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Estate Planning — What Is It? What Can It Do?

INTRODUCTION TO ESTATE PLANNING

Many people believe that estate planning is putting paperwork in place to determine how assets are divided at their death. Estate planning is much more than that. Estate planning is the accumulation, management, and ultimately the disposition of assets to the next generation. Estate planning is not just planning for your demise, but rather planning for the accumulation of wealth during your life, how you manage that wealth and grow your estate, and how you create a legacy and benefit future generations, institutions, or both. Your estate plan should be a living plan that adapts to changes as you move through various phases of your life. The best estate plans come together when a team of advisors — typically consisting of your financial advisor, accountant, attorney, and insurance advisor — work together to bring their expertise to the table.

A skilled estate planning attorney will have an understanding of all of the pieces and will work with your other advisors to craft a customized plan not only for the disposition of your assets upon your death, but also in a way that allows you to efficiently grow your assets and utilize them during your life.

Different clients require different levels of planning and sophistication from not only the legal documentation perspective, but also the engagement of other advisors. Typically, the amount of wealth someone has accumulated will drive the sophistication as well as the complexity of the planning, though that is not always the case. Sometimes family assets and businesses may create complexities and opportunities in the planning. Other times a business start-up in a high growth area may affect the planning, or one's occupation in a high liability occupation may dictate the need for asset protection.

BASIC ESTATE PLANNING (without legal fees)

Estate planning could be as simple as properly titling accounts, titles, and deeds, along with designating beneficiaries on insurance policies and retirement accounts. Keeping assets in retirement accounts and life insurance policies, as well as carrying suitable amounts of insurance, can be effective forms of asset protection. For some individuals and families, these techniques may be perfectly advisable, as they are the simplest form of what is traditionally thought of as estate and asset protection planning.

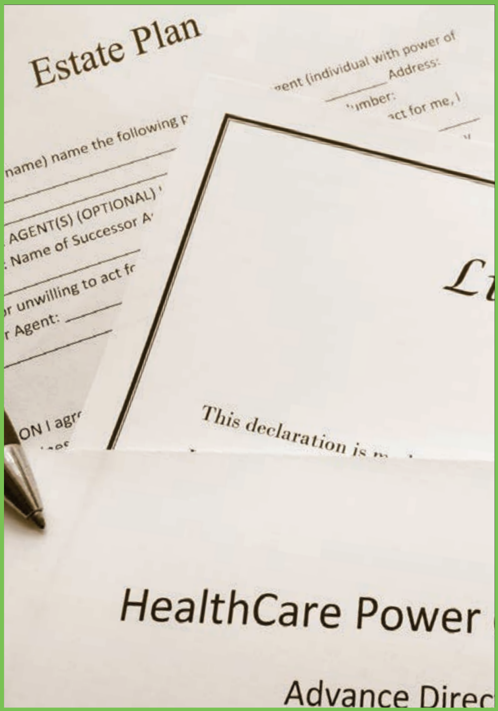
TESTAMENTARY PLANNING

The next level of planning would be testamentary planning, which utilizes a will or a revocable trust. The same opportunities are available through will-based estate documents as are available through revocable-trust-based documents; however, a revocable trust structure is superior because it allows for seamless management of assets during the settlor's incapacity and avoids probate, offering a more simplistic estate settlement process with lower expenses and provides privacy for both the decedent and beneficiaries. All revocable-trust-based plans should include a will that pours over assets titled in the decedent's individual name at death into the revocable trust through the probate process. If the decedent has any minor children, a will would designate the guardian for those children until they reach the age of majority.

The reason that the above documents are so important is that they deal with incapacity of the grantor of those powers. A financial power of attorney allows for the agent to handle the financial and administrative affairs of an individual in the event that they are unable to do so themselves. A healthcare power of attorney grants the agent the power to make healthcare decisions when an individual is incapacitated. Finally, a living will allows an individual to make decisions about their care in the event that they become incapacitated, should they not wish to be artificially kept alive when there is no real chance of recovery.

Other legal documents that should be considered even with the most simple estate planning techniques are:

- Financial Power of Attorney
- Healthcare Power of Attorney
- Living Will



IRREVOCABLE TRUST PLANNING

Raising the level of complexity further would be engaging in inter vivos planning. This type of planning involves taking action during life, typically through the use of irrevocable trusts and other entities. An irrevocable trust is not just an irrevocable trust. Irrevocable trusts come in many different forms to achieve different purposes.

