INSIGHT ON

ESTATE PLANNING

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Who needs an estate plan?

Quick answer: everyone

Despite what you might think, estate planning isn't limited to only the rich and famous. In fact, your family is likely to benefit from a comprehensive plan that divides your wealth, protects your well-being and provides a compass for your family's future.

Previously, avoiding or minimizing federal estate tax liability was a primary motivation for creating an estate plan. This isn't as critical for most people now that the Tax Cuts and Jobs Act (TCJA) has doubled the federal gift and estate exemption from $5 million to $10 million, and the inflation adjusted amount for 2018 is $11.18 million. Nevertheless, reducing exposure to federal estate tax is still significant for affluent individuals, while a wider segment of the population must consider the impact of state estate taxes.

Dividing your wealth

Estate planning is often associated with the division of your assets, and this is certainly a key component. It's typically accomplished, for the most part, by drafting a will, the foundation of an estate plan.

With a valid will, you determine who gets what, where, when and how. It can cover everything from the securities in your portfolio to personal property, such as cars, artwork or other family heirlooms.

In contrast, if you die without a will — referred to as dying "intestate" — state law will control the disposition of your assets. This may result in unintended consequences. For example, children from a prior marriage may be excluded if state law dictates that all assets are to go to a surviving spouse.

Typically, it's best to rely on an attorney to draft your estate plan. In addition, you'll need to name the executor of your estate. He or she will be responsible for carrying out your wishes according to your will. Your executor may be a professional, a family member or friend. Also, designate a successor in case your first choice is unable to handle the duties.

Understanding probate

If your estate plan includes only a will, your estate will most likely have to go through probate. Probate is a court-supervised process to protect the rights of creditors and beneficiaries and to ensure the orderly and timely transfer of assets. The complexity and duration of probate depends on the size of your estate and state law.

Be aware that certain types of property aren't subject to probate or controlled by your will. For example, if you own real estate as "joint tenants with rights of survivorship" (JTWROS) with your spouse, the property automatically passes to your spouse upon your death. Frequently, a couple will own a principal residence as JTWROS.

Furthermore, if you transfer assets to a living trust, those assets are exempt from the probate process. Thus, a living trust may supplement a will, giving heirs fast access to funds.

Also, beneficiary designations made for certain assets supersede any dispositions in a will. For instance, the beneficiaries named in life insurance policies and retirement plan documents, including 401(k) plans and IRAs, will take ownership upon your death, regardless of what your will says. Review these designations as part of your estate plan.

Protecting your well-being

An estate plan can help ensure that your long-term health care is handled in the way that you wish. Notably, you can create a health care power of attorney. It grants another person, for example, a family member or friend to act on your behalf in the event you're incapacitated. A power of attorney may be coordinated with a living will specifying your wishes in end-of-life situations and other health care directives.

Providing a compass

Finally, an estate plan can accomplish a variety of other objectives, depending on your preferences and circumstances. If you have minor children, name a guardian in your will in the event of your premature death. Without such a provision, the courts will appoint a guardian, regardless of your intent.

Your estate plan can also protect against creditors, primarily through trusts designed for these purposes. Accordingly, while trusts were often seen mainly as tax-saving devices in the past, they can fulfill a multitude of other roles.

There is one last document that ties up some loose ends. Although a "letter of instructions" isn't legally binding, it can express your wishes regarding numerous matters ranging from burial arrangements to the religious upbringing of children. It may also provide an inventory of your assets and their location.

Let the planning begin

Now that the need for an estate plan is clear, don't delay any longer. Contact your attorney or estate planning advisor to begin the process or if you have any questions. And if you already have an estate plan, it's a good idea to review (and, if needed, revise) it every few years or after a major life event, such as a marriage, birth of a child or divorce.

SIDEBAR: Consider your current life circumstances

Of course, every estate plan is different. Yours should be geared to your personal situation. However, some basic principles may apply across the board, especially when your current status is taken into account.

For example, suppose you and your spouse are raising a young family. Besides naming a guardian for your children, you may acquire a life insurance policy for your family's protection. Because premium costs are based on age, among other factors, doing so can be relatively inexpensive to obtain the coverage you need.

Conversely, if you're at or nearing retirement, the need for life insurance diminishes. Instead, you may consider long-term life insurance that will absorb some of the costs if you're forced into an extended stay at a nursing home or other facility.

