An Introduction to Basic Estate Planning

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I. Introductions and Definitions

1. What is estate planning?

a. An ongoing process for accomplishing lifetime goals and for planning for the disposition of assets at death.

b. The critical consideration is the ongoing nature of the process. It is not a one-shot deal, but changes as personal needs and objectives change and outside factors that can influence the plan (such as tax laws) change.

II. Seven Reasons to Do an Estate Plan

1. Reduce your gift and estate taxes.

a. The government taxes transfers of property both during lifetime (gift taxes) and at death (estate taxes). (We will refer to gift taxes and estate taxes collectively as transfer taxes.)

b. Under current law, as of January 1, 2004, the first $1,500,000 of assets that you give away at death are exemptfrom transfer taxes. This is known as the exclusion amount. Up to $1,000,000 of the exclusion amount may be given away instead during life, thereby reducing the amount of the exclusion available for death-time transfers. The exclusion amount (again under current law) will increase in severalsteps to $3,500,000 by 2009 and the top estate tax rates will begradually reduced from 55% to 40%. This is the result of estatetax reform legislation passed in June 2001.

c. Again, under current law the estate tax is scheduled for repeal in year 2010; however, the repeal provision "sunsets" in 2011 so, as it stands now, the estates of those dying after December 31, 2010 will again be subject to estate tax without the phased in benefits of the new law.

d. Once you exceed the exclusion amount, transfer taxes are steep and highly progressive. The next dollar above $ 1,500,000 currently would be taxed at a 37% rate and the rate rises quickly to 48% for transfers in excess of $3,000,000.

e. Everything an individual owns at death is potentially subject to estate taxes, including retirement benefits and life insurance proceeds. As a result, it is surprisingly easy to reach the $ 1,500,000 amount (even though you don't feel particularly "rich").

f. A second, additional tax, known as the generation skipping transfer tax, can apply to transfers to grandchildren or more remote generations. The GST tax is imposed at the highest marginal rate applicable to estate taxes (e.g., 48% in 2004).

2. Determine who will receive your property at death.

a. Government does estate planning for you if you don't: every state has an intestacy statute that governs the distribution of your estate if you don't have a will.

b. The statutes vary from state to state, but tend to follow what most people in a traditional family probably would do -- leave property to spouse and children.

c. A critical consideration: the intestacy statute is rigid. You cannot get around it by trying to argue in court that this is what the decedent would have done if he or she had, in fact, made out an estate plan.

3. Control the disposition of your personal remains.

Your wishes for funeral and burial arrangements can be expressed in your will (or can also be pre-arranged by contract). This can be a particularly important issue if there are differing views between family members and a non-spouse partner.

4. Select your choice for guardian for your minor children.

Although the Probate Court makes the ultimate decision with respect to appointing guardians for minor children, judges generally will give great weight to the person or persons named in the decedent's will.

5. Determine how and when your beneficiaries will receive your

property.

a. If you die intestate, all property that passes from your estate will be distributed outright to the beneficiaries, as required under the statute.

b. The only exceptions are for spouses, minor children and otherwise incompetent people (that is a legal term), for whom rigid rules exist.

c. There are multiple reasons why you may not want a person to receive property outright, including:

- Uncomfortable and/or inexperienced with handling money.
- Needs protection from creditors.
- Eligibility for government benefits may be affected

6. Satisfy charitable inclinations in a way that provides you with significant income and estate tax benefits.

This is probably beyond the scope of what we want to focus on today, other than to say that there are some significant steps you can take, both during lifetime and in your estate, involving charitable giving.

7. Peace of mind.

This is the reason that probably gets overlooked the most.

III. Basic Components of an Estate Plan: What They Are, What They Do and Why You Need Them

1. Will

a. The will is an important document because it allows you to control the disposition of your property and your remains at your death. As discussed above, without a will, the intestacy statutes apply; these statutes protect spouses and relatives of the decedent by blood or adoption.

b. In your will, you can also name the guardian of your minor children. In the end, the court will decide who would be the best guardian for the child, but the court will generally give strong preference to the person named in the will.

c. In your will, you also name the executor of your estate. The executor is the person entrusted with carrying out the wishes expressed in your will, and distributing the property as required in your will.

2. Durable General Power of Attorney

a. This document gives a person (called the "attorney in fact" or agent) the ability to handle the principal's financial affairs during his or her lifetime when he or she is incapacitated. This includes paying the person's bills and having access to the safe deposit boxes, bank accounts, etc. This is a big responsibility, as the attorney in fact can even do estate planning on behalf of the incapacitated individual, executing all documents except for a new will.

b. The power of attorney can take effect immediately upon executing the document or only upon the principal becoming incapacitated.

3. Health Care Proxy and Memorandum

a. A health care proxy is a document that allows a designated person (called the "health care agent") to make health care decisions for you if you become incapacitated and cannot make these decisions for yourself.

b. The health care proxy goes hand-in-hand with a health care memorandum or, as it is sometimes called, a "living will." The health care memorandum provides a set of guidelines for the health care agent and lets him or her know what your health care preferences are (for example, whether you want to be kept on life support if you are in a coma). This is not a legally binding document, but can be very useful in providing the agent with a set of guidelines to follow when making health care decisions for you.