Some of the most common inter vivos planning strategies are the use of irrevocable trusts to take advantage of the annual gift tax exemption, where a grantor can contribute up to the annual gift tax exemption amount into a trust based on the number of beneficiaries of the trust. After giving the beneficiary the right to withdraw the money for a period of time, that right of withdrawal lapses, and the gift can then grow outside of the estate of the grantor.

A similarly structured trust that utilizes the annual gift tax exemption is an irrevocable life insurance trust (ILIT) to purchase life insurance. In this case, the grantor would make annual gifts to the trust, give the beneficiaries the right to withdraw the funds, and after the right to withdraw the funds lapses, the trustee can pay life insurance premiums. This is a common method of funding an estate to pay estate and inheritance taxes or increasing the amount of assets passed on in a way that is not includable in the taxable estate of the decedent.

Individuals and married couples with assets near or above the lifetime gift and estate tax exemption (currently $11.7 individual / $23.4 million married couple) may wish to utilize lifetime taxable gift tax exemption to "freeze" the value of their estate by making a gift to a trust or multiple trusts. Once the gift is made, any future growth on those assets is out of the grantor's estate and protected from their creditors if structured properly. These trusts can be combined with entities to provide greater influence over the management of the trust assets to the grantor while discounting the fair market value of the gift. Care must be exercised over the use and ongoing operation of these structures to avoid giving the grantor too much control over the trust assets, which would pull them back into the estate. For individuals and married couples that have used up their lifetime gift tax exemption, installment sales and sales to trust in exchange for notes or annuities are also effective ways to get future appreciation out of their taxable estate.

One form of irrevocable trust that uses lifetime gift tax exemption that is very popular is a Spousal Lifetime Access Trust (SLAT). With a SLAT, one spouse makes a gift using some or all of his or her lifetime gift tax exemption to a trust for the benefit of his or her spouse. Since one spouse is a beneficiary of the trust, the assets can be used for both spouses while the beneficiary spouse is living and the couple is still married. There are some risks involved with this technique, but they can be mitigated with proper planning.

ASSET PROTECTION

Another reason for forming a trust is to protect assets from creditors. There are a number of ways to do this, including setting up a trust for the benefit of someone else, which is the most effective form of asset protection. A SLAT is one of the best ways to protect assets for married couples. There are also asset protection trusts that can be offshore trusts or domestic asset protection trusts (DAPTs) domiciled in states with asset protection trust statutes. DAPTs work well when the grantor of the trust lives in an asset protection trust state and domiciles the trust in that state. DAPTs have been defeated where the grantor lived in a non-asset protection state. A DAPT can be a complete gift, which means the assets and appreciation are out of the grantor's estate, or an incomplete gift, where the assets of the trust are includable in the grantor's estate. The grantor places assets into the trust and leaves distributions to the discretion of an independent trustee, typically a trust company. The grantor retains the ability to replace the trustee and to retain influence over the trustee, but, by giving up control of the assets, removes them from his or her estate.

SUPPLEMENTAL NEEDS TRUSTS

Another form of an asset protection trust is a special or supplemental needs trust (SNT). A SNT is set up for an individual with disabilities to provide for supplemental needs, but not essential needs that would otherwise be provided by social programs or the government. This type of trust allows an individual with disabilities to qualify for SSDI, Medicaid, and other programs that require that someone qualifies for those, because the assets of the trust are not seen as an available asset of the beneficiary. A SNT can pay for entertainment and socialization and improve the standard of living of the beneficiary, but the assets are protected from being depleted for care that is otherwise provided by government programs.

