WEALTH SOLUTIONS GROUP

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Private Wealth Management

Preserving Family Wealth

An Overview of Estate and Wealth Transfer Planning

Summarizes the basic components of an estate plan (e.g., Wills, trusts, powers of attorney) and other important planning steps. Gives a brief overview of various techniques used to transfer wealth to family and charity in a tax-efficient manner.

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Comprehensive estate planning coordinates the accumulation, conservation, and ultimate distribution of your estate in a manner that achieves your personal goals and objectives. A good estate plan also mitigates the impact of federal and state taxes that can diminish the amount of wealth available for distribution to your family upon your death. Developing an effective estate plan typically begins with consideration of the following questions.

- Has your existing estate plan been reviewed recently to ensure it continues to meet all of your personal goals and objectives?
- Is your plan structured in a way that minimizes taxes, expenses, and the publicity involved in a probate proceeding?
- Are your heirs mature and responsible enough to receive an inheritance outright, or would leaving assets to them in trust provide you with the peace of mind that the inherited assets will be protected from creditors, predators, or a failed marriage?
- Is the current titling of your assets consistent with your overall estate plan?
- Do assets automatically transfer outright to your surviving spouse outright upon your death, or are they held in trust for your surviving spouse's benefit for his or her remaining lifetime before passing to your children upon the surviving spouse's death?
- Do you have appropriate beneficiary designations on your qualified retirement assets, life insurance policies, and annuities?
- Would you consider transferring a portion of your estate as lifetime gifts to your children or grandchildren if doing so would reduce your overall transfer taxes?

ESTATE PLANNING DOCUMENTS

Depending on your individual circumstances, your estate may include some or all of the following estate planning documents:

Last Will and Testament

A Will is the legal expression or declaration that directs the disposition of a decedent's property at death. If it is necessary to use your Will at your death, the personal representative or executor you appoint will open a probate proceeding in your local county court. Under court supervision, your personal representative or executor will pay your final debts, expenses, and taxes, before distributing the remaining assets in your estate to beneficiaries according to your intent and instructions.

Revocable Trust

A revocable trust is an entity you create to consolidate the ownership of your assets during your lifetime, while also controlling the distribution of those assets upon your death. The advantage of creating and funding a revocable trust with your securities and other property is that your family will avoid the expense, delay, and publicity of a probate proceeding. Keep in mind that assets not owned in trust may be subject to probate. A revocable trust also provides incapacity planning by appointing a successor trustee to manage the trust assets for your benefit if you were to become temporarily or permanently incapacitated.

The benefits of using a revocable trust as the centerpiece of a comprehensive estate plan (along with a "pour over" Will to complement the trust) include the following:

- *Avoid expense of probate*. Probate expenses may exceed 2% of the value of all assets included in the probate estate. This expense can be avoided if your assets are transferred to a revocable trust during your lifetime.
- *Preserve financial privacy*. Probate files are public records, meaning anyone who might be interested can access your financial and other estate information, including the names of your heirs and the value of their inheritance.
- *Incapacity planning*. A revocable trust provides continuity of asset management by appointing a spouse, an adult child, or in some cases, a corporate entity, as successor trustee to take over management of the trust assets when the owner faces declining health or diminished capacity.
- *Immediate access to trust assets*. Probate proceedings often tie up estate assets for months or even years after a death. Trust assets are immediately available to the successor trustee to pay funeral expenses and to meet the financial needs of a spouse or children.

Durable Power of Attorney

A power of attorney (POA) for legal and financial matters authorizes your attorney-in-fact (your "agent") to make legal and financial decisions on your behalf in the event you become incapacitated. A power of attorney that is "durable" (DPOA) indicates that the authorized power does not automatically terminate if you become disabled or incapacitated. A "springing" power becomes effective only if upon disability or incapacity.