Smart estate planning begins with protecting your assets

It's one thing to earn enough to live a comfortable lifestyle. It's yet another to develop a plan for protecting your assets so that there is more for your heirs after your death. If you've been fortunate enough to achieve the former, there are estate planning tips to help with the latter.

Asset protection may take many forms, ranging from the simple to the sophisticated, often involving a combination of several techniques. In any event, you should begin planning now instead of leaving matters to chance.

Back to the basics

Traditionally, asset protection strategies have focused on avoiding or minimizing federal estate tax liability. Although estate taxes remain a concern for some families, most should find sufficient tax shelter under current estate tax law. However, be aware that estate taxes may still apply at the state level.

For instance, the Tax Cuts and Jobs Act (TCJA) hikes the unified gift and estate tax exemption to $10 million (subject to inflation indexing) for transfers to nonspousal beneficiaries, in addition to assets passing tax-free to a spouse under the unlimited marital deduction. The indexed exemption amount for 2018 is $11.18 million. Also, portability effectively allows couples to double this tax shelter to $22.36 million. Finally, you can still use the annual gift tax exclusion of $15,000 per recipient in 2018.

Thus, you can simply "gift" assets to your loved ones, realizing the estate tax benefits of the exemption and gift tax exclusion amounts.

For some, asset protection is as easy as that — case closed. But this simplified approach requires you to give up control of those assets during your lifetime, which might not be desirable or feasible. As a result, more complex techniques may be preferred.

A matter of trusts

Frequently, trusts are featured in an asset protection plan. The traditional bypass trust (or A-B trust), which was created mainly to avoid federal estate tax, is still a viable option. In particular, such trusts offer protection from creditors, while continuing to provide tax shelter.

A similar variation, often called a spendthrift trust, can be established for a beneficiary who isn't qualified to manage investments or might indulge in spending sprees. An independent trustee assumes the financial management responsibilities.

With a qualified terminable interest property (QTIP) trust, a grantor can provide an income stream for a surviving spouse while still determining the disposition of the trust assets when the spouse dies. This enables a surviving spouse to maintain a comparable lifestyle. A QTIP trust is often used by someone who has remarried and has children from a prior marriage. The children typically receive the assets when the trust terminates.

Another type of trust, the domestic asset protection trust (DAPT), has been growing in popularity. This is a "self-settled" trust, where the grantor personally benefits from the income. The main objectives are to provide protection from creditors and retain control over the assets. Accordingly, DAPTs may be used when there's a divorce or spendthrift concerns.

Currently, 16 states have enacted legislation authorizing DAPTs. They are: Alaska, Colorado, Delaware, Hawaii, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah and Virginia.

Finally, offshore trusts can be used to protect assets. These trusts are created in countries that are "tax havens" or have strict privacy laws. Professional guidance for these complex arrangements is recommended.

Focus on business matters

Asset protection is also vital to business owners. Depending on your situation, you might form a company as a C corporation to protect your business assets or as an S corporation providing partnership-type taxation. There are additional factors at work, so choose the business form carefully.

Another possibility is a limited liability company (LLC), which essentially combines the tax benefits of S corporations with the creditor protection of C corporations. LLCs may also offer more flexibility in management of assets. Again, all factors should be considered before you switch to LLC status.

Choosing the right asset strategy

The good news is that there are a multitude of ways to protect your assets, thus allowing you to be able to pass more on to your heirs. The key is to be proactive, not reactive. Consult with your advisor to determine which strategies work best with your estate plan.

Estate Planning Pitfall

You're not making direct payments of tuition and medical expenses

Now that the unified gift and estate tax exemption has jumped to $11.18 million in 2018, you may no longer have to worry about gift and estate taxes. On top of that, you can still use the annual gift tax exclusion of $15,000 per recipient in 2018.

In other words, you can give each recipient gifts valued up to $15,000 a year, thereby reducing the size of your taxable estate. For example, if you have three children and seven grandchildren, you can give each one $15,000, for a total of $150,000. If your spouse joins in the gifts, the tax-free total is doubled to $300,000. And, if you continue this pattern for five years, you'll have reduced your taxable estate by $1.5 million gift tax free.

But there are no guarantees that estate tax laws won't be revised in the future or that your accumulated assets won't eventually exceed the available exemption. Investigate other tax-saving possibilities.

