ESTATE PLANNING BASICS

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Introduction

We all leave something behind when we die. What we leave behind and how we leave it is the focus of estate planning — taking a systematic approach to preparing for the disposition of your assets. It is easy to procrastinate when doing estate planning since it requires facing up to the inevitability of death. But delay can be very costly if it leads to incomplete plans. If you want to control how your estate is distributed after your death, you should consider consulting with a professional estate planner while you are still mentally competent and insurable.

It can be tempting to save money by doing your own estate planning. Preparing a basic will or trust can be relatively simple — you can even buy do-it-yourself kits for basic estate planning. But there are a number of potentially complicated matters to consider such as estate taxes, generation skipping transfer taxes or claims from disgruntled relatives seeking a share of your estate.

Just as a professional architect will usually design a more appealing and functional house than a kitchen-table amateur, a professional estate planner can tailor a plan to fit your specific situation and needs. If you have concerns about how your assets will be handled upon your death or disability, you may want to consult an estate planning professional.

The concepts in this guide are not intended as tax or legal advice — this is a general introduction to some of the more common estate planning methods in use today. This may give you a basic understanding of estate issues when you seek professional advice.

Who gets what when you die?

Many people may feel they deserve some of your assets when you die. One aspect of estate planning is to give you as much control as possible over who actually receives the wealth you have accumulated. You can remove some assets from your estate while you still live, using trusts to provide separate ownership. For assets that you still own when you die, there are three common ways to transfer title: by operation of law, by contract, and by probate.

Some assets change ownership immediately upon your death as a matter of law. For example, if you and your spouse own a home as joint tenants with right of survivorship, upon your death your interest in the home generally transfers instantly to your spouse. These changes are automatic, without the need for a will or other legal proceedings.

Other assets are governed by contracts you have with other individuals or companies. For example, if you own a life insurance policy, you select the beneficiary of that policy. This is an agreement between you and the life insurance company, and the policy proceeds become payable to the beneficiary upon your death. A financial account registered in trust for another person transfers to that other person.

Retirement plans, annuities and business buy-sell agreements are examples of other assets that can transfer by contract upon your death. Again, this happens without a will or court proceedings.

Assets that remain in your estate after operation of law and contracts are distributed in court-supervised probate proceedings.

In the event you have not prepared for your assets upon your death, your state has established rules for who inherits your assets. These are "intestacy" laws. You may substitute your own directions through the use of a properly-drafted will. With or without a will, a court will appoint someone to oversee the winding up of your estate and distribution of your assets. This process, called "probate," varies by state, but can take months to complete and may cost a significant percentage of your estate's value.

To reduce costs and uncertainties, your estate plan can, for example:

- Remove as many assets as possible from probate proceedings
- Use a will to self-determine probate proceedings
- Use life insurance or other non-probate sources of funds to help pay expenses and estate taxes without liquidating other assets

What does it cost to die?

The United States tax system is designed, in part, to tax the transfer of accumulated wealth, driven by a desire to avoid perpetual family wealth like the landed gentry of Europe. Taxes originally designed to break up the wealth of the Gilded Age now apply to many families. At the federal level, there are three transfer taxes that have a significant impact on estate planning: estate tax, gift tax and the generation-skipping transfer tax (GSTT). Laws concerning exclusions and marginal tax brackets are often in flux. Additionally, many states have significant estate and inheritance taxes that are assessed at different, often lower, thresholds than the federal laws. Estate planning can help you navigate through these taxes as efficiently as possible. The following provides general information on these areas that may or may not apply to your situation.

Gift tax

It used to be that the easiest way to avoid death taxes was to give everything away before you died. The gift tax narrows that option by setting limits on tax-free giving. You may give an unlimited amount to a spouse who is a U.S. citizen or to qualified charities. Other giving is subject to both an annual gift tax exclusion and a lifetime limit of cumulative giving. Once your giving exceeds your cumulative lifetime limit, you must pay a gift tax on gifts exceeding the annual exclusion per recipient. While this was originally intended to tax the passing-on of great fortunes, it now applies to many individuals making more modest gifts.

