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ESTATE PLANNING PRINCIPLES

The purpose of this memorandum is to summarize some of the general principles involved in reviewing and updating your estate plan. This memorandum only contains general information. If you have questions about your specific situation, please call us.

1. **Transfer of Property on Death**. The following is a discussion of some common methods to transfer property on death.

    1. Nonprobate Transfers. "Nonprobate" property refers to property that does not require any court involvement to transfer title after the owner's death.

1. Joint Tenancy. Real or personal property titled in Colorado as John Doe and Jane Doe "*as joint tenants with right of survivorship*" or "*in joint tenancy*" becomes the property of the surviving joint tenant on the death of the first joint tenant. No court proceedings are necessary. If property in Colorado is titled in the names of more than one person, without adding words like the quoted phrases, then it is owned as "tenants in common." This means that the survivor does not become the owner of the entire property; rather, each tenant owns an undivided portion of the whole, and that portion passes according to the deceased tenant's Will or by intestacy. Therefore, it is important to review deeds and other documents evidencing title to determine whether property is owned as joint tenants or tenants in common. Titling real property in joint names is a current gift to the other joint tenant when the deed is recorded. Titling bank accounts in joint names is a gift when/if the other joint tenant withdraws funds. Either method of adding joint *owners* can cause the property to be available to the other joint owner's creditors or a spouse in the event of divorce. In 2008, the Colorado legislature amended the statutes to permit unequal joint tenancies, although such titling will not be recognized for purposes of Medicaid qualification.

2. Contracts/Beneficiary Designations. Life insurance, annuities and retirement benefits generally have beneficiary designations as part of the contracts. Proceeds on death are payable according to the contract terms, generally without any court proceedings, and such payments are not affected by the terms of the Will. It is important to coordinate beneficiary designations with the terms of wills, trusts, or other documents created in the estate plan. Bank accounts may have a "pay on death" designation, and investment accounts may have a "transfer on death" designation. In addition, Colorado real property may also be titled in a "Beneficiary Deed" so that title passes to the named beneficiary automatically upon the death of the owner outside probate proceedings. Such a designation is revocable during the owner's lifetime, and is not a current gift. The property is also not available to the beneficiary's creditors during the owner's lifetime.

3. Trusts. Property that is held in a trust will pass according to the terms of the trust agreement usually without court involvement. There has been a lot of discussion in recent years about the advantages of using revocable trusts instead of wills. There are a number of good reasons for using revocable trusts, but they are not necessary for everybody. Some of the advantages and disadvantages of the revocable trust are:

    (1) Avoidance of Probate. Colorado has a modern probate code that makes avoidance of probate less important that in some other states. However, you might want to use revocable trusts to avoid "ancillary" probate of any real estate outside of Colorado that you own or might acquire in the future.

(2) Privacy. A revocable trust, if funded during your lifetime, provides greater privacy than does a will.

(3) Planning for Incapacity. A revocable trust is a good way to provide for the management of your assets in the event of your incapacity. Durable powers of attorney can achieve some of the same objectives, but a revocable trust is more flexible and private in this regard.

(4) Complexity. Revocable living trusts with "pour over" wills are somewhat more complex that simply using wills.

4. Effect of Divorce. Even though nonprobate transfers are generally made to the designated beneficiaries, or the surviving joint tenant, there are exceptions. For example, if you get divorced, upon your death, any *revocable* transfers to the former spouse (or to the spouse's family members) are revoked, and the former spouse and/or family members are treated as having predeceased you.

5. Designated Beneficiary. Effective July 1, 2009, unmarried adults in Colorado may execute a Designated Beneficiary Agreement and record it in the county in which they reside, and designate each other as an intestate heir, as well as medical proxy decision-maker, person with priority for appointment as personal representative, conservator, or guardian, and person with authority to pursue a wrongful death claim or receive worker's compensation benefits.

2. Probate Transfers. Property titled in your own name must be "probated" after your death. "Probate" refers to the court proceeding to appoint a "personal representative" (executor) so that there will be someone with the authority to transfer your property to the persons entitled to it according to your Will or the intestate laws. In Colorado, the probate court proceeding is fairly simple and inexpensive provided there are no disputes among the beneficiaries or other interested parties.

