Introduction to Estate Planning

Estate planning is a highly personal process of creating, and then maintaining, arrangements for managing your assets during lifetime and disposing of them at death. Your estate plan must be designed to meet your needs and the needs of your beneficiaries as efficiently as possible, with the least disruption to the personal and financial well-being of those involved. At the outset, the process requires not only an assessment of your assets and objectives, but also an understanding of the legal and practical considerations that apply to estate planning.

This article is intended to give you a general overview of the planning process, to familiarize you with some of the planning opportunities available to you, and to help you reach decisions about how your plan should be designed and implemented.

Summarizing Your Assets

The estate planning process should begin with the preparation of a summary of the assets you own, either alone or with others. Generally those assets will fall into one of several categories:

- Solely owned assets which are held in your name alone and are freely disposable either during your lifetime or through your estate planning documents at death.

- Jointly owned assets which are owned with another person and automatically pass to the surviving owner at death. Although you may be free to withdraw assets from joint ownership during lifetime, at death your joint property passes to the surviving owner and is not controlled by your estate planning documents. Distribution of your joint property must be taken into consideration as part of your overall estate plan to ensure that it does not frustrate or defeat the tax and family planning incorporated in your estate planning documents.

- Assets controlled by beneficiary designations, which typically include life insurance proceeds, annuities, individual retirement accounts, company pensions and other employee benefits. Because assets in this category will pass directly to the named beneficiary at your death, the beneficiary designations must be carefully coordinated with your estate plan.

- Assets placed by you or by others in trust for your benefit are generally disposed of in accordance with the trust document, but you may also have an ability, limited or unlimited, to alter those trust provisions from time to time during life or at death. Consequently, all trust instruments in which you have an interest must be reviewed and coordinated with the rest of your estate plan.

Assessing Your Estate Planning Goals

Although estate planning is a very personal process, a number of goals are shared by many individuals:

- Providing for management of your assets during your lifetime, both for your own convenience and to guard against incapacity.

- Setting aside funds for the care or education of family members.

- Protecting your spouse's financial security after your death.

- Maximizing your family's inheritance by minimizing taxes and administration expenses.

- Planning for incapacity to avoid the need for a court-appointed conservator or guardian.

- Avoiding probate in the settlement of your estate or the ongoing administration of any trusts created for your family.

- Satisfying your charitable objectives in ways which produce the maximum personal and tax benefits.

- Avoiding the pitfalls of poor planning, including intestacy, unanticipated liquidity needs, inappropriate executor and trustee designations, outdated guardian appointments and improper asset allocation.

Because some of your goals may conflict with others, estate planning often involves the ongoing reassessment of your family concerns in relation to the size of your estate, the needs of your beneficiaries and the applicable estate and gift tax laws.

Gift and Estate Taxes-Briefly Explained

The United States government imposes tax on transfers during lifetime and at death. A decision as to whether to give away property during lifetime or at death has both transfer tax and income tax implications for your family. Although gift taxes are assessed on the market value of the gifted property at the time of the gift, the recipient of the gift receives the donor's cost basis in the property for purposes of computing the capital gains tax upon subsequent sale of that property. By contrast, inherited property receives a new "stepped-up" basis equal to the value of the property on which the estate tax was calculated, eliminating any capital gains tax other than on appreciation after death.

Incurring a gift tax is, of course, entirely voluntary, and occurs only when a taxable gift is made. As a result, taxable gifts are generally preceded by a careful assessment of both the benefits and the costs of the transfer. Estate taxes, on the other hand, cannot be so easily timed. Moreover, when federal estate taxes are triggered, they may well be substantial, as much as 45% of your estate. Additional estate tax may also be due the state. An important aspect of your estate planning will involve assessing, and where necessary, planning for the payment of those taxes.

Several important tax benefits are built into the federal transfer tax laws. Depending upon the size of your estate and your planning goals, your estate plan will undoubtedly incorporate some or all of these tax planning opportunities, as well as other techniques specially suited to your needs.

Annual exclusion gifts of $12,000 per recipient ($24,000 if you are married) may be made without incurring a federal gift tax liability. Because the gifted property is removed from your estate, it will typically not be subject to tax at your later death. Such transfers may be outright, to custodial accounts or to specially designed trusts, all with the same tax-free result. Transfers in excess of $12,000 which are made to meet the educational or medical needs of the beneficiary are also free of tax provided they are made directly to an educational institution or care provider.

Although gifts in excess of the annual exclusion limits are taxable for federal purposes, such transfers will not trigger a federal transfer tax until they exceed the gift tax-free amount, which currently is $1,000,000.

Transfers between spouses who are United States citizens can escape federal gift and estate taxation by qualifying for the unlimited marital deduction. Tax on all such transfers, whether made during lifetime or at death, and whether outright, to qualifying trusts, or by beneficiary designation or joint ownership, is deferred until the death of the last spouse to die.

