Get ahead of your estate planning

What you need to know about estate planning, including why you may need a will and assigning a power of attorney.

1. No matter your net worth, it's important to have a basic estate plan in place.

Such a plan ensures that your family and financial goals are met after you die.

2. An estate plan has several elements.

They include: a will; assignment of power of attorney; and a living will or health-care proxy (medical power of attorney). For some people, a trust may also make sense. When putting together a plan, you must be mindful of both federal and state laws governing estates.

3. Taking inventory of your assets is a good place to start.

Your assets include your investments, retirement savings, insurance policies, and real estate or business interests. Ask yourself three questions: Whom do you want to inherit your assets? Whom do you want handling your financial affairs if you're ever incapacitated? Whom do you want making medical decisions for you if you become unable to make them for yourself?

4. Everybody needs a will.

A will tells the world exactly where you want your assets distributed when you die. It's also the best place to name guardians for your children. Dying without a will -- also known as dying "intestate" -- can be costly to your heirs and leaves you no say over who gets your assets. Even if you have a trust, you still need a will to take care of any holdings outside of that trust when you die.

5. Trusts aren't just for the wealthy.

Trusts are legal mechanisms that let you put conditions on how and when your assets will be distributed upon your death. They also allow you to reduce your estate and gift taxes and to distribute assets to your heirs without the cost, delay and publicity of probate court, which administers wills. Some also offer greater protection of your assets from creditors and lawsuits.

6. Discussing your estate plans with your heirs may prevent disputes or confusion.

Inheritance can be a loaded issue. By being clear about your intentions, you help dispel potential conflicts after you're gone.

7. The federal estate tax exemption -- the amount you may leave to heirs free of federal tax -- is now set permanently at $5 million indexed for inflation.

In 2013, estates under $5.25 million are exempt from the tax. Amounts above that are taxed up to a top rate of 40%.

8. You may leave an unlimited amount of money to your spouse tax-free, but this isn't always the best tactic.

By leaving all your assets to your spouse, you don't use your estate tax exemption and instead increase your surviving spouse's taxable estate. That means your children are likely to pay more in estate taxes if your spouse leaves them the money when he or she dies. Plus, it defers the tough decisions about the distribution of your assets until your spouse's death.

9. There are two easy ways to give gifts tax-free and reduce your estate.

You may give up to $14,000 a year to an individual (or $28,000 if you're married and giving the gift with your spouse). You may also pay an unlimited amount of medical and education bills for someone if you pay the expenses directly to the institutions where they were incurred.

10. There are ways to give charitable gifts that keep on giving.

If you donate to a charitable gift fund or community foundation, your investment grows tax-free and you can select the charities to which contributions are given both before and after you die.

Identifying your assets

Assessing your assets and goals is groundwork for a good estate plan.

Few people relish estate planning. After all, deciding how you want your assets distributed after you die can serve as an unnerving reminder of your mortality. But there are plenty of reasons to tackle the task with some enthusiasm:

- You get to name the people to whom you wish to give your assets and know that your wishes carry the word of law.
- You can arrange it so that taxes siphon as little from your pot of gold as possible.
- And you have the satisfaction of knowing that your financial affairs are in order and that you're not bequeathing a costly administrative nightmare to your loved ones.

Your first step? Take stock of all your assets. These include your investments, retirement accounts, insurance policies, real estate and any business interests.

Next, decide what you want to achieve with those assets and who you want to inherit them. This is also the time to think about people you would trust to handle your business affairs and medical care in the event that you become incapacitated.

Once you decide what kinds of bequests you wish to make, be sure to discuss your plans with your heirs. The sooner and more distinctly you outline your intentions to your family and friends, the less chance there will be for disagreements when you're gone.

"If you treat your wealth as a hidden kingdom, a box that no one can open until you're gone, you're setting your family up for disaster," says Norman Ross of the Ross Companies, a New York estate-planning and benefits consulting firm.

In creating your estate plan, keep in mind that the laws governing estate planning are not set in stone.

Estate planning is far more complicated for people with sizable estates, and having a trusted and competent estate-planning lawyer is essential if you wish to protect as much of your assets from Uncle Sam (and your state tax collector) as possible. Such a lawyer can create legal documents, offer advice, keep your estate plan current with new laws and help administer the disposition of assets.

Why do I need a will?

If you don't have a will, a court decides who gets your assets.

A will is a device that lets you tell the world whom you want to get your assets. Die without one, and the state decides who gets what, without regard to your wishes or your heirs' needs.

So-called intestacy laws vary considerably from state to state. In general, though, if you die and leave a spouse and kids, your assets will be split between your surviving mate and children. If you're single with no children, then the state is likely to decide who among your blood relatives will inherit your estate.