1. Intestacy. If you die a resident of Colorado without a Will, the property in your own name will pass according to the intestate laws. The surviving spouse's share will be *all* of the estate if all of the decedent's children are also children of the spouse (the "nuclear" family), or if the decedent did not have any children *and* neither of the decedent's parents survived. If the decedent did not have any children, but a parent survived, the spouse receives the first $309,000, plus ¾ of the balance; the parent receives the remainder. If the spouse has children from a prior marriage, but the decedent does not, the spouse receives the first $232,000 plus ½ the balance; the remainder passes to the decedent's other heirs. If the decedent had any children from a prior marriage, whether or not the spouse did, the spouse will receive the first $154,000 if all of the decedent's children are adults, plus ½ the balance.

These dollar amounts are indexed for inflation in increments of $1,000 after 2011. The above figures are effective for 2012. In addition, you should be aware that included in the definition of a decedent's "children" are any children conceived within 36 months after the decedent's death under certain circumstances (frozen embryos, sperm, etc. resulting in a birth within 45 months after the decedent's death). If you do not want your family members to receive their intestate shares as described above, you must execute a Will.

2. Transfer by Will. If you die with a valid Will, property titled in your own name will pass according to the terms of your Will, subject to a few exceptions. One exception is the elective share of the surviving spouse. While you are free to disinherit your children, your surviving spouse has certain rights under Colorado law to receive a portion of your estate. Colorado law gives a spouse the right to take from 5% to 50% of the "augmented estate", depending upon the length of the marriage (5% for each full year of marriage). You and your spouse can waive your elective share rights in a marital agreement or by giving written consent to specific transfers.

2. **Providing for the Special Needs of Beneficiaries**.

1. Minor Beneficiaries. If you intend to benefit persons under the age of 18, you should not simply designate them as beneficiaries under your Will, life insurance policies or retirement accounts because they cannot legally hold title to property. If property is distributable directly to minors, a conservator may have to be appointed by the court to hold title to the property. A conservatorship proceeding is generally court supervised, requires at least one hearing to appoint the conservator, and consequently is fairly expensive. You should consider the creation of a trust in your Will or revocable trust to hold property for minor beneficiaries. An alternative to the creation of a trust is to authorize the personal representative or trustee to distribute property to a custodian under the Uniform Transfers to Minors Act, for the benefit of a minor beneficiary. Trusts give you more flexibility than UTMA accounts do, and can be used more effectively to reduce taxes, as discussed below.

   You should also designate a guardian for your minor children in your Will, or refer to a separate writing in which you designate a guardian. If you are divorced, you should be aware that your Will may not effectively control the designation of guardian if your former spouse survives you.

2. Incapacitated Beneficiaries. If a beneficiary is incapacitated, or is unable to manage property, then a trust should be considered to hold the beneficiary's share of your estate. If the beneficiary is receiving government benefits as a result of the incapacity, care should be taken in the kind of trust that is created, so as not to disqualify the beneficiary for those benefits.

3. Other Special Needs. Even if a beneficiary has legal capacity, you may be concerned that he or she will not be able to manage his or her property, or that he or she may have problems with creditors. In that event, a trust should be considered that is appropriately tailored to the beneficiary's needs.

3. **Reducing Taxes and Expenses Payable After Your Death**.

1. Federal Estate Tax. The U.S. imposes an estate tax on the fair market value of all property you own at your death, less certain deductions. The tax is due nine months after the date of death, and a return must be filed for any estate that has at least $5,000,000 in gross value, as indexed for inflation after 2011. If a person’s taxable estate exceeds the remaining “applicable exclusion amount” after considering any lifetime taxable gift, an estate tax is imposed at a 40% rate. If a first spouse to die does not fully use his or her estate tax exemption, then the remainder is “portable” under certain circumstances so that the second spouse may increase his or her exemption by the unused exemption.

2. Generation-Skipping Transfer Tax. In addition to the estate tax, the U.S. imposes a generation-skipping transfer (“GST”) tax on certain transfers, such as from a grandparent to a grandchild. This tax is imposed at the top estate tax rate (40%), but each person has a $5 million exemption (indexed for inflation) from the tax.

