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A Blank Piece of Paper

PLANNING YOUR LEGACY: NO TIME LIKE TODAY TO START

Procrastinate. We all do it, especially when the topic is uncomfortable or surrounded by uncertainty. To anyone reading who has not begun to plan for his or her legacy, you are not alone. Over 55% of Americans who die each year do not have a will or any estate plan, according to LexisNexis. The good news is that you have a blank piece of paper to begin to plan thoughtfully for future generations. To those of you who have created a plan but have not looked at it for a decade or so, there is no time like the present to take a fresh look. The coming months will likely provide a catalyst for future planning as the Trump administration takes aim at broad-based tax reform. You should be ready to act. As such, we have outlined a general framework to assist you in thinking through your family goals and your legacy. We have included select current tax law references throughout the paper and further details in the appendix. Planning, however, is more important than just current law. A well- thought-through plan and sustainable governance process for your family can be molded into any future tax regime and will stand the test of time for generations to come.

WHAT ARE MY PERSONAL GOALS?

Defining personal goals has begun to sound clichéd with the numerous financial planning advertisements floating around, but really, the first question to answer personally is, “What is the purpose of my wealth?” Is the purpose to set up a legacy for your family? Is the purpose to provide for those who may not be immediate family members? Is the purpose to benefit certain charitable causes that are near to your heart? Do not underestimate your personal needs to access your assets. Remember that capital markets can change quickly, so the time horizon of the plan must appropriately meet your needs.

Complexity, control, and flexibility should be considered from the start in any plan. While the plan is only an overview, it will become apparent that the process can become complex, with the likelihood of multiple legal structures. Any plan must be designed with your level of tolerance for maintenance and review in mind. Flexibility and control may be as important as determining the purpose of your wealth. Life changes and perhaps the people and causes important to you will change as well. You should balance the objectives of reducing taxes and maintaining control over your assets. Those goals may not always bring you to the same answer.

STARTING FROM A BLANK SHEET

Start simple. To paraphrase Benjamin Franklin, nothing is certain except death and taxes. While blunt, it is a true statement, and may help motivate action. If it accomplishes nothing else, having a plan can save your heirs significant costs down the line. Probate fees on average represent 2% of estate assets.[1] With no plan in place, the government's share of your pie from fees and taxes alone would likely be more than you would choose. Developing a basic outline of what, who, and when will fill up your blank sheet quickly...

- **What** are my financial or personal assets that will be passed along after me?
- **Who** are the people or organizations that should receive those assets? Further, who are the people or advisors I trust to give control of the process when I am not here?
- **When** will my beneficiaries gain control of those assets – immediately or over time?

With this outline, you can begin to generate some of the basic planning documents that focus on directives not only after you pass but also while you are still living. *Importantly, each of the following can be revised during your lifetime as your circumstances change:*

1. **A Last Will and Testament –** While you are living, you can control who will manage the estate settlement, who will receive your assets, and when they will receive them. In some cases, selecting the proper estate executor with specific expertise is critical. If minor children are in the home, selection of the proper *legal guardian* could also be outlined in the will. Creating a will ensures that your estate's settlement is determined by you rather than a probate court, which will default to the laws of your state.

   a. In some situations, it makes more sense to create a *revocable or living trust*. The trust would be funded currently, but the distributions to beneficiaries would not occur until death. A living trust is more complex than a will but avoids the probate process, which can be time-consuming and costly; a living trust also offers more privacy upon death.

   b. Assets not subject to probate include those in a living trust, retirement accounts with named beneficiaries, life insurance policies with named beneficiaries, certain jointly held real estate or bank accounts, and payable-on-death bank accounts. It is therefore critical that close attention be paid to beneficiaries of such assets while creating your estate plan.