Notably, be aware of this unique tax break: If you pay medical expenses on behalf of someone directly to a healthcare provider or pay tuition expenses of a student directly to the school, those payments are exempt from gift tax *above and beyond* any amount covered by the annual gift tax exclusion. For example, if you give your granddaughter $15,000 in 2018 and then pay her $35,000 tuition bill at an elite private college, the entire $50,000 is sheltered from gift tax. But remember that the gift must be made *directly* to the healthcare provider or educational institution. You can't use your granddaughter as a go-between.

Don't be afraid of probate

"Probate." The word itself is enough to strike fear into the hearts of elderly individuals and their loved ones. It conjures images of lengthy delays waiting for wealth to be transferred and bitter disputes among family members. Plus, probate is open to the public, so all your "dirty linen" may be aired. The reality is that probate doesn't have to be so terrible, and often isn't, but both property owners and their heirs should know what's in store.

Probate process explained

For starters, be aware that probate is predicated on state law, so the exact process varies from state-to-state. This has led to numerous misconceptions about the length of probate.

On average, the process takes no more than six to nine months, but it can run longer for complex situations in certain states. Also, some states exempt small estates or provide a simplified process for surviving spouses.

In basic terms, probate is the process of settling an estate and passing legal title of ownership of assets to heirs. If the deceased person has a valid will, probate begins when the executor named in the will presents the document in the county courthouse. If there is no will — the deceased has died "intestate" in legal parlance — the court will appoint someone to administer the estate. Thereafter, this person becomes the estate's legal representative.

With that in mind, here's how the process generally works, covering four basic steps.

First, a petition is filed with the probate court, providing notice to all the deceased heirs and beneficiaries under the will. Typically, such notice is published in a local newspaper for the general public's benefit. If someone wants to object to the petition, they can do so in court.

Second, the executor takes an inventory of the property owned by the deceased, including securities, real estate and business interests. In some states, an appraisal of value may be required. Then the executor must provide notice to all known creditors. Generally, a creditor must stake a claim within a limited period of time specified under state law.

Third, the executor determines which creditor claims are legitimate and then meets those obligations, along with paying any taxes and other debts that are owed by the estate. In some instances, state law may require the executor to sell assets to provide sufficient proceeds to settle the estate.

Fourth, ownership of assets is transferred to beneficiaries named in the will, following the waiting period allowed for creditors to file claims. If the deceased died intestate, state law governs the disposition of those assets. However, before any transfers take place, the executor must petition the court to distribute the assets as provided by will or state intestacy law.

Frequently, the will provides for the creation of a testamentary trust to benefit heirs. For instance, a trust may be established to benefit minor children who aren't yet capable of managing funds. In this case, control over the trust assets is transferred to the named trustee. Finally, the petition should include an accounting of the inventory of assets, unless this is properly waived under state law.

Planning to avoid probate

Besides certain assets that automatically are exempt from probate (see the sidebar, "What assets skip probate?" on page X), you may be able to avoid the process with advanced planning. The easiest ways to do this is through the initial form of ownership or use of a living trust.

With joint ownership with rights of survivorship, you acquire the property with another party, such as your spouse, and then the property automatically passes to the surviving joint tenant upon the death of the deceased joint tenant. This form of ownership typically is used when a married couple buys a home or other real estate. Similarly, with a tenancy by entirety, which is limited to married couples, the property goes to the surviving spouse without being probated.

A revocable living trust is often used to avoid probate and protect privacy. The assets transferred to the trust, managed by the trustee, pass to the designated beneficiaries upon your death. Thus, you may coordinate your will with a living trust, providing a quick transfer of wealth for some assets. You can act as the trustee and retain control over these assets during your lifetime.

Achieving all estate planning goals

When it comes to probate planning, discuss your options with family members to develop the best approach for your personal situation. Also, bear in mind that avoiding probate should be only one goal of your estate plan. Your estate planning advisor can help you develop a strategy that minimizes probate while reducing taxes and achieving your other goals.

SIDEBAR: What assets skip probate?

Your will controls the disposition of most assets you own, but not all assets have to go through probate. A few notable exceptions include funds in a qualified retirement plan, such as a 401(k) plan, or traditional and Roth IRAs. These pass to beneficiaries listed in the plan or IRA documents. Similarly, life insurance proceeds go to beneficiaries named in the proper forms (unless the estate is named). These designations supersede any provisions in a will.

Other property in a payable-on-death (POD) form — such as certain securities, bank accounts and U.S. Savings Bonds — automatically pass to beneficiaries without going through probate.