Making a will is especially important for people with young children, because wills are the best way to transfer guardianship of minors.

You may amend your will at any time. In fact, it's a good idea to review it periodically and especially when your marital status changes. At the same time, review your beneficiary designations for your 401(k), IRA, pension and life insurance policy since those accounts will be transferred automatically to your named beneficiaries when you die.

A will is also useful if you have a trust. A trust is a legal mechanism that lets you put conditions on how your assets are distributed after you die and it often lets you minimize gift and estate taxes. But you still need a will since most trusts deal only with specific assets such as life insurance or a piece of property, but not the sum total of your holdings.

Even if you have what's known as a revocable living trust in which you can put the bulk of your assets, you still need what's known as a pour-over will. In addition to letting you name a guardian for your children, a pour-over will ensures that all the assets you intended to put into the trust are put there even if you fail to retitle some of them before your death.

Any assets that are not retitled in the name of the trust are considered subject to probate. As a result, if you haven't specified in a will who should get those assets, a court may decide to distribute them to heirs whom you may not have chosen.

Living wills and health-care proxies

Making your medical wishes known through living wills and health-care proxies now can save a lot of heartache later.

A living will (also known as an advance medical directive) is a statement of your wishes for the kind of life-sustaining medical intervention you want, or don't want, in the event that you become terminally ill and unable to communicate.

Most states have living will statutes that define when a living will goes into effect (for example, when a person has less than six months to live). State law may also restrict the medical interventions to which such directives apply.

Your condition and the terms of your directive also will be subject to interpretation. Different institutions and doctors may come to different conclusions.

As a result, in some instances a living will may not be followed. Nevertheless, a patient's wishes are taken very seriously, and an advance medical directive is one of the best ways to have a say in your medical care when you can't express yourself otherwise.

You increase your chances of enforcing your directive when you have a health-care agent advocating on your behalf.

You can name such an agent by way of a health-care proxy, or by assigning what's called a medical power of attorney. You sign a legal document in which you name someone you trust to make medical decisions on your behalf in the event that you can't do so for yourself.

Living wills and health-care proxies

Making your medical wishes known through living wills and health-care proxies now can save a lot of heartache later.

A living will (also known as an advance medical directive) is a statement of your wishes for the kind of life-sustaining medical intervention you want, or don't want, in the event that you become terminally ill and unable to communicate.

Most states have living will statutes that define when a living will goes into effect (for example, when a person has less than six months to live). State law may also restrict the medical interventions to which such directives apply.

Your condition and the terms of your directive also will be subject to interpretation. Different institutions and doctors may come to different conclusions.

As a result, in some instances a living will may not be followed. Nevertheless, a patient's wishes are taken very seriously, and an advance medical directive is one of the best ways to have a say in your medical care when you can't express yourself otherwise.

You increase your chances of enforcing your directive when you have a health-care agent advocating on your behalf.

You can name such an agent by way of a health-care proxy, or by assigning what's called a medical power of attorney. You sign a legal document in which you name someone you trust to make medical decisions on your behalf in the event that you can't do so for yourself.

A health-care proxy applies to all instances when you're incapacitated, not just if you're terminally ill.

Choose your health-care agent carefully. That person should be able to do three key things: understand important medical information regarding your treatment, handle the stress of making tough decisions, and keep your best interests and wishes in mind when making those decisions.

Writing a will: Why should I assign power of attorney?

When you can't control your financial life, make sure someone you trust will by assigning power of attorney when writing your will.

No one is immune from aging or the loss of mental clarity that may come with it. And you're never immune to health crises that may leave you unable to handle the business of your life: paying bills, managing investments or making key financial decisions.

Granting someone you trust the power of attorney allows that person -- known as your "agent" or "attorney in fact" -- to manage your financial affairs if you are unable to do so.

Your agent is empowered to sign your name and is obligated to be your fiduciary -- meaning they must act in your best financial interest at all times and in accordance with your wishes.

There are different kinds of powers of attorney, but in estate planning there are two essential types you should know:

- The first is the "springing power of attorney," which only goes into effect under circumstances that you specify, the most typical being when you become incapacitated.

Often that means your agent cannot act until he or she provides doctors' letters and sometimes court orders to prove you are incapable of making decisions for yourself.

- There is also the "durable power of attorney." It is effective immediately, and your agent does not need to prove your incapacity in order to sign your name.

An attorney can help you decide which form makes the best sense for your circumstance. In any case, take care in choosing your agent. That person should be competent, trustworthy, willing to take on the burden of your affairs and financially secure.

If you choose a relative or friend as your agent, you probably won't have to pay them. But if you name a bank, lawyer or other outside party, you will have to negotiate compensation, which can range from hourly fees to a percentage of your assets paid annually.