2. **Living Will or Advanced Health Care Directive –** You can provide specific instructions regarding end-of- life care, including decisions about life support, if you are permanently incapacitated. A health care power of attorney may be combined with a living will in some states, but a living will is limited only to those with terminal illnesses or who are permanently unconscious. A temporary illness would need a health care power of attorney to provide direction.

3. **Power of Attorney –** You can legally designate someone to make financial and legal decisions on your behalf. A *durable power of attorney* could make those same legal and financial decisions even if you become incapacitated. A separate *health care power of attorney* would appoint the same or different person to make health care decisions on your behalf if you become incapacitated.

Collectively, these planning documents will begin to build the backbone of any wealth transfer plan. If you are starting from scratch, this section alone will start to fill up that blank page and let you see progress!

[1] Academy of Estate Planning Attorneys

DIVING A LITTLE DEEPER: WHAT ARE THE BASICS?

Walk Me Through the Current Estate and Gift Transfer Tax Structure

Once you define the purpose of your wealth and feel comfortable that you have outlined your financial goals, it is also important to understand the current estate and gift tax framework. Doing so will likely bring up the important topics referenced above of complexity, control, and flexibility.

Currently, the federal government imposes a transfer tax known as the estate tax on the market value of your gross assets upon death, less the following:

- Debt outstanding or losses
- Funeral and administrative costs
- All transfers to one's spouse
- Property donated to qualifying charitable organizations
- Lifetime transfer exemption

Each person is allowed a lifetime transfer amount of $5.49M (in 2017) on the net assets in his or her estate. Therefore a married couple, due to new portability rules, will not pay tax on approximately $11M of asset transfers after the allowable deductions listed above. For asset transfers in excess of the unified credit, a federal estate tax of 40% is applied. All property subject to the estate tax receives a "step up" in basis to the market value on the date of the decedent's death (or six months following) and historical cost basis is disregarded.

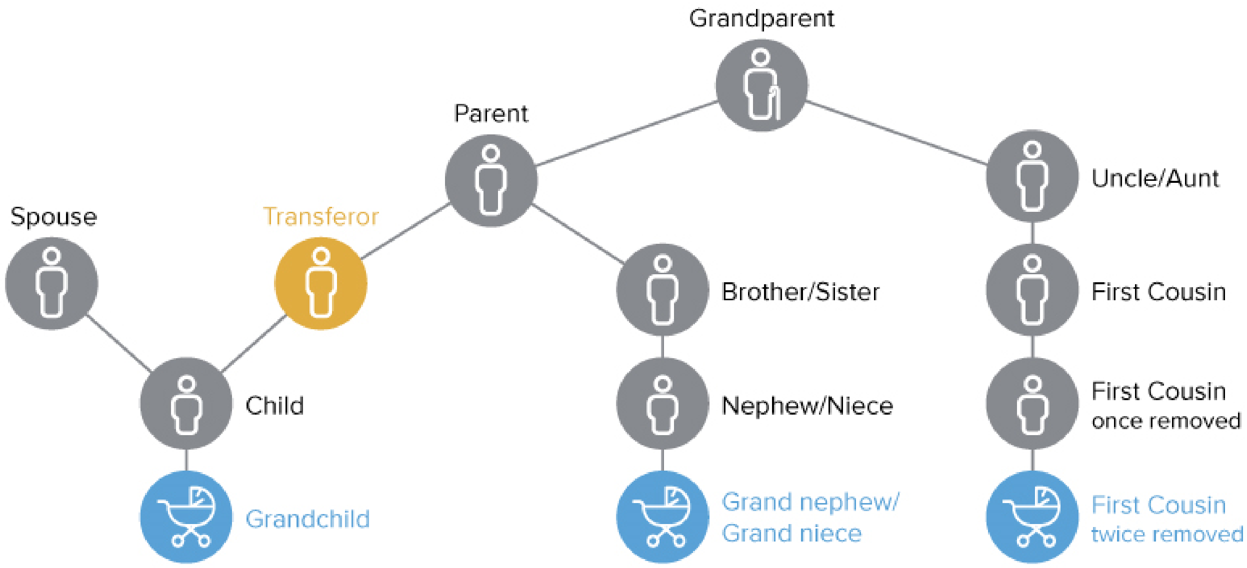
Asset transfers can be made during your life; however, the value of those transfers or "gifts" will reduce the total credit the estate can take at your death. The value of a gift is the fair market value on the date of transfer. Generally, the cost basis of that gift is the same income tax basis as it had when held by the donor, also known as "carryover basis." Once total gifts made during your lifetime exceed the unified credit, a gift tax would apply to future gifts at a 40% rate (2017). There are some "free gifts" that when effectively used can significantly compound over time, including a per-donee annual exclusion indexed for inflation ($14,000 in 2017). In addition to the annual exclusion and lifetime exclusion outlined above, the following gifts are not subject to a gift tax:

