Evergreen
LEGACY PLANNING LLP

Common Estate & Legacy Planning Terms

The world of estate planning has its own technical language. For people who aren't used to the lingo, it can get really confusing quickly. We believe that when people have a basic understanding of some of the key technical language in an estate plan, they're more likely to implement a successful plan and have the peace of mind they need. What follows is not complete in any way; we simply offer it here to help provide some foundational knowledge about some of the terms that get thrown around in a lot of estate plans.

We try to avoid using technical jargon in our strategic documents whenever possible and we really hate to use the terms in conversations with clients and their families. But you may come across some of these concepts as you research your own planning, and you'll see them in legal documents from time to time.

Strategic legal planning is certainly complex, but there's no reason to make it harder than it has to be. With that in mind we hope that this brief glossary of terms and acronyms is useful.

Annual Gift Exclusion: This is the amount that someone can give to another person during the calendar year without having to pay gift tax. Under the tax law the annual gift exclusion is set at $10,000, but that amount is adjusted for inflation from time to time. For gifts in 2018-2019 the annual exclusion is $15,000 per beneficiary. The annual gift exclusion amount adjustments are published by the IRS in Q4 each year and are available at www.IRS.gov.

Basic Exclusion Amount (BEA): This is the amount that someone can leave to their heirs free of estate tax at death. Under The Tax Cut and Jobs Act enacted in 2017, the basic exclusion amount was set to $10,000,000 per decedent, subject to periodic adjustments based on inflation. For individuals dying in 2018 the inflation-adjusted exclusion amount is $11,180,000.

It's important to note that the tax law is set to expire automatically on 12/31/2025. Unless Congress passes a replacement tax bill before then, the basic exclusion amount will go back to $5,000,000 per decedent (again adjusted for inflation).

Basis: Is the tax value of an asset, usually measured by the date on which the asset was acquired. Capital Gains tax is paid based on the increase in value (gain) from the owner's basis to the value when the asset is sold. For example, if you pay $10 for something and it increases over time to $100, you have a basis of $10 and a "capital gain" of $90. If you sell the asset, you pay state and federal capital gains tax based on that $90.

- "Carry-Over" Basis: If you give property away during your life, the person who receives the property has the same basis you had. This is "carry-over" basis. That means that if they sell the property for $100, their basis is still $10 and they pay state and federal capital gains tax on the $90 gain. Carry-over basis is generally undesirable, because the person who sells the asset has to pay the capital gains tax liability based on the original owner's "carried over" basis. This is essential to understand before gifting any property to someone.

- "Step-Up" Basis: If you die and you own an asset that has increased in value and it goes to someone, that person generally gets a "step up" in basis to the value measured at your date of death.

> *Assume again that the asset you bought for $10 increases to $100 by the time you die. After you die your beneficiaries receive the asset from your estate (valued at $100), and they then sell the asset for $100. They have taxable capital gain of $0 because their basis got "stepped up" in your estate when you died. Strategies that target basis adjustment seek to eliminate carryover basis and give step up basis to your beneficiaries.*

Beneficiary: This is the person, entity, or group for whom a trust is established. In many states like Colorado, it can even be an animal. A beneficiary may be entitled to receive distributions from a trust now (a "present interest"), or they may not be entitled to distributions until some point in the future (a "future interest"). There are many different kinds of beneficiary interests that can be created in trusts.

Bypass, or "Credit Shelter" Trust: This is the portion of a deceased spouse's property that uses the decedent's BEA (Basic Exclusion Amount; see that definition). The bypass trust can provide benefits for the surviving spouse or other beneficiaries (or a combination) and typically is designed so that it's not included in the surviving spouse's estate when he or she later dies. They can be very flexible and very powerful planning techniques for married people.

Clayton Election/Contingent QTIP Trust: This is a popular method of determining the amount of a deceased spouse's estate that will be set aside for the surviving spouse in a specific kind of trust. Property set aside for the marital deduction gets transferred to the marital trust, which is set up as a QTIP trust. A Federal Estate Tax Return is required to notify the IRS of the QTIP election and disclose the amounts going into the marital QTIP and bypass trusts. The decision to send property into a bypass trust (see above) or into a marital trust should be a balanced decision based on income tax planning priorities, asset protection needs, and a couple's overall legacy planning objectives.