TAX PLANNING

A common belief is that the only tax planning that is done with trusts is for estate and inheritance tax planning. Trusts can be used for income shifting, to move income from the parents (typically in a higher tax bracket) to their children (typically in a lower tax bracket) to reduce overall taxes for the family. Another form of income shifting is to domicile a trust in a low- or no-tax state by naming a trustee in that state and funding the trust with income-producing investments. By doing so, the grantor or beneficiary in many states, but not Pennsylvania, can avoid the state income tax on those passive investments by domiciling the trust in Nevada for example. Another use of trusts is to create separate taxpayers to take advantage of having some tax that would otherwise be paid by the grantor at the highest marginal tax bracket paid by a trust or trust beneficiary at a lower tax rate, or to take advantage of certain tax exemptions that may be limited to a certain amount per taxpayer. One such exemption comes into play for founders of and early investors in companies organized as C Corporations. Section 1202 exempts up to $10 million of capital gain per taxpayer per company for holders of Qualified Small Business Stock (QSBS). The company has to meet certain requirements to obtain QSBS status, and the stock must be original issue, meaning that it cannot have been sold or contributed to another entity after original issue. However, through gifts to trusts, a grantor can create additional taxpayers to “stack” or multiply the QSBS exemption. This is a situation where the trusts would be structured to not be taxable back to the grantor, and instead the additional taxpayers would pay their own taxes. A married taxpayer with three children filing jointly, using three irrevocable trusts could potentially exclude $80 million of capital gains in a single company from taxation under Section 1202.

PLANNING FOR RETIREMENT ASSETS

Traditionally, IRAs would not be paid into trusts for tax reasons that we will get into in the next section. In 2014, the U.S. Supreme Court ruled that inherited IRAs for non-spouses were not retirement assets and were therefore available to creditors. This led to planners and clients scrambling to protect large inherited IRA balances for their children. By naming a properly structured trust as the beneficiary of the IRA, the balance of the IRA would be protected from creditors, and, each year, the required minimum distribution would be paid out to the beneficiary. At the end of 2019, the SECURE Act was passed, which eliminated a lifetime stretch out for distributions from inherited IRAs and required that the entire balance of the IRA be paid out within 10 years of the decedent's death. Planners and clients were once again forced to adapt. Common practice for large IRA balances is now to designate a trust that can accumulate distributions from the IRA inside of it, as opposed to just passing them along to the beneficiary where a creditor could take them. It's better to pay a higher tax rate on the money and have the government take 37% of the distribution at the highest bracket versus having a creditor take 100% of the distribution.

TAXATION OF TRUSTS

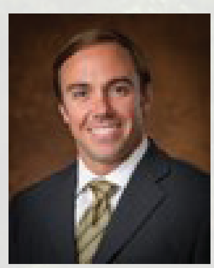
Trusts can be their own taxpayer or the grantor, or in some cases, the beneficiary can be the taxpayer. Trusts that are taxable back to the grantor are called "Defective Trusts." This does not mean that there is something wrong with them. In many cases, they are intentionally designed to be defective. Revocable trusts are always taxable back to the grantor, and the assets, for all practical purposes, are treated as if they are owned by the grantor. When the grantor of a revocable trust dies, the trust becomes irrevocable, and it also becomes its own taxpayer.

Trusts pay taxes at compressed tax brackets, meaning that they hit the top marginal tax bracket at much lower income amounts than individuals and married couples. Income that is distributed out to the beneficiary can be taxed to the beneficiary at their individual rates, so there are a number of benefits to properly planning the investment and distribution strategies when dealing with trusts.

In many cases, clients creating and funding irrevocable trusts during their lives will want the trust to be defective. A defective trust allows transactions such as sales or exchanges between the grantor and the trust to be disregarded for tax purposes. Defective trusts also have the grantor pay the tax liability of the trust at the grantor's tax bracket. For very wealthy individuals, the tax bracket may be the same as what the trust would pay, but, by having the grantor pay the tax out of their personal assets, they are "burning" off their taxable estate, while allowing the trust to grow without the hindrance of the trust having to pay tax on income and realized gains.

SUMMARY

Estate planning, when done correctly, is not just the creation of documents that dictate what happens to our assets when we die. Instead, estate planning is a multidisciplinary activity that can require a variety of advisors working as a team to achieve their mutual client's goals. It is an ongoing process in which different advisors have varying roles at different parts of the lifecycle of the plan. There are many tools, some of which are described above, that can be employed to help a client optimize their wealth accumulation, management, and disposition.



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Estate Design

Final Thoughts

Learn more about the importance of effective estate planning. Contact our team of financial advisors to help create a tailored-to-you plan that evolves and adapts as your life changes.

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