4. Revocable Trust

a. A revocable trust is an instrument created during the lifetime of the creator (also known as the "donor") that names a trustee to hold and take care of your property in accordance with the terms laid out in the trust instrument. The trustee is under a fiduciary obligation to carry out the trust's terms accurately.

b. The revocable trust is an important vehicle because it can give a person, whether a spouse or a partner, the right to receive income and principal after death of first person to die, and can require that the remaining estate pass to other persons (such as nieces or nephews) whom the donor wants to benefit.

c. The revocable trust also provides creditor protection for beneficiaries, which means that the trust principal cannot be reached by the beneficiary's creditors to pay the beneficiary's debts.

d. A revocable trust can also be funded during the donor's lifetime, and used to manage the donor's financial affairs if the donor cannot or does not want to do so.

e. Revocable trusts are not probate documents. As such, assets that are in a revocable trust at the time of the decedent's death escape probate (though not estate taxes). In Massachusetts, this is not likely to have any significant financial consequences (some states have probate fees that are based on a percentage of the assets in the probate estate). The bigger considerations here is that the probate process is time consuming and public. A revocable trust affords a considerably greater measure of privacy.

V. Other Estate Planning Devices

1. Life insurance policies and trusts

a. Life insurance can be used in conjunction with irrevocable trusts to pass on assets to a specific beneficiary while maximizing estate tax savings.

b. The Donor creates an irrevocable trust for the benefit of a named person and the trust purchases a new life insurance policy on the Donor's life. The Donor makes annual gifts to the trust, which the trustee then uses to pay the insurance premiums.

c. If the Donor's powers over the life insurance policy are sufficiently restricted, the insurance proceeds will pass to the trust free of estate taxes upon the Donor's death and the money can be used to generate income for the named beneficiary (under the terms of the trust).

d. This can be a helpful method for getting life insurance proceeds to the beneficiary you want by paying minimal transfer taxes. If the trust is properly structured, your annual gifts to the trust will qualify for the annual exclusion, so that there may be no transfer tax consequences at all.

2. Nominee Trusts and QPRT's for Real Estate

a. Nominee trusts are entities that hold legal title to real estate for the benefit of one or more beneficiaries. The trust and the original schedule of beneficiaries generally are recorded at the Registry of Deeds. Subsequent transfers generally do not have to be recorded and thus can remain private.

b. Qualified personal residence trusts (or "QPRT's") are a method for transferring ownership of real estate at a discounted transfer tax cost. This is a complicated arrangement that involves transfer of ownership of the property to a trust for a certain number of years, while you retain the right to live on the property during that time period. At the end of the period, the trust beneficiaries receive the property outright. You are subject to gift taxes upon transferring the property to the trust, but the value of the transfer is less than the full value of the property because you retained the right to live on the property for the term of the trust. This is an especially helpful device for transferring ownership of a vacation home or a primary residence that you want to hand down to a partner or a lower generation.

3. GRAT's and GRIT's for income producing assets

a. The acronyms stand for grantor retained annuity trusts and grantor retained income trusts. The idea is that the Donor transfers assets to an irrevocable trust and retains the right to receive income from the trust for a period of time. The income can be either a fixed amount (GRAT) or a fixed percentage of the value of the trust (GRIT). At the end of the trust period, the trust assets are distributed to the named beneficiaries.

b. This is a helpful device for transferring financial assets at a discounted transfer tax cost. You are subject to gift taxes upon transferring assets to the trust, but the value of the transfer is less than the value of the assets because you have retained the right to receive income from the assets for the term of the trust.

c. Although there are some complications and disadvantages here (for example, the trust assets will be included in your estate if you die before the term of the trust ends), this can be especially helpful for transferring assets that you expect to appreciate substantially over the next several years, such as stock in a start-up company.

4. CRAT's and CRUT's for charitable gifts

a. The acronyms stand for charitable remainder annuity trusts and charitable remainder unitrust. The idea is that the Donor transfers assets to an irrevocable trust and receives income from the trust either for a period of time, for the Donor's lifetime or for the lifetime of the Donor and another named beneficiary (or beneficiaries). The income can be either a fixed amount (CRAT) or a fixed percentage of the value of the trust (CRUT). At the end of the trust period, the trust assets are distributed to named charitable beneficiaries.

b. The Donor receives an income tax deduction for the value of the charity's interest when the trust is funded (which will be less than the full value of the assets because of the Donor's ongoing income rights) and the value of the assets is excluded from the Donor's estate at death (unless there are other income beneficiaries before the trust property is distributed to the charitable beneficiaries).

c. The trust can sell appreciated assets that it receives from the Donor and capital gains taxes can often be deferred (or avoided altogether) on the sale.

d. There are some complications and restrictions here, as well, but this can be especially helpful for transferring low basis, low yielding stock without incurring immediate capital gains, while still receiving income for the life of yourself and satisfying charitable inclinations.

VI. Other Estate Planning Techniques

1. Gift planning

Maximizing the use of annual exclusion gifts -- either outright or in trust -- can be an effective method for reducing transfer taxes.

2. Charitable giving

Charitable gifts allow income tax deductions during life and reduce estate taxes at death. Individuals with substantial estates and high interest in charitable giving may want to consider more formal ways of pursuing charitable giving through private foundations.

3. Planning for generation skips

Properly planning the use of the GST exemption can allow you to pass greater amounts of wealth to grandchildren or more remote generations without incurring generation skipping transfer taxes.

4. Education funding

Proper planning allows you to set up vehicles for funding education for younger generations (children, grandchildren, nieces, nephews, godchildren, etc.).

5. Wealth management

Your financial assets can be professionally managed through the use of funded trusts.