- Tuition or medical expenses you pay for someone else
- Gifts to your spouse
- Gifts to political organizations for its use

There is one hefty tax that may be imposed **in addition** to the gift tax, called a generation-skipping transfer (GST) tax. The tax was implemented in 1986 to prevent high-net-worth families from transferring assets more than one generation, thus delaying or avoiding the estate tax liability that would otherwise be paid by the generation in between the transferor and the transferee. There is an exemption to the GST tax that is in addition to the estate and gift tax exemption. In 2017, the GST exemption amount is $5.49M. The GST tax is better understood using this example: If a grandparent were to transfer assets to a grandchild and had already used his or her lifetime exemption as well as the GST exemption, the gift would be subject to the 40% gift tax and the 40% GST tax. Further, the money used to pay the GST tax is also subject to gift tax! There is an annual GST exclusion ($14,000 in 2017) for select trust transfers only. See following page for a diagram developed by Deloitte to further define transfers subject to the GST tax in various scenarios:

GENERATION ASSIGNMENT - RELATED PARTIES

(blue = skip person)



Does It Matter if I Live in a Certain State?

Yes. In addition to the transfer taxes discussed above, select states impose an estate or inheritance tax, while only one state has a gift tax. Please see the table in the appendix for more state-related specifics.

Walk Me Through Transferring Assets to Others

While the tax rates for estate and gift transfers are the same, the gift tax is a more effective way to transfer assets, assuming the donor has the ability and desire to give up control over those assets during his or her lifetime because:

- The gift tax is applied only to the value of a present interest transferred rather than to the total estate's assets.
- The gift tax applies to the fair market value on the date of the gift, to which certain marketability or minority interest discounts may then be applied. (Note that proposed regulations under Section 2704 issued by the Treasury at the end of 2016 may dramatically reduce the discounts currently available for wealth transfer plans. See our white paper on the subject, *Treasury Prompts Planning Opportunity for Families*, for more details.)
- The gift tax allows an estate to "freeze" assets as of a specific date and removes future compounded growth from the estate of the donor.

When making a lifetime transfer, certain care should be taken to transfer the most efficient assets whenever possible. Such assets include those that may be illiquid and subject to certain discounts, or those that are expected to grow significantly prior to the passing of the transferor. For example, the gift of a minority interest in a family business could be subject to discounts related to the lack of marketability and control of those shares, therefore allowing the business to be transferred at a lower market value over time. Finally, a structured timeline for gift transfers is important to consider, as gifts made within three years of the donor's passing will be brought back into the estate for estate tax calculations.