The Clayton election is a very flexible marital deduction planning tool and is most desirable for clients who have moderate to nearly-taxable estates, or in times of significant uncertainty in the estate tax (which it seems like we're always in). It is generally our favorite method of designing trusts for married couples.

Community Property: Community Property refers to property acquired by a couple during marriage, or property that is combined - or commingled - between spouses. It only applies in nine states (the "community property states"): Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Alaska, South Dakota, and Tennessee have optional, or elective community property laws, allowing married couples to elect to have jointly-held property treated as community property.

The biggest benefit of community property is that the entire value of the property gets a basis adjustment (step up; see that definition) when one of the spouses dies. If a surviving spouse sells community property after the death of their spouse, the capital gain is based only on the increase in value from the first spouse's death (where the basis got adjusted on both spouses' shares) to the value at the date of the sale. This allows the survivor to significantly save money on capital gains tax liability.

Community Property Trust (created in Alaska, South Dakota, or Tennessee): This is a special type of joint revocable trust that takes advantage of special laws in Alaska, South Dakota, or Tennessee that allow nonresidents who live in non-community property states to opt in to the state's favorable community property laws. The value behind the strategy is to allow a married couple to get a "double step-up" in basis – a step up in the deceased spouse's property AND in the surviving spouse's property.

This can be a great strategy for married couples in Colorado or other non-community property states who have highly-appreciated property that they intend to keep until the first spouse dies.

CLT, or Charitable Lead Trust: This is a trust that provides a benefit to one or more charitable beneficiaries for a predetermined period of time, and then returns the property to the person who created the trust, or to his or her other beneficiaries. CLTs can be a compelling strategy to provide an economic benefit to charity, rather than to the treasury, and then return the trust property back to the donor or someone else. There are different types of charitable lead trusts, but they all share this general structure. They can be powerful tools to reduce income and estate tax liability. Sometimes they get included inside a client's *revocable* trust as a backup strategy to eliminate estate taxes.

CRT, or Charitable Remainder Trust: This is a tax-exempt irrevocable trust designed to reduce the taxable income of individuals by first dispersing income to the beneficiaries of the trust for a specified period of time and then donating the remainder of the trust to the designated charity. It's the inverse of the Charitable Lead Trust, discussed above, and is also a powerful tax-reduction strategy. Like the CLT, a CRT may be created during life or after death.

Decanting: This is the process by which a trustee exercises the power to distribute property from one trust (the "originating" trust or the "inception" trust) into a new trust for the benefit of a beneficiary. Decanting is an increasingly popular strategy to allow a trustee to create new, more favorable trust terms for a beneficiary. It can be a useful way to allow a trust to be changed if the law changes, or if a beneficiary's circumstances change significantly after the trust has become irrevocable. Different states have different rules regarding trust decanting and the tax implications are unclear, so trustees must be very cautious before decanting a trust.

Disclaimer: A disclaimer is a legal "no thank you." It's a technique under the tax code that allows someone who is entitled to receive property to disclaim that property, allowing it to be distributed somewhere else without triggering a taxable gift. In the context of marital deduction planning, the disclaimer method allows the surviving spouse to disclaim property into a bypass trust, providing some flexibility in marital deduction planning. Although it seems straightforward, disclaimers are easy to mess up. If not done properly, a failed disclaimer may result in a taxable gift.

Executor/Personal Representative: This is the person who is named in a will to administer the estate of a deceased person. The trustee administers the trust; the executor or personal representative administers the probate estate. Remember: an "executor" for the will; a "trustee" for the trust.