For transfers to spouses who are not United States citizens, the unlimited marital deduction is available only if such transfers meet certain requirements. If your spouse is a resident of the United States but is not a United States citizen, the marital deduction is not available for unlimited gift transfers. Tax-free lifetime transfers to a non-citizen spouse are limited to a total of currently $128,000 per year, as indexed for inflation. The marital deduction is available for estate transfers only if the marital deduction property is held in a specially designed trust known as a Qualified Domestic Trust. Any individual subject to these special rules must take particular care to address these requirements as part of the planning process.

If you or your spouse are neither residents nor citizens of the United States, your estate plan must be coordinated not only with applicable United States tax rules, but also with the tax and estate laws of your country of citizenship.

Estate Planning for Married Couples

Creating an Estate Tax-Sheltered Trust

If tax planning and management issues were irrelevant, many couples would choose an estate plan leaving everything outright to each other, with their combined estates eventually passing to their children or other beneficiaries. Such a plan may work well for couples whose combined estates will not exceed the tax-free amount, which is currently $2,000,000 (and scheduled to increase to $3,500,000 in 2009), and for whom management issues are not a concern.

For couples with combined estates in excess of $2,000,000, this simple plan would result in a substantial (and otherwise avoidable) tax at the death of the surviving spouse. To reduce taxes at the surviving spouse's death, your estate plan must preserve the possibility of using each spouse's $2,000,000 estate tax-sheltered amount to double the amount of property that can ultimately pass tax free to the children or other beneficiaries on the death of the survivor. If property passes outright to the survivor, it automatically qualifies for the marital deduction which merely defers the tax until the surviving spouse's later death. If, instead, the $2,000,000 tax-sheltered amount is placed in an estate tax-sheltered trust for the surviving spouse's benefit, then it will not be taxed at the survivor's later death. In this way, a married couple can use both spouses' tax-free amounts to pass up to $4,000,000 (and any subsequent appreciation of such property) to their ultimate beneficiaries free of federal transfer tax.

The estate tax-sheltered trust can be designed in a variety of ways. Income of the trust could be payable to the surviving spouse during his or her lifetime. In addition, trust principal could be made available to the survivor as needed. Other rights could be granted to the surviving spouse, including the right to make limited withdrawals of trust principal and to direct the final distribution of the trust assets among family members. Although an estate tax-sheltered trust of this sort remains available to the surviving spouse for his or her lifetime, this trust will not be included in the surviving spouse's estate for estate tax purposes. At the surviving spouse's later death, the remaining trust assets, including appreciation on those assets, would pass estate tax free to the ultimate beneficiaries. Or, if the surviving spouse does not need access to the tax-free amount, it could be given directly to the children or held in trust for their benefit.

Lifetime Gifts Between Spouses

If a married couple has combined assets in excess of $2,000,000, but most of those assets are in one spouse's name, are jointly-held, or otherwise pass outside of the estate planning documents, it is unlikely that sufficient assets will be available at the first death to take full advantage of the opportunity to ultimately pass the estate tax-sheltered amount tax-free to the estate beneficiaries. Even if a couple's combined assets are $4,000,000, if less than $2,000,000 of those assets is disposable under the plan of the first spouse to die, the opportunity to take maximum advantage of the $2,000,000 tax-free amount is lost.

To remedy this problem, asset ownership between spouses must be carefully rearranged to give each spouse a disposable estate of at least $2,000,000. To accomplish the optimum tax result, one spouse might make an outright gift to the other spouse with the smaller estate. Or, spouses might "unjoin" some of the jointly held assets. For instance, a house held in joint names could be retitled as "tenants in common" so that one-half of the value of the house would be available as a part of the $2,000,000 tax-free amount. Beneficiary designations should also be examined to determine whether, for example, insurance proceeds that might otherwise pass directly to a surviving spouse could instead be directed into the estate tax-sheltered trust.

Managing the Marital Deduction Share

After the estate tax-sheltered amount has been set aside in an appropriately designed trust for the benefit of the surviving spouse or other family members, transfer taxes on the balance of the first estate can be postponed, if desirable, until the survivor's death by qualifying the balance of the property for the federal unlimited marital deduction. Outright transfers to a surviving spouse will qualify for the marital deduction so long as the

survivor is a United States citizen. Outright transfers may be appropriate where the amount of the marital deduction is not expected to be large, where special management is not needed or where there is no particular desire on the part of the first spouse to control distribution of the property at the surviving spouse's death.

If, rather than using an outright marital deduction gift, some trust management for the marital share is appropriate or desirable, the federal tax law also permits the marital deduction property to be held in a variety of trust arrangements without sacrificing the benefits of the deferral of tax in the first spouse's estate.