3. State Taxes. Colorado used to impose an estate tax if the U.S. imposed the tax, in the amount of the “state death tax credit” on the federal return. Effective for 2005, there was no longer a state death tax credit on the federal return, and therefore, Colorado no longer imposed an estate tax. There are other states that have separate inheritance taxes, and if you are a resident of a different state, or own real property in another state, you should determine if any additional death taxes will have to be paid.

4. Minimizing Death Taxes. The following is a summary of some of the common ways to reduce death taxes.

    1. Use of Estate Tax “Exemption”. Each U.S. citizen or U.S. resident can pass $5,000,000 (as indexed for inflation) free of estate or gift tax. If both husband and wife use their exemptions, $10,000,000 may be passed to beneficiaries without estate or gift tax. This kind of planning usually includes formulas in the Will or Trust referring to an amount that can pass estate-tax free, with the remainder to a marital gift. In addition, the unused exemption of the first spouse to die is “portable” to the surviving spouse without the creation of a Family Trust or Credit Shelter Trust. However, there are many uncertainties with the effect of a remarriage or asset protection with “portability” so we often recommend that the formula division and creation of a Family Trust still be used for taxable estates.

2. Use of Generation-Skipping Tax Exemption. Each person has a $5 million GST exemption (as indexed for inflation). Use of that exemption by each spouse in the creation and funding of trusts can protect $10 million from GST, and minimize estate taxes at the deaths of children and grandchildren. The GST exemption is not "portable." Again, if formulas are used in Wills or Trusts to divide assets between "exempt" and "nonexempt" shares, those formulas should be reviewed to determine how they will be applied as the exemption changes.

3. Charitable Gifts. Gifts made to charity (that meet certain requirements) are not subject to gift or estate tax. Charitable remainder trusts or gift annuities can be used to provide for lifetime income to the donor or designated beneficiaries, with remainder to charity.

4. Life Insurance. Life insurance is very useful to provide cash for the payment of estate taxes and other needs. Only proceeds from policies owned by the insured are included in the insured's estate for estate tax purposes, so proper planning can avoid increasing the size of your estate by the amount of life insurance proceeds. For example, if the policies are owned by and payable to an irrevocable life insurance trust, the proceeds should not be included in the insured's estate, assuming all IRS requirements have been met in the creation and administration of the trust.

5. Lifetime Gifts. By using "annual exclusion" gifts, you can reduce your estate without estate or gift tax consequences. A single person can give $14,000 per year (in 2013) to each of any number of individuals without gift tax, and a married person can give $28,000 per year per donee, if the spouse consents to split the gift. The gifts must be "present interests," so only outright gifts and certain types of gifts to trusts will qualify. You should not make a gift to yourself as custodian for your minor children under the Uniform Transfers to Minors Act, because such property *will be included in your estate* for federal estate tax purposes. You must name someone else as custodian.

   In some situations, it makes sense to make lifetime gifts in excess of the annual exclusion gifts. So long as the taxable gifts are under the aggregate of $5,000,000 (as indexed for inflation), no gift tax will actually have to be paid (although the amount of the applicable exclusion amount available at death will be reduced). The unused estate tax exemption from the first deceased spouse is "portable" for both gift and estate tax exemptions for the surviving spouse. Use of the gift tax exemption can be "leveraged" if a gift is made that provides a discounted value for the property transferred. For example, if a residential property is transferred to a "Qualified Personal Residence Trust," and the donor retains the right to live in the residence for a certain number of years (with the remainder to children), the value of the gift to the children for gift tax purposes is the fair market value of the property *less* the value of the retained interest of the donor.

Taxable gifts in excess of the exemption are taxed at a 40% rate.

6. Reduce the Size of Your Estate. One way to reduce the size of your estate is to make lifetime gifts. In addition, a sale of assets that you believe may appreciate will remove the future appreciation from your estate. Planning to take advantage of discounts for minority interests in business entities or fractional interests in real estate can significantly reduce values for estate tax purposes, but Congress is considering giving Treasury authority to issue regulations limiting discounts in family entities. Special Use Valuation can lower the value of real estate used for farming, if you qualify.