STRUCTURES TO FACILITATE GIFTING:

Trusts are common structures used by a donor when there is a desire to place certain constraints on the use of gifted assets. Transfers to irrevocable trusts are permanent, with little flexibility allowed for future changes. Certain states allow more flexibility than others, so the governing state law is an important consideration when setting up an irrevocable trust. Types of irrevocable trusts include simple, complex, or grantor trusts. Because grantor trusts are disregarded as separate entities from the grantor for federal income tax purposes, but typically are considered a separate entity for estate tax purposes, they are very common. The grantor of this intentionally defective irrevocable trust (IDIT) should be allowed to pay federal income tax for the trust, therefore further reducing his or her taxable estate during life, even though the completed gift and its subsequent appreciation will be removed from the total assets subject to the estate tax. As discussed above, trusts created and funded during the grantor's life are not subject to the probate process after his or her death. In order to shield assets from the probate process that would otherwise be freely passed to the spouse through the marital deduction, some may consider a qualified terminable interest property (QTIP) trust. Another popular planning tool is the qualified personal residence trust (QPRT) that, when structured properly, will freeze the value of the donor's residence for estate tax purposes, allow the donor to continue to live in the property during the term of the QPRT, and pass along ownership of the residence at the end of the term. Higher federal interest rates would be more favorable for this structure as the discount to the gift value would be greater and subsequent gift tax would be lower.

Interfamily loans are commonly used to accumulate wealth for heirs while the donor avoids transfer taxes. Donors may loan money to their heirs and charge a nominal interest rate (the applicable federal rate, or AFR, determined by the IRS). The AFR is significantly lower than equivalent rates charged by financial institutions, and generally the assets can be invested to earn a return greater than the loan payment. Low federal interest rates benefit this planning tool. Further, the donor could forgive a portion of the debt annually to the extent of the annual exclusion amount. A grantor retained annuity trust (GRAT) structure takes advantage of the use of family leverage by freezing an asset at the current fair market value, creating an annuity for the donor based on the current fair market value of the assets and an interest rate determined by the IRS, and then transferring the appreciation of the asset over a term to a defined beneficiary.

Family limited partnerships are pooled investment vehicles that can give individual family members access to investments that may not otherwise be available to them. The structure is also commonly used in private businesses to ensure that a proper succession plan and management structure remain in place as the company is passed to the next generation. With the proper use of valuation experts, many families can slowly transfer interests in a closely held business while promoting responsibility among the next generation of owners. As discussed above, proposed regulations for §2704 may restrict the level of discounting available for transfers of family limited partnership interests; however, currently a 40% combined discount for the lack of marketability and lack of control may be applied to the transfer and can create powerful gifting opportunities for these structures.

Why Is Life Insurance So Often Discussed in Estate Planning?

Proceeds from life insurance remain tax-free for federal income tax purposes, and if properly held in an irrevocable trust, the proceeds may also avoid estate taxes. Compounding tax-free growth can be very valuable, especially when an estate will have significant exposure to illiquid assets including a closely held family business or real estate investment.

Life insurance policies can be as simple as a term life policy that mandates an annual premium amount for a stated period (10, 20, 30 years) in return for a lump sum payout if the insured dies during the stated term. Other permanent policies require more in-depth discussion but may be suitable in certain situations, specifically if the purpose of the insurance policy is to provide liquidity to an estate. Selecting an appropriate life insurance product should be done carefully with the guidance of a trusted insurance professional.

What Does Asset Protection Mean?

Asset protection is the process of securing your assets against creditors or successful lawsuits. Many of the estate planning techniques we have already discussed could serve a dual role of protecting your assets and planning for your financial future. It is important to consider asset protection within the context of your estate plan.

The simplest form of asset protection is liability insurance, also referred to as an umbrella policy. The rule of thumb is to have personal umbrella liability coverage equal to your net worth. For some, that amount is unreasonable, and therefore other legal structures outlined above would complement a personal umbrella policy.

During your planning process, you should consider the structures of any business ventures, from partnerships to rental homes. Whenever reasonable and with the guidance of your financial team, those ventures may be suited for separate LLCs to provide legal protection from your personal assets.

HOW DO I SELECT MY TEAM?

Time. Customization. Care.

Having made it to this point in the paper, you can appreciate the complexity inherent in the wealth planning process. Striking a balance between complexity, control, and flexibility is a very personal decision that must be made with your team of trusted advisors.

