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Tax & Financial Newsletter

This *Tax and Financial Newsletter* is devoted to Estate Planning, and has five sections. The first section states the objectives of estate planning, including what is estate planning. The three sections afterward provide practical information about Wills, Revocable Trusts, and General Durable Powers of Attorneys. The last section discusses tax strategies to consider for §401(k)s, IRAs, including the Roth counterparts.

INTRODUCTION – ESTATE PLANNING OBJECTIVES

A well-designed estate plan achieves four objectives. First, it helps ensure your property is distributed in the manner you desire which reduces the emotional stress for all. Second, careful estate planning reduces the time and money your survivors will spend settling your affairs. Third, a good estate plan provides for contingencies, such as disabilities, minor children inheriting, etc.; and fourth, prudent estate planning can reduce *income* and *estate* taxes. Fortunately estate taxes are only applicable to fairly large estates. But, pension plan *income* taxes are common in almost all estates.

Perhaps the main driving force behind estate plans in Oklahoma is avoiding probate. Transferring assets in probate is expensive, time consuming, and slow. Other times the catalyst is to address existing and possible future physical and mental disabilities of those involved.

Thus, it is crucial to tailor the estate plan to the circumstances, including the size of the estate, the different types of assets, and address the complexities related to the surviving family members, including blended families. Essentially, good estate planning is a tool to help your family. The next several sections explain the "nuts and bolts" of estate planning.

WHAT IS ESTATE PLANNING?

Estate planning is arranging your affairs utilizing several types of laws including that of trusts, wills, taxes, probate, insurance, property, LLCs and corporations, family law, etc.

The most basic estate plan is probably using joint tenancy deeds, and then perhaps Pay on Death accounts, or Transfer on Death deeds. These are inexpensive and do work, but issues can arise with the unanticipated. For example, the intended joint tenant beneficiary passes away first, or he or she ends up with creditor problems (many times the IRS) entangling another's assets. Sometimes even a current gift that is meant to take effect upon death results in inadvertent *income* taxes. Thus, a well-intended simple estate plan can be a financial mistake. Fortunately, a Will can solve some of these problems.

A WILL - THE BASIC DOCUMENT

A Will is a written document by which you make provisions for the disposition of your property upon your death. A personal representative (PR) is appointed pursuant to the Will and approved by the probate court.

The PR gathers and accounts for your property and make distributions according to the provisions of your Will, including the payment of debts, all of which is done under court supervision.

However, not all property "passes" pursuant to a Will. Thus, probate property has to be coordinated with property that passes "outside" the Will or probate. Generally joint tenancy assets, life insurance, and pension plans are not governed by a Will. Thus, it is important to know what property will pass pursuant to a Will, and what property is transferred out side of a Will, and just as important, what property passes to another subject to a debt or mortgage.

A rule of thumb: a Will controls property that is owned in your name individually at the time of your death, or is otherwise paid to your estate by contract or other agreement.

A Will has five major drawbacks, including it: (1) requires probate; (2) it cannot provide a plan for mental or physical disabilities while one is alive; (3) it does not protect your privacy or that of your family; (4) it can be easily contested in a probate; (5) and probate invites creditors, real and putative, demanding money.

REVOCABLE (LIVING) TRUST – THE DOMINATE ESTATE PLAN TOOL

The alternative to a Will is a "Living Trust." Legally known as an *inter vivos* revocable trust. A trust is a legal entity with four elements: property, a trustee, trust terms, and beneficiaries. A grantor, and many times a married couple as joint grantors, create the Living Trust by signing a "trust instrument." The instrument has the terms. Then property is titled in the trust's name. Typically the grantors are the current beneficiaries and the trustees. Hence, the Living Trust becomes operative during the lifetime of the grantors.

Upon the death of the grantors, a second person or entity becomes the trustee. The successor trustee distributes the trust's assets according to the directions in the trust. Therefore, a Living Trust is similar to a Will…it distributes property after someone passes away. Unlike a Will, however, the Living Trust avoids probate.

Living Trusts – Transfers & Flexible

For a Living Trust to avoid probate, it has to be properly funded. Typically this includes preparing and filing deeds, changing the style and headings of bank and brokerage accounts, and preparing assignments for other assets. Our office, as CPAs too, is especially adept at helping fund trusts. We know how to account for assets! We draft a custom checklist to properly fund the trust and guide you.

A Living Trust can further provide for the management of your assets if you are unable. Typically what happens is the co-trustee or a successor trustee legally takes over asset management and works with your banks, etc. No court appointed guardian required.