Estate tax

The federal tax code totals the value of your estate at the time of your death, including the fair value of any property and investments owned by you at the time of your death, even if these assets will be transferred by law or contract. Removing an asset from your probate estate does not necessarily remove it from your taxable estate. Among the assets within your taxable estate are the proceeds of any life insurance policy owned by you on your own life. (Insurance on your life owned by others, such as a policy owned by your spouse, your child, an irrevocable trust, or your employer, is generally not included in your taxable estate — only life insurance owned by you is included.)

From the total value of your assets, the tax code allows deductions for debts, estate expenses, qualified transfers to spouses and gifts to charity. The net amount after these deductions is your taxable estate. Any unused applicable exclusion amount (non-taxable gifts you could have made but did not) is subtracted from the taxable estate value, and the remainder is taxed at a rate defined by Congress. It is important to remember that the exclusion amounts and tax rates set by Congress today can be changed by Congress tomorrow, so your estate planning should allow flexibility for future changes.

Generation Skipping Transfer Tax (GSTT)

Because the death of a wealthy individual is what triggers transfer taxes, another way to avoid the estate tax was to leave assets to the youngest generation of a family, so that the assets would skip one or more generation of taxation. For example, leaving a family home to a great-grandchild could keep the home in the family for three or more generations with only one application of estate tax.

Congress addressed this by imposing a separate tax on transfers to grandchildren or later generations. After subtracting a GSTT exemption, generation-skipping bequests are subject to ordinary estate tax, then to the additional GSTT at the highest applicable estate tax rate. This can result in a combined tax rate of over 70 percent on transfers to grandchildren or younger generations.

Other estate planning goals

Beyond distributing assets to your chosen beneficiaries and heirs as efficiently as possible, you may want to provide for durable power of attorney for yourself in case you become disabled or mentally incompetent before your death. Estate planning can include designating a guardian for yourself and establishing a trust to preserve assets for your care.

You may also be concerned for the recipients of your wealth after your death. Will they be competent to manage an inheritance? Will they be swindled or tricked? Will they spend profligately until the money runs out? Estate planning can also include appointing trustees to administer the wealth you leave to future generations, creating incentives for your heirs to live up to your expectations or disincentives to behavior you oppose.

Developing an estate plan that addresses all of these goals in an efficient manner is what distinguishes professional estate planning from kitchen-table amateurs. Spending the money for professional consultation is a choice that, for some, can pay off well for future generations.

Estate planning tools

The desire to protect a legacy for future generations has driven the development of many tools for estate planning. We will address them only briefly, to give you a basic introduction to some of the options you may wish to consider.

Last will and testament

Besides being an essential plot element in murder mysteries, a will is the foundation of most estate plans. It is simply a document in which you make clear your intentions for the distribution of your worldly goods. A properly-drafted will should designate fiduciaries to help in the administration of your estate, beneficiaries to receive your estate and the manner in which your assets are to be distributed to these beneficiaries. While you supply the desires behind the will, an attorney can provide the legal language to implement your desires.

Advantages of a will:

- **Simplicity —** A will can be a very simple document, easy to draft and easy to understand. Requirements vary by state, but in many cases you simply need your will to be witnessed by two people who are neither beneficiaries nor fiduciaries in the will.
- **Broad effect —** A will applies to all assets left in your estate after operation of law and contracts, so you don't need to establish special forms of ownership or inventory all your worldly goods — your will can distribute everything else after any other more specific plans are implemented.
- **Flexibility —** Your will can include alternate beneficiaries and fiduciaries in case the people you originally designate are no longer around. Because a will is written specifically to implement your desires, it can be crafted around any number of contingencies unique to your situation. Transfer of assets by law or contract is much less flexible, since most laws and contracts are drafted with few options.

