From Basic to Advanced

KEY TOOLS FOR YOUR ESTATE PLANNING NEEDS
THE BENEFITS OF ESTATE PLANNING

Estate planning is a crucial component of financial stability, and it can actually be a simple process. Even for families or individuals with more complex tax planning considerations, the options are finite and straightforward. And the benefits are well worth the effort:

- **Ensure your wishes.** Estate planning can give you the peace of mind that your wishes will be carried out after you’re gone.

- **Simpler, faster resolution for heirs.** The process of administering an estate after the passing of a loved one can be simple and efficient—or cumbersome and conflicted. A small amount of structure goes a long way.

- **Effective planning for taxes.** For families or individuals whose net worth is expected to surpass estate tax limits, planning tools can drive the most efficient organization of your assets for tax purposes.

- **Cover your living needs.** Estate planning tools also protect your wishes and assets in a circumstance where you become incapacitated or otherwise unable to manage your own affairs. Some tools, such as life insurance or select types of trusts, can also act as dual-purpose assets meant to support loved ones after you’re gone while providing accessible value to you in your living years.

WHEN THERE IS NO PLAN

Estates are governed primarily by state law, and if someone passes away without essential documents in place, there is a default process for how their estate is handled. While every state is different, a few basics generally apply:

**Everything goes through the probate process.** Probate courts are special courts that resolve the debts and assets of the deceased. Without estate documents and structures, a probate court will collect evidence of all liabilities and assets, oversee the process of paying taxes and other debts, and distribute remaining assets to heirs. The court will appoint an executor to manage the administration. The process can take anywhere from several months to years, in extreme cases.

**Assets go to next of kin.** Every state is slightly different, but assets are generally disbursed to next of kin, including spouses or children, or more distant relatives if needed.

Each state has specific laws in place to determine what’s required there to probate an estate.

These laws are included in the estate’s “probate codes,” as well as laws for “intestate succession” when a decedent dies without a will.
Maximum estate taxes may apply. Estates may be subject to federal or state taxes, upon death, if the total value of the estate exceeds current limits.

- Federal limit of $10M (in 2011 dollars), indexed to inflation for future years. The Tax Cuts and Jobs Act of 2017 updated the base exemption amount for gift and estate taxes to $10 million (in 2011 dollars, indexed each year to inflation), up from the prior base of $5 million (also indexed to inflation). For 2019, the exemption limit is $11.4 million ($22.8 million for married couples when estates are handled properly). We do note, however, that the legislation has a “sunset” provision—the $10 million base will revert back to the old $5 million base as of 2025, unless new legislation is passed to preserve it.

Think of it this way: over your lifetime, you can gift or bequeath a total of $11.4 million to heirs. The value of your estate above that amount is subject to federal estate taxes of up to 40%. If you have distributed prior annual gifts in excess of the annual gift limit, the value of excess gifts is added back to your estate for determining taxable assets.

- State inheritance and estate taxes. Some states have their own estate or inheritance tax (or a combination of the two), often at a lower threshold for estate value than for federal taxes. Consult your tax advisor for the specifics of your state.

### STATE BY STATE TAX LAW

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<th>STATE</th>
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<th>2019 STATE DEATH TAX THRESHOLD</th>
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Source: The American College of Trust and Estate Counsel. This chart is maintained for ACTEC website and is as of the last published revision date of January 26, 2019. https://www.actec.org/resources/state-death-tax-chart/
INHERITANCE, PROBATE, AND TAX EXCEPTIONS DRIVE ESTATE PLANNING TOOLS

Estate planning is essentially a set of tools that use the exceptions in the inheritance, probate, and tax process to give you more control over the outcome of your estate. In this guide, we’ll cover these key tools, from the basics that everyone should have in place, into more sophisticated options for tax planning and complex situations.

I—BASIC ESTATE PLANNING TOOLS

THE BASIC TOOLS THAT EVERYONE NEEDS

Let’s start with the basic tools that cover your needs, regardless of your family or wealth situation:

**Key tool: A will.** A will is a document that outlines specific distribution of your assets according to your wishes. In this document, you also typically name an estate executor or representative, the person you wish to oversee your estate’s resolution.

**Key tool: Power of attorney (POA).** A POA appoints someone to act on your behalf in legal or financial matters. It’s primarily a tool to protect you while living, in case you need a trusted person to make decisions in your interest, if you are incapacitated.

**Key tool: Medical POA.** This document, also referred to as a living will, healthcare directive, or health proxy, appoints someone you trust to make medical decisions on your behalf if needed.