Fiduciary: This describes the nature of a relationship where one party owes legal duties to another party and is held legally responsible for the outcomes of their actions. As a quick run-down:

- Trustees are fiduciaries of trusts, with duties to the trust beneficiaries.
- Executors are fiduciaries of wills, with duties to the beneficiaries under the will.
- Guardians and conservators are fiduciaries, with duties to the ward (the disabled person).
- Agents and attorneys-in-fact are fiduciaries, with duties to the principal under a Power of Attorney.
- Health Care Proxies or surrogates are fiduciaries, with duties to the maker of a Living Will / Advance Directive.
- Trust "protectors" & trust "advisors" may or may not be fiduciaries, depending on the nature of the power that they're given. In most circumstances they owe a fiduciary duty to the creator of the trust, and not to any particular beneficiary. This allows the trust protector or trust advisor to carry out the trust maker's wishes, even if the beneficiaries don't like it.

Funding: This is the process of transferring property to the trust. The trust must hold title to property in order for it to work, just like a car needs fuel to run. Funding should take place during the trust maker's lifetime. If there is any property that has not been funded to the trust when the client dies, that property must generally go through state probate proceedings before anyone can do anything with that property.

Grantor/Settlor/Trust Maker: These terms are generally synonymous, though there are subtle, technical differences. In general, they refer to the individual who establishes a trust.

> Think of it this way: The Settlor/Trust Maker establishes the trust and determines how the trust will operate. The Grantor (a technical tax term) puts his or her property into the trust. (Thus, the Grantor and Settlor-Trust Maker is usually the same person.) The trustee manages and administers the trust for the benefit of the beneficiary or beneficiaries.

Guardianship/conservatorship: There are subtle differences between these terms but they're generally considered to be synonyms. This is the court proceeding that is undertaken when an individual lacks the legal capacity to make decisions for themselves or otherwise protect their own interests. That lack of legal capacity can be due to mental or physical illness, injury, or because the person is a minor child. A guardian or conservator is a fiduciary appointed by the court to make decisions on behalf of the disabled person (who is called the "ward"). That fiduciary must provide periodic accountings to the court and the court proceedings continue until the ward (the person under a legal disability) dies or is no longer under the legal disability. Durable powers of attorney and trust-oriented planning helps avoid guardianship or conservatorship proceedings.

ILIT: Irrevocable Life Insurance Trust. This is a very popular form of irrevocable trust that is designed to own high-value life insurance. An individual establishes an ILIT and pays enough money into the trust to allow the trustee to buy life insurance on the life of the client (and often, the client's spouse). When the insured person dies, the death benefit of the life insurance is paid into the trust but is not included in the gross estate of the client (thus keeping it away from estate tax liability).

It's important to understand the different levels of protection available under the laws of different states, and the life insurance premium tax can vary widely from one state to the next.

Intestate/Intestacy: This describes the condition of someone who dies without having a will or trust in place. If you don't proactive do your estate planning, your property will pass through the laws of intestacy in the state where you resided. The laws of intestacy vary from state to state and are set forth in state statutes.

It is not accurate to think that, "the state gets your property." If you die without an intentional estate plan, one or more of your legal heirs will have to convince a judge to appoint them as administrator of your estate, and then they'll follow the probate laws as overseen by the court. Once the probate process is complete, the net amount of your estate remaining after the court process will be distributed to your "heirs at law" as determined by state law. This usually means your surviving spouse will get up to half, and your children or other heirs will share the remaining half. The actual fractions vary from state to state and on your marital and family status when you die. Needless to say, it isn't proactive planning. It leaves important decisions up to the default rules of the state, which is not what most people seem to want.

Marital Deduction: The marital deduction allows a married person to leave property to his or her surviving spouse free of estate tax. (This includes same-gender spouses under U.S. law.) U.S. citizens can leave an unlimited amount for their surviving spouse, assuming the survivor is also a U.S. citizen, and assuming the gift qualifies under the tax laws.

Marital Trust: This is the portion of the deceased spouse's property that is transferred into a trust that qualifies for the marital deduction. When the surviving spouse later dies the value remaining in the marital trust is included in that spouse's estate. This can be a great benefit for income tax planning purposes, but it must be done intentionally.