Even if you have created and funded a revocable trust, it is important to have a DPOA to allow your attorney-in-fact to sign your tax returns, apply for tax refunds, settle tax controversies, apply for Social Security, apply for insurance benefits, etc.

Advanced Health Care Directives

Health care documents are also extremely important to help avoid confusion and emotional distress for your family members if you become seriously ill or incapacitated. Your health care documents should include:

- *Durable Power of Attorney for Health Care.* This document appoints a trusted person to act as your agent or proxy to make health care decisions for you if you are seriously ill or incapacitated. Your health care agent may approve medical care and treatment you might need if you are incapacitated and not able to make such decisions on your own behalf.
- *Living Will.* A living will is your personal declaration to physicians and other health care providers about your preferences regarding the use of extraordinary medical procedures if you become terminally ill or permanently incapacitated.
- *Federal Medical Privacy Act Considerations.* A form complying with the Health Insurance Portability and Accountability Act (HIPAA) authorizes the release of your medical information to third parties. A HIPAA agreement gives family members access to your medical records and allows them to discuss your condition with health care providers.

OTHER PLANNING CONSIDERATIONS

When you meet with your attorney to prepare an estate plan, there are other considerations that might make your estate plan even more effective:

- *Asset Titling*. How your assets are titled is another important aspect of estate planning. If you have created a revocable living trust, you should register your investments in the trust and re-title other property in the name of the trust to avoid the probate process.
- *Alternate Fiduciary Designations*. You should appoint one or more alternates to the role of successor trustee in your trust agreement. Naming alternates ensures that someone you trust can take over a role that could be left vacant due to the resignation, incapacity, or death of your first appointee.
- *Beneficiary Designations*. You should coordinate beneficiary designations on all of your qualified retirement accounts, insurance policies, and annuities with the dispositive provisions in your will and trust.
- *Personal Property List*. You can prepare a list of all of your possessions and tangible personal property. The list can address special gifts or distributions you wish to make to beneficiaries and designate how you want the remainder of your personal property to be administered.
- *Funeral Instructions*. Many people choose to plan and prepay their funerals during their life. It may also be a good idea to prepare funeral instructions to guide your family in their time of grief.

WEALTH TRANSFER PLANNING

The Tax Cuts and Jobs Act of 2017 increased the federal estate tax exemption from $5,600,000 to $11,180,000 per person for 2018. For 2023, the exemption has been increased to $12,920,000; this amount will continue to be adjusted for inflation each year. However, the increase is due to expire after 2025, and the amount will revert to pre-2018 levels (indexed for inflation). Nevertheless, mitigating the impact of state and federal estate taxes may still be an important part of your overall estate plan. By minimizing the amount of estate tax incurred at your death, you can maximize the legacy that will pass to your heirs and survivors. Some of the basic strategies that can be used to transfer wealth in a tax-efficient manner include:

Credit Shelter Planning for Married Couples

One of the first principles of wealth transfer planning for married couples is ensuring that both spouses will fully utilize their respective federal estate tax exemptions (also known as the "exemption equivalent amount"). With proper planning, a married couple can shelter more than $25,840,000 from federal estate taxes using testamentary irrevocable trusts commonly known as a Credit Shelter Trust, a Family Trust, or a By-Pass Trust. Generally, the surviving spouse is entitled to receive income and principle from the trust during his/her remaining lifetime, after which, the remaining trust assets pass to the couple's children or other named beneficiaries.

Under estate tax rules made permanent under the American Taxpayer Relief Act of 2012, funding a credit shelter trust may no longer be necessary to reduce estate taxes for married couples because the federal exemption is now "portable" between spouses. The portability of the federal exemption allows any unused exemption at the death of the first spouse to be transferred to his/her surviving spouse. However, you should consider the advantages and disadvantages of relying on portability before deciding whether you need credit shelter provisions in your will or trust. Many married couples still structure credit shelter planning into their estate plan to achieve non-tax objectives, such as protecting the estate from creditors and predators.