Surround yourself with those attorneys, accountants, and financial advisors who are qualified, especially if unique business- or industry-specific situations arise, but just as important, also select those advisors who are willing to take the time to listen fully and understand your goals. With the many techniques available to transfer wealth, it is critical to know that your team of experts will dedicate the time to explore all options and to develop a customized plan that best meets *your* objectives.

Below are a few parting thoughts as you build and evaluate your wealth planning team:

- Ensure each donor, in the case of married couples, is comfortable expressing personal views with the team and agrees with the plan outline.

- Plan ahead and determine the best method to communicate your completed plan with future generations, so that education and stewardship of the assets become part of the planning process from the start.

- Finally, ensure that your team sets up a proper governance structure to monitor your plan going forward, and can make recommendations as life events occur, capital markets adjust, or tax law changes.

There is a lot of information to digest. Please do not hesitate to contact members of your client team, who can help arrange a formal discussion with your trusted advisors regarding your personal wealth plan.

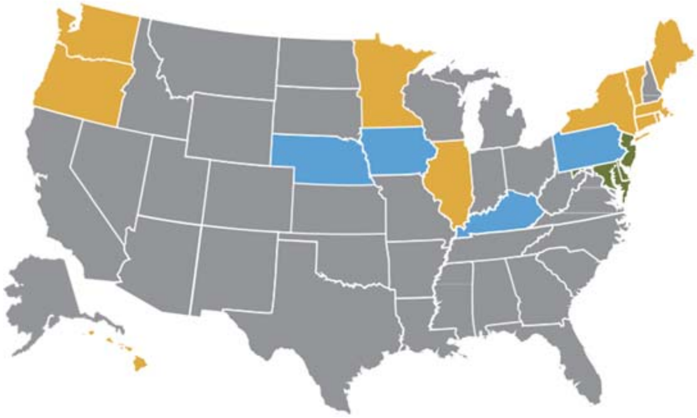
APPENDIX – SUMMARY OF CURRENT TRANSFER TAX

Unified estate and gift tax exemption for 2017

Highest rate	Exemption
40%	$5.49 million*

*Adjusted annually for inflation

State estate and inheritance tax rate and exemptions in 2016



- State has an estate tax
- State has an inheritance tax
- State has both an estate and inheritance tax

Note: Exemption amounts are shown for state estate taxes only. Inheritance taxes are levied on the posthumous transfer of assets based on the relationship to the descendent; different rates and exemptions apply depending on the relationship.

Sources: IRS, Deloitte, Schwab

State	Inheritance tax	Estate tax
Connecticut		$2M; 7.2%-12%
Delaware		$5.45M; 0.8%-16%
Hawaii		$5.45M; 0.8%-16%
Iowa	0%-15%	
Illinois		$4M; 0.8%-16%
Kentucky	0%-16%	
Maine		$5.45M; 0.8%-16%
Maryland	0%-10%	$2M; 0%-10%
Massachusetts		$1M; 0.8%-16%
Minnesota		$1.6M; 9%-16%
Nebraska	1%-15%	
New Jersey	0%-16%	$675K; 0.8%-16%
New York		$3.125M; 3.06%-16%
Oregon		$1M; 10%-16%
Pennsylvania	0%-15%	
Rhode Island		$1.5M; 0.8%-16%
Vermont		$2.75M; 0.8%-16%
Washington		$2.078M; 0%-20%
District of Columbia		$1M; 0.8%-16%

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Elizabeth Mackie is a Managing Director and member of the Research Team at Edge Capital. Since joining Edge in 2007, she has been instrumental in working with some of our largest clients to build customized portfolio solutions, solve the unique challenges of multi-generational families, and build relationships with clients' trusted advisors. Elizabeth now focuses her time on building long-term client relationships as well as capital markets research, strategy due diligence, and idea generation that is implemented across Edge client portfolios.

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