Probate: If you do not have a "funded" living trust, probate is the court proceeding that must be undertaken to transfer your property after your death to your surviving beneficiaries. Probate procedures vary widely from state to state but generally they're public proceedings and can be time consuming and rather expensive. One of the objectives of trust-based planning is to avoid probate, primarily to save time, minimize the likelihood of disputes among heirs, and preserve privacy. If you have property in more than one state, you will probably have to have a probate in each state (unless that property is held in your trust.)

QTIP election trust: This is a special kind of marital trust that a deceased person can create for his or her surviving spouse. It qualifies for the unlimited marital deduction (thus avoiding estate tax when the first spouse dies) and the property in the QTIP trust gets a basis adjustment (see above) when the surviving spouse later dies. Deciding which kind of marital trust to create requires technical analysis during the estate planning and estate administration phase.

Retirement Legacy Trust. This is a special type of trust designed to receive "qualified retirement accounts" like IRAs, 401(k)s, etc. It's designed to allow trust beneficiaries to continue to defer income tax on the account balance for as long as possible. (This is referred to as a "stretch out.") SRTs also provide a lot of protection for retirement account balances after they're inherited by beneficiaries.

Revocable Living Trust (RLT). This is the main document & planning solution most trusts & estates attorneys implement for their clients. The client transfers their property to the revocable living trust during their life so that their chosen trustee can manage the trust property for the client if the client becomes disabled and when the client dies. Because the <u>trust</u> owns the property, probate is not necessary to transfer property after the client dies.

Separate Property/Common Law State: Unlike community property (see above), separate/common law property receives a basis adjustment only on the share of the property that a person owns when they die. In the case of a married couple who live in Colorado (or another separate/common law property state), when one of the spouses dies, only that deceased person's portion of the property receives a step up in basis. The surviving spouse keeps the same original basis. This means that if the surviving spouse sells an appreciated asset after the death of the other spouse, there will be capital gains computation based on the mixed basis of the stepped up share of the deceased spouse and the carried-over basis for the surviving spouse. (Confusing, huh?)

All states that are not community property states are separate property states. In some situations this can be avoided with special planning under the laws of Alaska, South Dakota, or Tennessee. (See Community Property Trust discussion above.)

Special/Supplemental Needs Trust (SNT). This is a special type of trust designed to set aside assets for the benefit of a beneficiary whose disabilities may allow the beneficiary to receive public assistance for medical and other care expenses. They may be created as a separate trust when a beneficiary has a known disability, or they may be created as a contingent trust inside the revocable living trust just in case a beneficiary develops a disability later in life.

Survivor's Trust: This term only applies in the context of a joint RLT plan. The survivor's trust is the surviving spouse's share of the joint trust property, plus any separate property the surviving spouse had. The deceased spouse's property will typically flow into the marital and/or bypass trusts. The survivor's trust is fully revocable by the surviving spouse for the remainder of the survivor's life. It's treated just as if the surviving spouse had established his or her own individual revocable living trust.

Trust: A "trust" is really just a formal legal relationship where someone (the trust maker) appoints someone else (the trustee) to hold title to and manage trust property for the benefit of one or more people (the beneficiaries). When folks talk about "trusts" they're usually referring to documents, but in its basic form a trust is simply a specific type of fiduciary relationship. Trust documents take many forms, each of which is designed for a specific strategic purpose.

Trust Advisor/Trust Protector: Many attorneys use these terms interchangeably. Whether those terms are truly synonymous is open to question, and is still an evolving issue under the law. In essence, the advisor or protector is someone other than the trustee or a beneficiary who is given special administrative powers over an irrevocable trust. They're designed to carry out the trust maker's intent even as the law or other circumstances change over time, allowing the trust to remain flexible.

Trustee: This is the day-to-day decision maker for a trust. The trustee has a series of fiduciary duties to the beneficiaries to make sure that the trust is administered properly according to the trust's terms and governing law, and that the beneficiaries' interests are protected. There must always be a trustee for a valid trust to exist, and all trustees are always held to a fiduciary standard.

We welcome your inquiries about strategic legal planning. Please let us know how we can help.

Evergreen LEGACY PLANNING LLP

www.EvergreenLegacyPlanning.com
32065 Castle Court, Suite 250A-C
Evergreen, Colorado 80439
877.757.8120