Lifetime Gifting

Making gifts to loved ones during your lifetime can be a rewarding experience and may also reduce estate taxes at your death. Some of the following gifting techniques are easy to implement, while others are highly complex and require the assistance of an experienced attorney who specializes in estate planning.

- *Annual Exclusion Gifts*. The annual gift tax exclusion allows you to make gifts each year of up to $17,000, or a combined $34,000 by married couples, without incurring gift tax. You can make tax-free gifts in these amounts to as many people as you wish in each calendar year. These tax-free gifts can be made to your children, your grandchildren, to the spouse of your children and grandchildren, and to any other individuals you choose. Importantly, if you are reluctant to make outright gifts to younger children or grandchildren, or to older beneficiaries with spendthrift issues, you can make gifts to an irrevocable trust that is controlled by a designated trustee. In some cases, you may choose to allow the trust beneficiary to gain greater access to the trust assets at a designated age, or upon fulfilling specific objectives, such as completing a college education. By keeping assets in trust for beneficiaries, you may also provide some protection from potential creditors, or from a property settlement in the event the beneficiary experiences a failed marriage.
- *529 College Savings Plans*.[1] You can begin an annual gifting program for younger children and grandchildren using a 529 College Savings Plan. The earnings in a 529 Plan will not be subject to income tax if distributions are used for "qualified higher educational purposes." You can combine 5 years of annual exclusions and make a one-time gift of $85,000 to a 529 Plan for one or more individuals. After five years have passed, you can make additional annual exclusion gifts to those individuals. You must survive the entire 5-year period, or a portion of the original $85,000 gift may be brought back into your taxable estate. You may retain control over the assets in the plan and can change the beneficiary to related parties at any time. You may even distribute the 529 funds to yourself in the future, if needed, however, you would pay income tax, and a 10%penalty, on any accrued income in the plan.
- *Lifetime Gifts of Applicable Exclusion Amount*. In addition to the ability to make annual gifts of $17,000, you may also make cumulative tax-free gifts of up to $12,920,000 by using the applicable exclusion amount during your lifetime. If you make such gifts, not only will the gifted assets be permanently removed from your taxable estate, but all future appreciation on the gifted assets will also be excluded from your estate. All gifts above the $16,000 annual exclusion amount should be reported on a U.S. Gift Tax Return (Form 709).

<u>*Life Insurance Planning*</u>

Favorable income and estate tax treatment may make life insurance an effective means to provide liquidity to pay estate taxes, or to increase an inheritance. Life insurance proceeds are fully exempt from federal (and most state) income tax. Insurance proceeds payable to beneficiaries (other than the insured's estate) are also fully exempt from federal estate tax if the insured does not own or control the policy at the time of death, or has transferred ownership in the policy more than three years prior to death. Owning insurance in an irrevocable life insurance trust may be an effective way to keep the insurance proceeds out of the insured's taxable estate.

- *Irrevocable Life Insurance Trust ("ILIT")*. An ILIT is an insurance trust that owns one or more insurance policies on an individual or married couple. Life insurance owned by the trustee of an ILIT is not considered to be part of the insured's taxable estate as long as the insured did not own any "incidents of ownership" in the insurance policy at death. "Incidents of ownership" that might cause the insurance proceeds to be part of the insured's estate include: the power to change beneficiaries, the power to surrender or cancel the policy, the power to pledge the policy for a loan, etc. The best way to avoid the "incidents of ownership" test is to have a third-party trustee purchase the insurance policy on behalf of the ILIT. Proceeds of an existing insurance policy transferred to an ILIT will be excluded from the insured's taxable estate if the insured does not die

[1] *Investors should consider the investment objectives, risks, charges and expenses associated with a 529 Plan before investing. This and other information is available in a Plan's official statement. The official statement should be read carefully before investing. Depending on your state of residence, there may be an in-state plan that provides tax and other benefits such as financial aid, scholarships and creditor protection that are not available through an out-of-state plan. Before investing in any state's 529 plan, you should consult your tax advisor.*

within three years of transferring the policy. Note, however, that the transfer of an existing insurance policy to an ILIT may have gift tax implications.