A trust qualifying for the marital deduction can be a simple management vehicle providing for supervision of investments by a trustee, or it can impose restrictions on the surviving spouse's access to the property and power to choose the ultimate recipients of the property.

A typical marital trust, frequently referred to as a QTIP trust, might provide that the surviving spouse would be entitled to all of the trust income, the trust principal if an independent trustee determined that funds were needed by the surviving spouse, and, possibly, limited access to a portion of the trust principal without trustee approval. A surviving spouse might also be given a power, exercisable as part of the surviving spouse's estate plan, to direct the final distribution of the trust property to or among the children and grandchildren.

Use of the marital deduction is valuable in the estate planning process as a way to defer rather than avoid taxes. Although the marital trust technique allows for tax-free treatment at the first death, all property remaining in the marital deduction trust at the surviving spouse's death is subject to federal estate tax as though the marital trust property had been owned by the surviving spouse at his or her death.

Life Insurance Trusts

Even after a tax efficient estate plan is in place, a federal transfer tax will be imposed on assets over $2,000,000 for single individuals or $4,000,000 for married couples. In order to reduce this tax, assets must be given during lifetime to the ultimate estate beneficiaries. If handled properly, the gifted property and all future appreciation will be removed from the donor's estate.

Assets with a low current value but with a high potential for future appreciation are ideal for gifting purposes. Life insurance typically meets this description. Although some insurance policies may have substantial current cash value, many policies, including term insurance, have little or no current

value but may have significant value at the insured's death. Since the value of the policy for gift tax purposes is its cash value on the date of the gift, there is often an opportunity to give the policy away during the insured's lifetime with little or no gift tax impact. If the insured survives three years from the date of the gift, then the proceeds collected at the insured's death will not be included in his or her estate for tax purposes.

A gift of the insurance policy to an irrevocable insurance trust established by the insured during his or her lifetime can shelter the insurance proceeds from tax in both spouses' estates, without depriving the surviving spouse of the benefits of the insurance proceeds. Such a gift can also shelter the insurance proceeds from tax at the death of an unmarried insured person.

For married couples, an insurance trust typically provides that the income and principal of the trust will be available to the surviving spouse and, where desirable, to children or other family members. Although such a trust must be irrevocable and therefore cannot be modified by the insured once established, the insured's spouse can be given a power to return the policy to the insured or to otherwise modify the provisions that will apply to the children or other beneficiaries after the death of both spouses. Some flexibility can therefore be built into the trust to cover unforeseen circumstances that might arise in the future.

In addition to planning for life insurance on one person's life, many couples consider purchasing "joint" or "second-to-die" life insurance which is designed to pay a benefit only on the death of the survivor spouse. The payment of the proceeds coincides with the time when substantial estate taxes become due on property that remains taxable in the estate of the second spouse to die. Such joint insurance can also be fully sheltered from estate taxes in both spouses' estates through the use of an irrevocable insurance trust designed for the benefit of the children or other beneficiaries.

Whenever possible, the insurance should be acquired by the trust when it is initially purchased in order to avoid the three-year waiting period for favorable tax results. The trust should be the initial applicant, owner and beneficiary of the policy.

Managing the Gifts or Inheritances of Your Other Beneficiaries

A variety of planning techniques exist for the management of transfers that you may wish to make to beneficiaries other than your spouse. Transfers to children, grandchildren or other individuals who eventually inherit your estate can be accomplished in several ways:

- Outright transfers, without restriction or management arrangements, are only appropriate for adult beneficiaries who are capable of managing their own assets.

- Custodial gifts under the Uniform Gifts to Minors Act are well suited for relatively small lifetime gifts that can be effectively managed by the custodian and will not present a planning problem when the recipient reaches the age of majority. The donor of such a gift should not act as custodian in order to avoid inclusion of the gift in his or her taxable estate at death.

- Estate reduction trusts, also referred to as "Crummey" Trusts, are often used for larger gifts where management of the trust assets should continue beyond the age of majority.

- Generation-skipping trusts may be established during lifetime or, alternatively, at death, to set aside the maximum amount that can eventually pass free of tax to the grandchildren at the children's deaths. Each person has a maximum $2,000,000 exemption. Spouses have a $4,000,000 combined exemption.

- Management trusts, established either during lifetime or at death, can be designed to address the ongoing financial needs of beneficiaries while also protecting the trust assets for some period of time. These trust arrangements are also appropriate for protecting the assets of disabled beneficiaries.

Revocable Living Trusts

In addition to reducing estate taxes, many people design their estate plans to provide for asset management during lifetime and to simplify estate settlement at death. Revocable living trusts play a prominent role in this type of planning.

Although living trusts do not offer any opportunities for tax savings that could not otherwise be achieved through the use of conventional wills, living trusts do offer a number of unique estate planning features.