Testamentary trusts

One option to consider within your will is to establish a trust that distributes assets over time, subject to conditions laid out in your will. A testamentary trust appoints a trustee to manage assets for the benefit of the beneficiaries you name, following rules you lay out in your will.

You may use this to provide continuing support for a vulnerable heir or to impose conditions your heirs must continue to meet in order to receive an ongoing inheritance. Implementation of a testamentary trust maintains court supervision of the estate beyond probate, requiring the trustee to file reports with the court and often allowing beneficiaries to challenge any perceived mismanagement by the trustee.

In addition to the administrative cost of managing a testamentary trust, adding one or more trusts to your will increases the complexity of the will, making it more expensive to draft and more expensive to administer. This is another consideration you may want to discuss with your attorney or professional estate planner.

Estate planning trusts: removing assets from your estate in advance

A trust is a contract you can establish with someone who will own and manage certain assets you give to the trust for the good of beneficiaries you select. We saw this above in a will, where a trustee manages the distribution of assets you place into a testamentary trust after your death.

Estate planning can include the use of many other types of trusts to remove assets from your probate estate, to avoid or reduce estate taxes, to protect assets from certain claims or to manage assets for specified purposes. Some states allow the creation of a trust orally in certain circumstances, but any planned estate should use trusts that are written by an attorney familiar with the laws of your state to reduce uncertainty and the risk of misinterpretation or challenges to the beneficiaries and trust.

The elements necessary to create a trust are simple. A "grantor" or "settler" must designate a "trustee" to manage the trust. The trustee must agree to manage the assets responsibly, following the directions laid out in the trust agreement. And the grantor must place assets into the trust for the trustee to manage. This last step is often a stumbling block: a trust cannot protect or manage assets which have never been placed into the trust. No matter how well your attorney drafts a trust to preserve your home for your spouse, if the house is never re-titled so that it is owned by the trust, the trust does not own and cannot preserve the house. Many estate plans have foundered, not on the complexities of trust law, but on the mundane paperwork of establishing new title for assets that were supposed to be placed in trust.

Revocable vs. irrevocable trusts

When you establish a trust, you may keep control of the assets in the trust and reserve the right to amend or revoke the trust agreement. This is known as a "revocable" or "living" trust. Placing assets into a revocable trust can remove them from your probate estate, so that those assets would not be subject to probate proceedings upon your death. But because you have the choice to pull the assets back out of a revocable trust, the assets are considered yours for the purposes of estate taxation and may leave them vulnerable to the claims of your creditors.

If instead you declare that you want to give up title to the assets in trust permanently and do not reserve the right to amend or revoke the trust, this creates an "irrevocable" trust. The assets no longer belong to you, so they are no longer part of your taxable estate or vulnerable to claims of your creditors. The disadvantage, of course, is that the trust really is irrevocable, and you cannot change your mind if your priorities change or if changes in tax laws make the trust less effective than originally intended.

Choice of trustee

When you establish a trust, you must name a trustee to manage its assets. For many living or revocable trusts, you may choose to name yourself as the trustee. In this case, there is little difference between managing the trust and simply caring for your own assets. You must be careful, however, to establish and maintain proper title to any property you wish to protect with the trust. For irrevocable trusts, it is necessary to appoint someone other than the grantor to administer the trust. This could be a trusted friend or relative, or a professional trust administrator. Many revocable trusts transform into irrevocable trusts at the death of the grantor and the deceased grantor is replaced with an appointed trustee to manage the trust thereafter.

Planned giving

Many people want to give back to the society or institutions that have helped them achieve success. Yet many of us are unsure how much we can afford to give without lowering our own standard of living in retirement or taking away from our loved ones. Estate planning offers numerous techniques that make significant charitable contributions possible even for families of modest means, while preserving income or assets for you and your family.

If there is a cause you have supported throughout your life, an organization that helped you at a time of need, or a foundation that promotes values you hold dear, ask your estate planning professionals how you might give back while still benefitting those you love.

Contact your Farmers® agent to discuss your options.

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