- *The "Crummey" Trust—Qualifying Premiums for the Annual Gift Tax Exclusion.* An insured person who pays the premiums on an insurance policy owned by an ILIT will be making an indirect gift to the trust beneficiaries. In order for a gift to qualify for the annual gift tax exclusion, the gifted property must be a "present interest." The premium payments will satisfy the "present interest" test if the trust agreement contains special language, commonly known as a "Crummey" provision (named after a taxpayer in a U.S. Tax Court case). The Crummey provision directs the trustee to give notice to all trust beneficiaries that a gift has made to the trust and is available for distribution to them upon request. This "withdrawal right" satisfies the "present interest" test and qualifies that transfer for the annual gift exclusion. If the beneficiary does not exercise the withdrawal right, the funds become a permanent part of the trust and may be used by the trustee to pay the insurance premiums. Notification to a minor beneficiary may be given to the beneficiary's parent or legal guardian.

Valuation Discounts

A valuation discount may be available if the transferred property is "non-marketable" and represents a "non-controlling" interest in a privately-owned business. These two factors support the use of valuation discounts when valuing the transferred property for purposes of gift or estate taxes. Discounting the value of property may allow you to leverage the amount you can transfer to your heirs during your lifetime or at death without incurring gift or estate taxes. If you make transfers of one of the several types of property that can be discounted for gift and estate tax purposes, you should work closely with your attorney and accountant to ensure that a qualified valuation expert prepares all valuation opinions.

- *Closely Held Corporations.* An ownership interest in a closely-held company may be discounted for transfer tax purposes. Gifts of discounted closely-held stock may be transferred to qualify for the $17,000 per annual gift tax exclusion, or some or all of the current $12,920,000 lifetime exemption may be used to make gifts of closely-held stock in amounts above the annual gift exclusion limit. Courts have allowed valuation discounts of 30% and higher for transfers of stock in a closely-held business.
- *Family Limited Partnerships ("FLPs") and Limited Liability Companies ("LLCs").* An ownership interest in FLPs and LLCs can also be transferred at a discounted value, however, these entities have a greater likelihood of being audited by the IRS. Entities funded with commercial or undeveloped real estate will have a better chance of withstanding heightened IRS scrutiny than an entity funded exclusively with marketable securities.
- *Fractional Interests in Real Property.* A fractional interest discount is a recognition that an owner of less than 100% of an asset does not have the unrestricted right to decide how to manage the asset, or when it should be sold. Courts have allowed fractional interest discounts of 15% and higher for an undivided fractional interest in real property.

Qualified Personal Residence Trust (QPRT)

Another technique that may be used to reduce the size of your taxable estate is a Qualified Personal Residence Trust (QPRT). With a QPRT, you make a gift of a future interest in your residence or vacation home to your children at a discounted value. The trust language establishes the period of years during which you would continue to treat the property as your own before it becomes the property of your children. By delaying the gift for the stated term of years, you are able to discount the gift to the present value of what the property will be worth at the designated future date when the property is transferred to your children. You may be able to continue living on the property after the ownership of the real estate passes to your children, but you would be required lease the property and make regular rent payments to your children. Although this concept might seem counter-intuitive, the rent payments to your children would further reduce the size of your taxable estate over time. The downside of a QPRT is the loss of a stepped-up basis for the property that would be available if the property is owned at death. For this reason, you might prefer to fund a QPRT with vacation property, such as a cottage or condominium, that family-members are more likely to keep and use after your death.