For minor children, it is common to have a "support/education trust" within the Living Trust. This sub-trust generally directs for the payment of a child's living expenses including college or vocational school. If the trust has assets afterwards, your children

receive their inheritance. Of course, many variations to this general framework exist and should be tailored to your specific requirements. For example, larger estates many times stagger distributions.

A Living Trust is also flexible because it can be adjusted when your circumstances change. A common amendment to a Living Trust is to fine-tune it after children are grown.

But, just like a Will, the same types of property generally do not "pass" pursuant to a Living Trust e.g. joint tenancy property, pension plans, and life insurance. Our office will work with you to make sure all your assets are accounted for in your estate plan.

In conclusion, a Living Trust is the primary estate planning tool because it is effective for a wide range of circumstances. The main disadvantage is it is initially more expensive than a Will; and it does require some effort and time to transfer assets to it. Perhaps the second, and at times the most important document in an estate plan is the Durable Power of Attorney.

DURABLE POWER OF ATTORNEY

A Durable Power of Attorney (DPOA) is a document that legally allows another to act on your behalf while you are alive if you are unable. Many times a DPOA is first used when someone starts having difficulty managing their day to day finances. The power holder steps in and performs those tasks; and the power holder usually assists with decisions such as long-term care, signing contracts, or buying and selling property. Accordingly, the DPOA is a powerful document not to be entered into lightly. However, the power holder can't change someone's Will or Trust, or transfer assets away. That is because the power holder has fiduciary obligation to the principal and must at all times act in the best interests of the principal.

Almost always married couples appoint the other spouse as their power holder. A responsible adult child or other relative is also a common power holder. More than one person can serve as the power holder, and they may or may not act independent of each other, depending on what the client chooses. Usually the appointment is effective upon a disability, but not always, and a DPOA expires when the principal passes away.

There are a few other documents in a good estate plan besides the three mentioned herein, such as Advanced Directives for Health Care, Memorandums of Trust, etc. But the Will, the Living Trust, and DPOA are the main three; and they work best together after the estate planning alternatives are explored, including a solid accounting for the assets and debts.

PENSION PLAN TAX STRATEGIES

Often the largest assets of an estate are pension plans. Pension plans usually come loaded with *income* taxes. Hence, estate planning is not complete without addressing pension plan income taxes. As CPAs experienced in tax law and preparation, our offices are especially adept at assisting clients with their traditional §401(k)s and IRA taxes. The basic pension plan tax rule is distributions from traditional pension

plans are included in the taxable income of the recipient, while distributions from Roth IRAs or Roth §401(k)s are non-taxable.

Hence, because of taxes, a $100,000 Roth is more desirable than the same assets in a non-Roth IRA or §401(k); and a $100,000 piece of land might be more desirable than $120,000 taxable pension plan. The drawback to Roths are they are almost always more expensive to initially fund because Roth contributions are not tax deductible, while contributions to traditional pension plans are deductible.

The best pension plan advice for younger people is never underestimate how quickly one can grow old. Thus, save now, monitor your investments, and keep an eye on the taxes by considering the following tax tips.

Tax Tip! Usually in time, because of *income* taxes, the initially more expensive Roth plans are better than deductible IRAs, or deductible §401(k)s.

Tax Tip! If you are fortunate enough to have a diversified portfolio of stocks, bonds, etc., invest the lower risk bonds in taxable IRAs, and §401(k)s.

Tax Tip! Long term appreciating assets held in a taxable pension plan are subject to *ordinary* income tax rates upon distributions, and do not enjoy the *preferential* long-term capital gain rates.

Tax Tip! Roth IRAs and Roth §401(k)s are excellent tax vehicles for growth-oriented investments.

Tax Tip! Considering taxes only, an adult child in a low-income tax bracket is a preferably beneficiary of taxable pension plans vs. a higher tax bracket child; make up the difference by gifting non-pension plan assets to the higher tax bracket child.

Tax Tip! If your taxable income is negative in a year, consider converting a taxable IRA to a Roth IRA. It could reduce income taxes.

Tax Tip! A "backdoor Roth" is a strategy to fund a Roth IRA when a taxpayer's income is otherwise too high for a Roth contribution.

Tax Tip! If you are charitably inclined, a good strategy is designate your favorite charity as the successor beneficiary of your pension plan. The non-profit can usually avoid the taxes.

Tax Tip! Coordinate taxable pension plan distributions with payment of deductible medical bills, such as nursing home care.

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