned in joint tenancy.

While it is possible to prepare a will without the services of an attorney, it is rarely advisable. In many cases, a will is all the estate planning that an individual really needs.

There are online services that you can use to create a will. Just be certain that you are meeting all the requirements mentioned earlier to ensure that the will is

valid. It would be a good idea to be familiar with your state's unique requirements.

Unless your situation is very simple, the assistance of an attorney is recommended.

"It is far better to foresee even without certainty
than not to foresee at all."

- Henri Poincare

The Role of Life Insurance in Estate Planning

Life insurance has a place in most estate plans. It can provide financial support for living expenses, educational expenses, and just about anything else that requires money.

For those with modest estates, life insurance is not necessary for reducing taxes. For most of us, an insurance policy is strictly a source of funds for our beneficiaries.

Generally, funds received from an insurance policy are not taxed, but this is not always the case.

There are two types of life insurance policies commonly used for estate planning purposes:

1. **Survivorship Life Insurance Policy:** This type of policy is also called a “second to die” policy. It insures two or more people, but only pays when the last covered person dies. The premium is lower on this type of policy than for the next policy.

2. **First-to-die-Life-Insurance Policy:** This policy also covers two or more people, but pays when the first person dies. These policies typically cover a married couple or a parent and child.

Choosing the beneficiary for a life insurance policy can be a tricky decision. Naming an individual instead of a trust is much less expensive, but it can create many challenges. First, you don't have any control over how the proceeds from the insurance will be used.

Plus, if the beneficiary is a minor, things can become very challenging. You're likely to find that someone else will be put in charge of the funds. That person could even be your ex-spouse.

The situation is different if the estate or a trust is named as the beneficiary. Naming the estate as the beneficiary includes the insurance proceeds as part of the gross estate and will increase the probate costs. These funds are also available to creditors.

Using a trust as the beneficiary can provide much more flexibility and protection from creditors.

Understanding Trusts

A trust is just an agreement that sets forth how property is to be held and managed for the benefit of another individual. Many different types of trusts exist for a variety of purposes.

All trusts can be classified into one or more of the following designations:

1. Revocable. This type of trust can be revoked by the grantor. This is usually used to provide resources if the grantor of the trust becomes incapacitated.
2. Irrevocable. This trust cannot be changed by the grantor after it has been established
3. Living trust. A living trust is created during the lifetime of the grantor by transferring property to a trustee. In most cases, the grantor can dissolve the trust and take back the property. The trust becomes irrevocable at the time of death.
4. Testamentary trust. Testamentary trusts are created by a will after the grantor dies.

Trusts have several powerful advantages. Trusts can be used for avoiding probate and can be an excellent way of providing financial support to your family. There are also many privacy advantages provided by trusts.

The tax implications can vary with the type of trust. Some trusts, irrevocable trusts for example, actually get a TIN (tax identification number) and are required to file a tax return each year.

Marital and Non-Marital Trusts

Marital Trusts

A marital trust is a tool that permits the grantor to provide for the surviving spouse and ensure that any children will receive their inheritance. This can be valuable in many ways. Can you be certain that if your spouse remarries after your death that he or she won't leave all the assets to the new spouse and exclude your children?

This is the primary purpose of this type of trust. You can actually have some control after your death. There are also significant tax advantages. Spouses can pass an unlimited amount of assets between each other during life or after death without any tax issues.

“Life is a series of choices. The choices we make now affect the options available for the next round of choices.”

- T Jay Taylor

Distributions from trusts vary with the type of trust. Some trusts distribute funds regularly during the lifetime of your surviving spouse. In other cases, the trust will only distribute funds for specific reasons, such as medical expenses and educational expenses.

There are three forms of marital trusts:

1. A qualified terminable interest property trust (QTIP) only provides for the surviving spouse during their lifetime. This means that the surviving spouse alone receives payments from the trust, but they have no control over the trust at the time of their death. The remainder of the trust goes to the surviving children.
 - ❖ The great benefit of this trust is your ability to retain control of your assets after you and your spouse have both passed away. Your spouse cannot direct the assets after their death.
2. A credit shelter trust is the most common marital trust. It is also referred to as an “AB Trust.” The trust is split into two parts when the first spouse dies. One trust holds the assets of the surviving spouse, and the other trust holds the assets of the deceased spouse.
 - ❖ This can reduce taxes on the estate of the surviving spouse, since they technically do not own the assets

in the other trust. The surviving spouse will still have access, however.

3. A GPA, or general power of appointment marital trust, provides the most control to the surviving spouse. The surviving spouse receives income for life and can control the remainder of the trust at the time of his or her death. In general, this type of trust is used when there are no children.

Non-Marital Trusts

These trusts are also sometimes referred to as bypass trust. This type of trust can also provide for your spouse and children, but it is able to avoid estate taxes for your estate and the estate of your spouse.

Typically, this trust is irrevocable and names your spouse and children as beneficiaries. The trust must exist for at least 3 years before the grantor's death for the trust to remain intact. Otherwise, the trust will be voided.

As long as the three-year rule has been met, the assets of the trust are excluded from your gross estate and shielded from taxes.

“Stop acting as if life is a rehearsal. Live this day as if it were your last. The past is over and gone. The future is not guaranteed.”