Grantor Retained Annuity Trust (GRAT)

A GRAT is a special trust incorporating a retained annuity payable to you for a period of years, and a remainder interest that is gifted to your designated beneficiaries. The value of the gift is the present value of the remainder interest calculated using a predetermined interest rate. The interest rate used to determine the remainder value of a GRAT is the Applicable Federal Rate (AFR), published monthly by the IRS. (The current AFR rate is near a historic low). The actual value of the remainder interest that will pass to your beneficiaries will depend on the how well the trust assets appreciate during the term of the annuity. If the trust assets "out-perform" the AFR rate, all appreciation above that rate will pass to the remainder beneficiaries free of gift tax. If the trust assets under-perform the AFR rate, the grantor will receive all of the transferred assets back in the form of annuity payments.

Generation Skipping Trusts

The federal estate tax law is structured so that all estates above a certain threshold amount will be taxed when wealth passes from one generation to the next. To prevent families from avoiding the estate tax by establishing trusts for grandchildren that "skip" a generation, Congress added a second layer of tax for any transfer by one generation to a "skipped" generation, such as a gift to a grandchild. This second layer of tax for transfers that skip a generation is aptly named the Generation Skipping Transfer ("GST") Tax. However, a GST "exemption" in the amount of $12,920,000 allows a limited amount of gifts to skip a generation without the triggering the additional 40% GST tax. GST gifts are generally made using a Generation Skipping Trust because of the flexibility it provides. GST exemption may be allocated to transfers made during your lifetime, or at death.

Dynasty Trusts

The Generation Skipping Trust may be extended in perpetuity in many states using a "Dynasty Trust." With a dynasty trust, you could endow future generations for educational or other purposes without estate taxes being incurred on the trust assets at any generation. If the assets of the trust are invested carefully, and if only the income is used for distributions to beneficiaries, this trust may have the potential for exceptional growth over a long time-frame. Some families establish a dynasty trust that spins off excess principal every few years to fund a charitable family foundation. In this way, the legacy provides for their progeny, as well as the assisting with the needs of others in society. A generation skipping dynasty trust is typically established using the laws of a state that has eliminated the "Rule-Against-Perpetuities," which may limit the duration of the trust. Some states have no Rule-Against-Perpetuities, other states allow trusts to continue for as long as 1,000 years. You may also select a state that has no state income tax on trust earnings to eliminate tax on any income that remains undistributed each year.

CHARITABLE GIVING AND PLANNING FOR YOUR LEGACY

If there are charitable organizations that you would like to support, charitable giving might be a good way for you to use some of your "social capital." A general principle of tax planning is that individuals who make lifetime charitable gifts receive a double tax benefit -- donors receive an income tax charitable deduction at the time of the gift, and, in effect, an estate tax charitable deduction because the donated property has been removed from the donor's estate. If you are charitably-inclined, several types of charitable trusts might be considered.

Charitable Remainder Trusts ("CRT")

In its simplest form, a CRT provides an income stream to the donor, a current income tax deduction, and a remainder gift to one or more qualified charitable organizations. The donor transfers property to a trust, naming one or more non-charitable beneficiaries (typically the donor) to receive an income stream from the trust. A CRT is required to make payments of at least 5% of the trust property to the income beneficiary, payable at least annually. At the end of the trust term, the balance of the trust assets passes to qualified charitable organizations. The term of the trust can be for the lives of the income beneficiaries, or for a fixed term of no more than 20 years. As a result, the donor receives a current charitable income tax deduction for the present value of the remainder interest that will eventually pass to the charitable organization. At the end of the specified term, or when the donor dies, the trust terminates and the remaining trust assets pass directly to designated charitable organizations.