**Key tool: Designated beneficiaries.** Some assets are not subject to probate court, including those that have designated beneficiaries—specifically retirement plan assets like 401(k)s and life insurance policies. Your designated beneficiary entries even supersede your will, legally.

If you have dependents, two other basic tools will provide security for their needs:

**Key tool: Appointing a guardian.** You should appoint a legal guardian to care for your children. You’ll include it as an additional clause in your will.

**Key tool: Life insurance to provide for dependents.** The primary role of life insurance is to receive a payout upon your death to provide financially for your children or other dependents. However, as we’ll detail in the next section, life insurance policies can be very flexible planning tools for other purposes as well.

HOW MUCH LIFE INSURANCE DO I NEED?

The amount of life insurance you need to provide for dependents is particular to your situation; you’ll want to strike a balance between the expense of policy premiums today versus the size of the benefit upon death.

This is especially important for families with young children who could need support for many years.
II—INTERMEDIATE PLANNING TOOLS

INTERMEDIATE ESTATE PLANNING: GIFTING, SOPHISTICATED INSURANCE OPTIONS, AND TRUSTS

A large portion of upper-middle-class and high-net-worth families would also benefit from intermediate-level planning: annual gifting, establishing trusts to carry out specific goals and/or using life insurance in a more sophisticated strategy.

GIFTING: MOVING ASSETS OUT OF YOUR ESTATE.

Each year, you can transfer tax-free gifts to an unlimited number of family members and other individuals, and as long as you don’t exceed the per-gift limit, it is not taxable. However, any amount over the limit is taxable, and furthermore, must be added back to the value of your estate for tax computation purposes at death.

Gifting has the benefit of lowering your total estate value and moving future appreciation out of your estate. Considering that the tax-exemption threshold only moves up at the rate of annual inflation, but your assets could grow at a much higher rate, that can be a substantial benefit.

Key tool: Gifting. 2019 limits allow annually for $15,000 per gift to an unlimited number of family members or other individuals, or to organizations including trusts. Annual gifts larger than that amount may be subject to federal gift taxes. For married couples, each spouse can make a gift to the same person, transferring up to $30,000 tax-free.

TRUSTS: FLEXIBLE TOOLS WITH MANY OPTIONS

A trust is a legal entity that you set up through a lawyer which becomes “the owner” of your named assets. As part of creating a trust, you appoint one or more trustees, who are responsible for managing assets in the trust. Often, the grantor is the trustee, with a successor trustee also appointed.

A main benefit of putting your assets in a trust is that they will not go through the probate process. The documents which form the trust also specify the beneficiaries, as if it has its own separate will. Another important benefit is that if you become incapacitated during your lifetime, the successor trustee is already set up to step in and manage those assets on your behalf.
REVOCABLE/LIVING TRUSTS VS. IRREVOCABLE TRUSTS: CONTROL VS. TAX EFFICIENCY

There are many specific types of trusts, but all fall into two categories: revocable or irrevocable.

**Key tool: Revocable trust.** It’s simple and advantageous to set up a revocable trust to hold your assets. You can name and update your trustee(s) and beneficiaries, and the assets will typically not be subject to the probate process upon death.

Revocable means that the trust creator, the grantor, retains control over the assets and can revoke the trust at any time. Assets in a revocable trust remain in your estate, for tax purposes. They can also be subject to creditor claims or lawsuits and used to pay your debts upon death.

**Key tool: Irrevocable trust.** An irrevocable trust can provide immediate income tax benefits, as well as future estate tax benefits.

An irrevocable trust is one that, once created, cannot be reclaimed by the grantor. The assets in an irrevocable trust “exit” your estate for tax purposes, a key benefit for those whose net worth may surpass estate-tax limits. In most cases, the taxable income on the assets is no longer attributed to the grantor; instead, the trust pays its own income tax.

LIFE INSURANCE AS A LIQUID ASSET, POSSIBLY OUTSIDE OF YOUR TAXABLE ESTATE

Life insurance benefits can be counted toward your taxable estate for two reasons: if the estate is named as the beneficiary, or if the deceased is the owner of the policy at the time of death. Most of the time, the named beneficiary is a spouse or children. The ownership of the policy is something that can be favorably adjusted using estate planning tools. This is where an ILIT, SLAT, or split-dollar arrangement can be used to move the value of the policy all or partially out of your taxable estate.

**Key tool: Split dollar arrangements.** In this setup, two parties “split” the premiums and benefits of a life insurance policy. It is often between employer and employee, but in estate planning it’s common to see a grantor and a trust as the two parties. Again, this functions as a way to make a trust the part owner of a life insurance policy.