If you do become incapacitated without having assigned power of attorney, the court will step in to appoint a guardian. This process might cost your family well over $1,000, not including the cost of the guardian's annual visits to court to report on your situation. Plus, the person chosen may not be someone you would have picked.

Estate planning: Is a trust beneficial?

These tools aren't just for Rockefellers. Use the tips below to determine whether or not setting up a trust the best for you.

The notion of a legal trust may conjure up images of country clubbers cradling gin-and-tonics.

The truth is a trust may be a useful estate-planning tool for your family if you have a net worth of at least $100,000 and meet one of the following conditions, says Mike Janko, executive director of the National Association of Financial and Estate Planning (NAFEP):

- A sizable amount of your assets is in real estate, a business or an art collection;
- You want to leave your estate to your heirs in a way that is not directly and immediately payable to them upon your death. For example, you may want to stipulate that they receive their inheritance in three parts, or upon certain conditions being met, such as graduating from college;
- You want to support your surviving spouse, but also want to ensure that the principal or remainder of your estate goes to your chosen heirs (e.g., your children from a first marriage) after your spouse dies;
- You and your spouse want to maximize your estate-tax exemptions;
- You have a disabled relative whom you would like to provide for without disqualifying him or her from Medicaid or other government assistance.

Among the chief advantages of trusts, they let you:

- Put conditions on how and when your assets are distributed after you die;
- Reduce estate and gift taxes;
- Distribute assets to heirs efficiently without the cost, delay and publicity of probate court. Probate can cost between 5% to 7% of your estate;
- Better protect your assets from creditors and lawsuits;
- Name a successor trustee, who not only manages your trust after you die, but is empowered to manage the trust assets if you become unable to do so.

Trusts are flexible, varied and complex. Each type has advantages and disadvantages, which you should discuss thoroughly with your estate-planning attorney before setting one up.

When it comes to cost, a basic trust plan may run anywhere from $1,600 to $3,000, or possibly more depending on the complexity of the trust. Such a plan should include the trust setup, a will, a living will and a health-care proxy. You will also pay fees to amend the trust if it's revocable and to administer the trust after you die.

One caveat: Assets you want protected by the trust must be retitled in the name of the trust. Anything that is not so titled when you die will have to be probated and may not go to the heir you intended but to one the probate court chooses.

For a trust in which you want to put the majority of your assets -- known as a revocable living trust -- you also have to have a "pour-over will" to cover any of your holdings that might be outside of your trust if you die unexpectedly. A pour-over will essentially directs that any assets outside of the trust at the time of your death be put into it so they can go to the heirs you choose.

If you'd like to learn about different kinds of trusts, read on.

5 standard forms of trusts

Credit-shelter trust: With a credit-shelter trust (also called a bypass or family trust), you write a will bequeathing an amount to the trust up to but not exceeding the estate-tax exemption. Then you pass the rest of your estate to your spouse tax-free. You also specify how you want the trust to be used -- for example, you may stipulate that income from the trust after you die goes to your spouse and that when he or she dies, the principal will be distributed tax-free among your children.

Since your spouse is also entitled to an estate-tax exemption, the two of you can effectively double (or more than double) that portion of your kids' inheritance that is shielded from estate taxes by using this strategy.

And there's an added bonus: Once money is placed in a bypass trust it is forever free of estate tax, even if it grows. So if your surviving spouse invests it wisely, he or she may add to your children's inheritance, says attorney Roger Levine of Levine, Furman & Smeltzer in East Brunswick, N.J.

Of course, you can pass an amount equal to the estate-tax exemption directly to your kids when you die, but the reason for a bypass trust is to protect your spouse financially in the event he or she has need for income from the trust or in the event you think your children will squander their inheritance before the surviving parent dies.

Generation-skipping trust: A generation-skipping trust (also called a dynasty trust) allows you to transfer a substantial amount of money tax-free to beneficiaries who are at least two generations your junior -- typically your grandchildren.

You may specify that your children may receive income from the trust and even use its principal for almost anything that would benefit your grand kids, including health care, housing or tuition bills.

Beware, however. If you leave more than the exemption amount, the bequest will be subject to a generation-skipping transfer tax. This tax is separate from estate taxes, and is designed to stop wealthy seniors from funneling all their money to their grandchildren.

Qualified personal residence trust: A qualified personal residence trust (QPRT) can remove the value of your home or vacation dwelling from your estate and is particularly useful if your home is likely to appreciate in value.

A QPRT lets you give your home as a gift -- most commonly to your children -- while you keep control of it for a period that you stipulate, say 10 years. You may continue to live in the home and maintain full control of it during that time.