- *CRT Combined with Life Insurance*. When a CRT is combined with the purchase of life insurance, the benefits of the CRT strategy can often be leveraged to an even greater degree. This more advanced technique involves two additional features: (1) the donor uses the income stream from the CRT to purchase life insurance on his/her life, and (2) the life insurance policy is owned inside an Irrevocable Life Insurance Trust (ILIT). By using the stream of income from the CRT to purchase life insurance on the donor's life, the death benefit passes to the donor's heirs upon his/her death, effectively *replacing* the amount originally donated to the CRT. By having the life insurance policy purchased and owned by an ILIT, the death benefit is excluded from the donor's gross estate for federal estate tax purposes. Properly structured, this strategy will replace the donor's original assets with life insurance proceeds that are not subject to estate tax upon the donor's death. This combination technique is commonly known as a "wealth replacement trust".
- *Deferring Capital Gains Tax on Appreciated Assets*. Yet another way to leverage this gift is by transferring *highly appreciated assets* to the CRT. Donors owning highly appreciated assets may be interested in diversifying their investments, but diversification has been delayed because of the capital gain tax impact of selling appreciated securities. By transferring the highly appreciated assets to the CRT, the donor avoids any immediate capital gains tax that may be incurred when the appreciated assets are sold by the trustee. After the CRT is funded, the trustee may sell the assets without incurring capital gains tax because CRTs are generally tax-exempt entities. The annual income distributions from the trust may be taxable to the income beneficiary, but the tax effect of the sale is spread out over the distribution period, likely many years.

Charitable Lead Trust ("CLT")

A CLT reverses the process of a CRT by providing current payments to qualified charities, with a remainder gift to the donor's non-charitable beneficiaries (typically children or grandchildren). Like a QPRT, a CLT allows you to reduce the size of a taxable gift to your heirs because of the actuarial computation used to value the future gift. This technique allows you to pass assets to your family at discounted values, while also supporting charities during your lifetime.

Family Foundations

Family Foundations are private foundations that qualify as Section 501(c)(3) charitable entities. These foundations allow you to make charitable gifts during your lifetime, or at death, to benefit one or more qualified charitable organizations. The advantage over making direct charitable donations is that you and your family members maintain control of all investments and distributions. There are, however, more restrictions and limitations for this type of entity than other qualified charitable organizations. For example, a family foundation must distribute 5% of the principal of the foundation each year, and there is a 1.35% surtax on income earned by the foundation. There are also administrative expenses involved to create and maintain a family foundation. Although some families find the restrictions and regulations of a family foundation cumbersome, others may find these requirements a small price to pay for retaining control of your charitable giving.

Community Foundations

You could also work with a local Community Foundation to establish a long-range gifting program. You and your family may choose programs or specific charities that will receive future gifts. If a gift of $250,000 or more is made to a Community Foundation, the Foundation may allow your financial advisor to manage the investments in order to obtain maximum investment performance.

Donor Advised Funds

Donor Advised Funds are tax-exempt charitable organizations established by major mutual fund companies. These funds can be used to provide ongoing charitable donations, while allowing you to use the full charitable deduction immediately for income tax purposes. As the donor, you and your family may recommend how future charitable distributions are made. This alternative may be best suited for donors seeking simplicity and anonymity more than complete control.

Charitable Giving Using IRAs and Retirement Plan Assets

Should you decide to make charitable gifts at your death, you may consider using your IRA or your retirement plan to make these gifts. You can name a charity as the designated beneficiary of IRAs and other Qualified Plans. Qualified charitable organizations incur no income tax on these accounts.

SUMMARY

Effective estate and wealth transfer planning involves making some of the most important decisions you will ever face. Variables range from the personal health of you and your family, to the economic and geopolitical events happening in the U.S. and elsewhere. All of these factors can impact your decision-making process. This analysis should be read against the backdrop of our ever-changing tax laws and national political climate. If federal estate tax laws are modified in any way, you should revisit this analysis to determine the impact of the new laws on your existing estate plan. Whatever decisions you make on these matters, you are encouraged to meet with a qualified estate planning attorney to decide on the appropriate estate plan for you and your loved ones. Baird does not provide tax or legal advice, and this information is provided for educational purposes only. You are strongly advised to seek advice from legal and tax counsel to determine the applicability of this information to your estate and financial planning decisions.