Estate Planning 101

Estate planning is a commonly used term for the process by which you are able to (1) direct who will receive your property when you die; (2) select who will oversee the distribution of your property; (3) allow your property to be distributed to your intended beneficiaries in a time and cost efficient manner; and (4) in some circumstances, save taxes.

If you do not undertake any estate planning, the law of the state where you live will do it for you. Your property will be distributed to your "heirs at law" - usually your surviving spouse and children, if any, and if none, then your parents, siblings, and so on. Your assets will be distributed outright, and the Probate Court will appoint someone to oversee the distribution process. That person, called an "Administrator", has very limited powers and often must return to Court for authorization to take many relatively routine actions, for example, to sell a house. This process can be quite cumbersome, expensive and time-consuming.

Alternatively, you can take control of the process. Let's start with how you direct who will receive your property when you die. The most common way to do this is with a Will. Anyone over age 18 and of "sound mind" can make a Will. There are certain formalities associated with making a valid Will, which vary from state to state. In your Will, you can name any individuals you choose (related or not), charities, even pets, as beneficiaries of your assets. The only person who has a right to any portion of your property is a surviving spouse; the amount to which a spouse is entitled (the spousal "right of election") varies from state to state.

In addition to a Will, you can control who receives your property through a variety of other means, such as joint ownership (the surviving owner receives the asset), beneficiary designation (for example, with a retirement account or a life insurance policy), or a "transfer on death" account. Often, a combination of these approaches is used.

In your Will, you may also designate the person or institution whom you wish to oversee the distribution of your property. This person, called an "Executor" in many states, is appointed by the Court at the time your Will is admitted to probate. In essence, your Executor steps into your shoes and has the same ability to manage your property after your death as you had during lifetime. The Executor identifies everything you own, determines each asset's value as of the date of your death, pays your outstanding bills, wraps up business matters, files your tax returns, and is responsible for safeguarding the estate's property until it is distributed to your beneficiaries. Once these matters are settled, the Executor distributes the remaining property according to the terms of your Will.

If you have a Will, you may direct that your property either be distributed outright to your beneficiaries, or to a trust for their benefit. An outright distribution goes into the beneficiary's pocket, to be spent, saved, or invested however the beneficiary chooses. A distribution in trust goes to a Trustee, who is legally obligated to manage the property according to the terms of the trust (which may be included in the Will, or in a separate trust document) and in the best interests of the beneficiary.

Why leave property in trust? The most common reason is the age of the beneficiary. Until the beneficiary reaches the age that you select - at least 18, which is the legal age of majority, but generally a much later age - the property is protected by the Trustee from unwise dissipation or mismanagement. Other reasons to create a trust are the beneficiary's lack of ability, interest or time to manage the property by himself or herself, to provide protection from the beneficiary's creditors (including divorcing spouses), and in some cases, to take advantage of estate tax savings.

And so to the matter of taxes…The federal government and many state governments impose an estate tax based on the value of all of the property that makes up your "taxable estate." Your taxable estate includes everything you own, alone or with another person, on your date of death. It may also include property over which you can exercise some form of control; anything you once owned but can still use whenever you like; and in some cases, gifts you made close to your date of death. The good news is that both federal and state law allow an estate and gift tax exemption to every individual; property up to the exemption amount is not subject to tax. As a result of 2017 legislation, for 2018 through 2025, the federal estate and gift tax exemption amount is $10,000,000, and is indexed for inflation. The exemption (as indexed) is **$11,400,000 for 2019** and will be adjusted for inflation each year thereafter through 2025. The increase in the federal estate tax exemption is scheduled to "sunset" after 2025 and revert to the pre-2018 exemption of $5,000,000 (which was $5,490,000 in 2017 as adjusted for inflation). The Connecticut estate and gift tax exemption is **$3,600,000 for 2019**; $5,100,000 for 2020; $7,100,000 for 2021; $9,100,000 for 2022, and will match the then federal exemption in 2023, absent a change in the law.

In addition to the exemption amounts, estate and gift taxes may be controlled through the use of various deductions. The "marital deduction" is perhaps most common. Any amount of property transferring to or passing to a surviving spouse outright, or to a trust for the surviving spouse's sole benefit, is not subject to tax at the first spouse's death -- but any unused property (along with the surviving spouse's own property) is subject to tax at the surviving spouse's death. Any amount passing to charity is also deductible from the taxable estate. After all deductions are taken, and the available estate tax exemptions are applied, the remainder of the taxable estate will be subject to tax. The current federal estate tax rate is 40%; the Connecticut rate starts at 7.2% and tops out at 12%.

Many people are not aware of an additional federal tax, the "generation-skipping transfer tax" or GST tax. This tax applies to outright transfers to beneficiaries who are two or more generations younger than the transferor, or, with respect to unrelated beneficiaries, to those that are more than 37 1/2 years younger than the transferor. The GST tax also applies to distributions from trusts for their benefit. As with the estate and gift tax, federal law allows each individual an exemption from the GST tax. Currently, that exemption is the same as the federal estate and gift tax exemption.

Finally, certain assets may also be subject to income tax at your death. Deferred compensation, annuities, and retirement accounts may fall into this category. On the bright side, the capital gain tax on appreciated assets that you own as of your date of death vanishes; the assets receive a new "stepped up" basis equal to their date of death value.

In summary, estate planning involves making decisions about whom you wish to receive your assets when you die; selecting the individuals or institutions to carry out your wishes; reviewing what you own and understanding how it will pass at your death; and working with your lawyer to assure an optimal tax result. Most estate planning documents are revocable, meaning you can change their provisions as time goes on and circumstances change, which they inevitably will. The one thing you cannot do is create them after you are gone.