In valuing the gift, the IRS assumes your home is worth less than its present-day value since your kids won't take possession of it for several years. (The longer the term of the trust, the less the value of the gift.)

Say you put a $675,000 home in a 10-year QPRT. The value of that gift in 10 years will be assumed to be less -- say, $400,000 -- based on IRS calculations that take into account current interest rates, your life expectancy and other factors. Even if the house appreciates in 10 years, the gift will still be valued at $400,000.

Here's the catch: If you don't outlive the trust, the full market value of your house at the time of your death will be counted in your estate. In order for the trust to be valid, you must outlive it, and then either move out of your home or pay your children fair market rent to continue living there, Janko says. While that may not seem ideal, the upside is that the rent you pay will reduce your estate further, Levine notes.

Irrevocable life insurance trust: An irrevocable life insurance trust (ILIT) can remove your life insurance from your taxable estate, help pay estate costs, and provide your heirs with cash for a variety of purposes. To remove the policy from your estate, you surrender ownership rights, which means you may no longer borrow against it or change beneficiaries. In return, the proceeds from the policy may be used to pay any estate costs after you die and provide your beneficiaries with tax-free income.

That can be useful in cases where you leave heirs an illiquid asset such as a business. The business might take a while to sell, and in the meantime your heirs will have to pay operating expenses. If they don't have cash on hand, they might have to have a fire sale just to meet the bills. But proceeds from an ILIT can help tide them over.

Qualified terminable interest property trust: If you're part of a family where there have been divorces, remarriages and stepchildren, you may want to direct your assets to particular relatives through a qualified terminable interest property (QTIP) trust.

Your surviving spouse will receive income from the trust, and the beneficiaries you specify (e.g., your children from a first marriage) will get the principal or remainder after your spouse dies. People typically use QTIP trusts to ensure that a fair portion of their wealth ultimately passes to their own children and not someone else's.

Money in a QTIP trust, unlike that in a bypass trust, is treated as part of the surviving spouse's estate and may be subject to estate tax. That's why you should create a bypass trust first, which shelters assets up to the estate-tax exemption, and then if you have assets left over you can put it in a QTIP, Levine says.

Estate planning: Best ways to give money now

Giving gifts to family and charity while you're alive can be a boon to them - and your estate.

Estate planning isn't just about how you want your assets distributed after you die. It's about deciding how much you want to give away while you're still alive. If you plan carefully -- so you don't outlive your assets -- giving allows you to reduce your taxable estate and provide advance help to your beneficiaries.

There are two easy ways to give gifts without incurring the gift tax:

- You may pay an unlimited amount in medical or educational expenses for another person, if you give the money directly to the institutions where the expenses were incurred.

- You may give up to $14,000 a year in cash or assets to as many people as you like.

Anytime you give more than $14,000 annually to any one person you must file a gift-tax return and the excess amount will be applied toward your unified lifetime gift and estate tax exclusion of $5.25 million.

If at any point your gifts exceed that exclusion, you will have to pay gift tax on the excess amount. The top tax rate on gifts and estates is 40% in 2013.

Keep in mind, too, that gifts you give that exceed the lifetime exclusion will reduce the amount of money you may leave to your heirs free of federal estate taxes. For example, if you give away $100,000 in taxable gifts, your estate-tax exemption will be reduced by $100,000.

If you want to invest in a 529 college savings plan for a beneficiary, contributions are treated as gifts. You may put in as much as $70,000 in one year ($140,000 with your spouse), but that contribution will be treated as if it were being made in $14,000 installments over five years.

That means you can't give any more money to that beneficiary tax-free during that five-year period. Should you die before the five years are up, part of the money you gave will be included in your taxable estate, specifically the $65,000 minus $13,000 for each year you were alive.

The tax consequence of making large gifts can get complicated. So if you have a large estate, consult with your financial or tax planner to see how much giving you can do without triggering a big tax bill.

Charitable donations are another way to reduce your estate. By investing in charitable gift funds and community foundations, those donations can stretch beyond your death.

Charitable gift funds, which are offered by Fidelity, Vanguard and others, permit you to make a tax-deductible donation, grow your investment tax-free, and then direct a contribution -- in your name -- to nonprofits of your choosing whenever you like.

Community foundations are regionally based charities that take donations of as little as $5,000 in cash, stock or property. The foundations invest that money, pool the gains, and allocate grants, usually to local nonprofits. In most cases, you may either have the foundation give money to organizations you choose or ask the foundation to locate a worthy recipient for a cause you like.

You also can set up what's known as a charitable lead trust, from which a charity receives the income and your heirs the principal; or a charitable remainder trust, in which your heirs get the income and the charity gets the principal. ■