COMMONLY USED IRREVOCABLE TRUSTS

- **Irrevocable life insurance trust (ILIT).** An ILIT is typically the owner and the beneficiary of a life insurance policy funded by the grantor. If funded properly, the ILIT is not subject to income tax or estate tax.

- **Spousal lifetime access trust (SLAT).** In this type of ILIT, the grantor’s spouse is named as a beneficiary, giving the spouse access to trust assets which may include the cash value of life insurance policies.

- **Dynasty trust.** These long-term trusts are meant to continue for as many generations as state law allows. They give future generations access to assets to pay for things like healthcare and education, providing an effective way for future generations to use those assets without an outright transfer, which would likely trigger the GST (generation-skipping transfer) tax.

- **Intentionally defective grantor trust.** This kind of trust removes assets for estate-tax purposes but the grantor continues to pay income taxes on the assets. This may be an advantage for assets that provide a high level of income, since trust tax rates can be higher than personal tax rates.
A CLOSER LOOK AT LIFE INSURANCE AS A TAX PLANNING TOOL

Life insurance policies can be an effective way to plan for taxes, especially permanent policies, also known as whole life insurance.

First, a brief review of the two broad categories of life insurance: term and permanent. Term policies provide a death benefit if you die within a specified term; a 20-year policy bought when you're 35 will pay a death benefit if you pass before 55. If you outlive the term, there is no benefit. Permanent or whole policies, on the other hand, pay a death benefit no matter when you pass away, as long as you are paid up on premiums, but such policies also accrue a “cash value” over time, effectively serving as an alternate investment vehicle.

Permanent policies are usually the choice for tax planning purposes. Here’s a commonplace approach: establish an irrevocable trust to own the policy, typically an ILIT or a SLAT. Gift cash to the trust every year using the annual gift exclusion, and the trust will then use the cash to pay premiums on a whole life insurance policy on you (and/or your spouse, depending on the policy). Upon your death, the paid benefit will be outside of your estate. This not only avoids estate tax on that asset; it can also provide liquidity for heirs to pay estate taxes on illiquid assets such as real estate or a family business.

Such a policy offers two additional benefits: it’s an income-tax-free savings and investment vehicle outside of your taxable estate (if set up correctly), and it accrues a cash value over time.

A WAY TO USE LIFE INSURANCE IN A TRUST AS A PART OF AN ESTATE PLAN

Grantors gift assets, usually cash, to trust using annual gift-tax exclusion

Trust distributes purchased estate assets and any remaining insurance proceeds to beneficiaries according to the terms of the trust.

Proceeds On death of grantors, proceeds of life insurance policy are paid to trust.

Premiums Trust uses those assets to pay premiums on life insurance policy on one or both grantors.

Estate Expenses May be available to replace cash used to pay estate related expenses.

Source: Fidelity Investments.
**III—SOPHISTICATED PLANNING TOOLS**

For families and individuals with very specific needs, there are more sophisticated planning options. This includes families who own a private business or assets like shares in a high-appreciation startup, for instance.

**Key tool: Family limited partnerships (FLPs).** An FLP or an LLC structure can be an advantageous structure particularly for families that own businesses. Such an option allows the primary owners to shift income or appreciation to other family members, or to a trust for their benefit, at a discounted value.

**Key tool: Grantor retained annuity trusts (GRATs).** In this structure, a grantor contributes a high-appreciation asset, such as stocks, to the trust and pays tax at the time of contribution. The grantor receives back an annuity at a rate determined by the IRS, the 7520 rate. The GRAT has a fixed term, and after its expiration, the value of the trust exits the taxable estate and the assets belong to the beneficiaries. This tool is effective for passing appreciation to heirs without triggering estate taxes.

**Key tool: Qualified personal residence trusts (QPRTs).** A similar tool to the GRAT, the QPRT, is specifically for primary or vacation homes. After the term of the QPRT expires, ownership of the property passes to heirs free of gift or estate tax, though the grantor is typically required to pay market rent to the QPRT if he continues to reside on the property.

**Key tool: Private loan to trust.** This is one way to fund a trust, often an ILIT, without gifting. Instead, you can make a loan to the trust, which pays interest at an IRS-determined rate, and uses the loan proceeds to purchase an insurance policy or other appreciating asset. At the end of the term, the loan is repaid to the grantor, and the appreciation is left in the trust, outside of the estate value.

**Key tool: Sale to an intentionally defective grantor trust.** This is another mechanism that allows you to put a high-appreciation asset in a trust. The grantor typically funds the trust with a “seed” gift, then “sells” a high-appreciation asset to the trust with a financing arrangement including paid interest. At the end of the financing term, the original loan amount is repaid to the grantor, but the asset appreciation remains in the trust, outside the estate.

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