7. Community Property. Colorado will recognize the community nature of such property brought to Colorado from one of the community property states. This can make a significant difference in the new basis available to a surviving spouse at death of the first spouse. Ordinarily, only one-half of joint tenancy property is included in the estate of a deceased spouse domiciled in a separate property state (like Colorado), and only one-half of that property receives a new basis equal to fair market value on date of death. But at the death of the first spouse, *community property* receives a new basis for the *entire* property, even though only one-half is included in the first spouse's estate for estate tax purposes. So keeping the community nature of property identifiable and segregated from separate property acquired while a Colorado resident can significantly reduce capital gains that the surviving spouse may need to pay after the first spouse's death.

5. IRAs, Qualified Plan Benefits, and Tax-Deferred Annuities. Retirement benefits are included in a decedent's estate for estate tax purposes. Income tax will also apply when such benefits are paid to the named beneficiaries, except for Roth IRAs. A surviving spouse as beneficiary has more options than a trust or children to postpone income tax on the benefits. If retirement benefits make up a large part of your estate, the beneficiary designations must be carefully coordinated with your estate plan. If you have Roth IRAs, those generally may be treated in the same manner as non-retirement investment accounts if the 5-year period has passed and distributions will not be subject to income taxes. However, if you converted to a Roth IRA and are still recognizing income on that conversion, only the surviving spouse as beneficiary can continue the four-year deferral of income.

6. Reduce Expenses. One way to reduce expenses at your death is to keep your estate plan current, and to keep your designated personal representative informed. Be sure he or she knows where your original documents are located, and who to contact in the event of your death. You should also try to anticipate problems. A Will contest is very expensive. If you anticipate a contest, take steps now to support the validity

of your Will. If you have an unusual asset that will be difficult to value, leave instructions about who to contact, or who may be interested in buying it from the estate.

4. **Planning For Your Incapacity**. An estate plan will usually include planning for incapacity. If you have appropriate powers of attorney, you should be able to avoid court proceedings to appoint a guardian or conservator for you in the event of incapacity.

    1. Medical Power of Attorney. Colorado law gives you the power to designate someone as your agent to make health care decisions for you if you are unable to do so. You should also designate persons who may receive private health information in a HIPAA authorization form. Unmarried individuals may also designate each other as a "health proxy" in a Designated Beneficiary Agreement under new Colorado law.

    2. Living Will. Colorado law also gives you the power to sign a "living will" that directs your doctor to remove life support equipment if you are in a terminal condition and there is no hope of recovery.

    3. Financial Power of Attorney. You should also consider signing a general durable power of attorney in which you can designate an agent to manage your financial affairs. Colorado adopted a version of the Uniform Power of Attorney Act, effective January 1, 2010.

    4. Long-Term Care Planning. You may want to consider how you would pay for long-term nursing home care, if it is needed. Colorado's 2012 average monthly cost for nursing home care is about $6,623. Medicare only pays for a limited number of days for "skilled" nursing home care; custodial care is not included. Many persons purchase long-term care insurance to cover this cost, and that can be an important component of an estate plan. If insurance is not an option, then you would have to pay for long-term care from your personal assets, unless you could not afford to do so. Medicaid is the federal/state program that will pay for long-term care, if an individual cannot otherwise pay for care, and qualifies for the program. At this time there are two tests for qualification: an income test and an asset test. Under the income test, the individual must receive less than $2,094 (for 2012) of monthly income (although if the individual receives more than $2,022 but less than the average monthly cost of $6,623, by using a "Miller Trust" the individual can still qualify). Under the asset test, the individual must own less than $2,000 in "available" assets that are non-exempt. While the house is generally an exempt asset, Medicaid will be reimbursed at the individual's death through a lien on the house. Up to $525,000 of equity in the home in 2012 is exempt, and if the spouse is living in the home, the exemption is unlimited. Special rules govern transfers of assets in order to meet the $2,000 test. If gifts are made, a penalty period of up to five years will apply. The spouse who is not in the nursing home (the "community spouse") may own up to $113,640 in assets (in 2012). Because of limited government resources, it is likely that qualification for Medicaid to pay for nursing homes will become more difficult.

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