- Wayne Dyer

Qualified Domestic Trust (QDOT)

This type of trust is most commonly used when your spouse is a non-citizen. When your spouse is a non-US citizen, the limit on annual gifts between the two of you is \$128,000 instead of being unlimited as it is when you're both citizens.

This type of trust allows your surviving spouse to receive income for life, but they don't have access to the principal. It is also required that the surviving spouse receive all the income from the trust, so any children would be excluded.

There are many rules and regulations surrounding this type of trust. For example, if the trust holds assets of more than \$2 million, a US bank must serve as the trustee. There are many other stipulations that must be met. Be sure to contact an attorney in your state for the details.

Irrevocable Life Insurance Trusts (ILIT)

This is a cornerstone of estate planning for the estates of wealthy families. This trust provides a means to remove any life insurance from the portion of the estate that is taxed. It can also be used to pay any estate costs or to simply provide cash to any heirs. However, you lose your right to borrow against the life insurance policy or to change beneficiaries.

Charitable Trusts

This type of trust has many advantages, especially for wealthier individuals. A charitable trust is actually not tax-exempt. Though, in general, the gifts given to a charity at death are deductible from the estate and there is no limit on the amount. It can greatly reduce the taxes owed by the estate.

Charitable Remainder Trust

This is a great estate planning tool for anyone with appreciated assets like stocks or real estate. This allows you to sell these assets without having to pay a capital gains tax. This is a great way to transfer these types of assets, reduce estate taxes, and get the charitable income tax deduction. And you still get the income from those assets!

There are a few types of charitable remainder trusts with different characteristics.

Charitable Lead Trusts

This trust serves to reduce the amount of your current taxable income. A charitable lead trust donates a portion of the income from the trust and then transfers the remaining portion of the trust to the beneficiaries after a period of time.

This allows the beneficiaries to pay less in gift taxes and estate taxes. You also receive a federal tax deduction equal to the value of the annual trust payments made to the charity.

Many organizations are happy to help you set up this type of trust.

“For time and the world do not stand still. Change is the law of life. And those who look only to the past or the present are certain to miss the future.”

- John F. Kennedy

Taxes and Your Estate

Estate taxes are commonly referred to as a “death tax.” It taxes property that is transferred or received at the death of the owner of that property.

Inheritance tax is a state level tax and is not found in all states. Estate tax is a federal tax and is a tax on the estate itself. It is not technically a tax on those that are receiving property from an estate. Inheritance tax is imposed on the person or party receiving the property.

With regards to estate taxes, anything above the estate exclusion amount is subject to federal taxes. That amount has risen considerably over the years and has been set permanently at \$5 million with adjustments made for inflation. An estate tax return has to be filed if the estate is valued above this level.

How Taxes are Calculated

Estates are taxed based on the net value of the estate. To find the net, one must start with the gross.

The gross value of the estate includes all the assets of the estate. This would include all the probate and non-probate assets.

The following items are then subtracted from the gross estate value:

- ❖ Funeral expenses
- ❖ Claims against the estate, such as unpaid taxes and any legal actions
- ❖ Unpaid debts, including mortgages
- ❖ Expenses that are related to the administration of the estate

Assets are valued by determining the fair market value. A great advantage to the beneficiaries is the avoidance of capital gains tax. For example, if you purchased stock for \$10,000 that is now worth \$100,000, your heirs will not have to pay taxes on the \$90,000 capital gains!

Once again, certain assets must pass a three-year rule to remain out of the reach of Uncle Sam.

“The only difference between death and taxes is that death doesn't get worse every time Congress meets.”

- Will Rogers

Health Issues and Other Concerns

Estate planning isn't just about money and taxes. There can be a variety of decisions near the end of your life that require some thought and pre-planning. Many of these are in regards to decreased level of competence when you are unable to make wise decisions.

Who will make these decisions when you cannot? This is another issue that you can address in your estate plan.

Consider these items:

1. Durable power of attorney. You can designate someone to make your health decisions with a durable power of attorney for healthcare. This agreement allows someone to make medical decisions on your behalf, but does not permit them to make life or death decisions.
2. Financial power of attorney. A financial power of attorney allows someone to make financial decisions on your behalf.

3. Living will. Living wills describe your wishes regarding life support. It allows your wishes to be followed and frees your loved ones from being forced to deal with the decision.
4. Funeral planning. Funeral planning is another issue that you can spell out rather than leaving those decisions to your loved ones. It makes everything easier on everyone.
5. Post-mortem letter. This letter serves to provide information, but does not have any real legal use. You can describe the locations of assets, list professionals that you've used in the past that might have important records, and even say goodbye to loved ones.

Conclusion

You now know the basics of estate planning and can begin to get an idea of how you wish to proceed. It is always wise to consult an attorney in your state when planning your estate. Understanding these fundamentals will allow you to better understand your attorney and ask effective questions.

Many attorneys are not familiar with many of the tools used in estate planning. Be sure to contact an attorney that specializes in estate planning.

It's important to build a plan that addresses all the needs of your loved ones while reducing any taxes your estate might face. Trusts are valuable tools, but they can be expensive to set up and administer. You don't have to be wealthy to use trusts to your advantage, but the advantages are greater for those with a considerable net worth.

Addressing your wishes with regards to medical care and life saving treatments is also a wise decision, if only to ease the burden on your loved ones.