- Living trusts, when funded during your lifetime, can significantly reduce probate court involvement in the settlement of your estate. However, in some states such as Connecticut, the court will still collect a fee based upon the size of your taxable estate, including any assets held in your living trust.

- Living trusts can provide for the establishment of ongoing trusts after your death (for example, estate tax-sheltered trusts, marital deduction trusts or management trusts for your family) which will not be subject to probate court supervision. Consequently, these trusts will not be required to file accountings with the court on an ongoing basis.

- Living trusts offer a degree of privacy since the trust documents do not become part of the probate court record.

- Living trusts can provide for effective asset management in the event of incapacity and can eliminate the need for a probate court-appointed conservator for this purpose.

- Living trusts, if funded with assets owned in several different states, can avoid multi-state probate administration.

- Living trusts can simplify the settlement of an estate at death, at least to the extent that assets have been transferred to the trust during lifetime.

Living trusts will not necessarily shorten the time it takes to complete the settlement of your estate. Since such trusts are fully includable in your estate for tax purposes, to the extent that your estate may present tax issues that will delay final settlement with the taxing authorities, the same delays will be experienced whether a conventional will or a living trust is used. Other issues that might arise in the settlement of an estate, including disputed creditors claims, business issues, and disputes with beneficiaries, could also delay final settlement of the estate whether or not a living trust is used.

Planning for Incapacity

Connecticut and many other states offer a statutory durable power of attorney which you may grant to a trusted family member or associate that will allow the holder of that power to act on your behalf if you are temporarily or permanently unable to attend to your own affairs. Such powers of attorney may be very broad in nature or can be modified to be applicable in only specified situations. Among the powers that are typically granted are powers to manage financial affairs, sign tax returns and pay bills. Powers of attorney can also permit the making of gifts and the completion of the funding of a living trust.

Living Wills and Appointments of Health Care Representatives

Many states have enacted a statutory form of a living will which allows you to express your wishes with respect to the use or withholding of

extraordinary medical procedures if you become terminally ill. In addition, these laws usually allow you to appoint a health care representative who is authorized to intervene on your behalf to make ultimate decisions with respect to your care should any uncertainty arise with respect to the expression of your wishes in your living will. In Connecticut, your health care representative is also authorized to act on your behalf with respect to mental health treatment.

Selection of Executors, Trustees and Guardians

During the course of your estate planning, you will need to identify individuals or institutions which will play a critical role in ensuring that your estate plan is carried out in accordance with your wishes. The roles to be filled are those of executor, trustee and, where needed, guardian. Executors, trustees and guardians are sometimes referred to separately or collectively as "fiduciaries," in recognition of the special duty of care that they owe to your beneficiaries.

Whether or not your plan employs a living trust, you will need to designate an executor to ensure that your estate is properly settled and that your assets are either distributed in accordance with your will or are added to your living trust. Your executor will also have ultimate responsibility for filing your estate tax returns and paying all taxes due. Depending upon the size of your estate and the complexity of your affairs, the executor you select should either have the professional experience needed to handle the responsibilities of settling your estate or the wisdom to seek appropriate advice.

With regard to the selection of trustees, you may choose to serve as the sole trustee of a living trust that you establish as part of your plan. If at least one objective of your living trust is to plan for your incapacity, however, you will certainly wish to carefully select a co-trustee or successor trustee to serve in that event.

In selecting trustees for trusts that will continue after your death, you will generally wish to consider the need both to provide for effective financial management, which may continue over a long period of time and require attention to the needs of a variety of beneficiaries, and to establish relationships that will function smoothly between beneficiaries and trustees.

If you have minor children, your will should express your wishes as to whom should be appointed as guardian in the event both parents die leaving minor children.

Charitable Giving

If charitable giving is an important part of your personal, tax or financial planning, a number of attractive trust techniques are available to meet both your charitable and non-charitable objectives. Included among those techniques would be the creation of private foundations and charitable split-interest trusts, such as Charitable Remainder Trusts and Charitable Lead Trusts. Our lawyers would be glad to discuss the available options with you in greater detail.

Marital Agreements

If a prior marriage ended in divorce, your separation agreement may create rights or obligations which should be taken into consideration as part of your estate planning. Similarly, if you entered into a premarital agreement prior to your current marriage, a review of the provisions of that agreement should also be part of the planning process.

If you are contemplating marriage and wish to protect your estate from claims which your spouse might otherwise be entitled to make as a matter of state law, you may wish to consider entering into a premarital agreement which will fix your obligations to your spouse in the event of death or divorce. Such agreements can be especially valuable in situations in which you and your spouse have children from different marriages.

Conclusion

We hope that this article gives you an idea of some of the many estate planning options available to you and your family. Again, the personal nature of the estate planning process requires that each plan be prepared to meet the specific needs of the client. We would welcome the opportunity to discuss your planning goals and concerns and to help create the plan that is right for you.