PERSONAL INVESTMENT STRATEGIES

ESTATE PLANNING AND CHARITABLE GIVING

EXECUTIVE SUMMARY

Program Produced By:
Harvard Business School Alumni Association of Boston
www.HBSAB.org

Program Date: July 19, 2011

Produced for HBSAB by:

Executive Summary sponsored by:

www.fidelitycharitable.org

Personal Investment Strategies: Estate Planning and Charitable Giving

- Speakers: **Sarah Connolly**, Partner, Nixon Peabody
  Karla Valas, Managing Director of the Complex Asset Group, Fidelity Charitable[SM]
  Jay Moriarty, Senior Development Manager**,** New York Life Insurance Company

Overview

After a career spent accumulating assets, planning is necessary to preserve those assets for future generations, and to donate those assets to charitable organizations.

An estate plan—including a will and a trust—enables a person to decide how to distribute their assets and minimizes estate taxes. Life insurance is a tool that provides liquidity and mitigates risks. And careful thought about what is given to charity and how it is given can provide charities with more assets while decreasing taxes.

Creating an estate plan doesn't have to be hard. With adequate planning and the advice of experts, anyone can create an effective, well-thought-out plan that achieves their objectives.

Context

Sarah Connolly, an attorney who specializes in estate planning, covered the basics of estate planning and explained the benefits of using a trust to save estate tax. Jay Moriarty of New York Life described the important role that life insurance plays in a financial plan. And Karla Valas from Fidelity Charitable[SM] discussed creative and effective ways to incorporate charitable giving into a personal financial plan.

Key Takeaways

There are several important reasons to have an estate plan, and a few basic steps to be taken.

Ms. Connolly emphasized three reasons to have an estate plan:

- *To make decisions about assets.* An estate plan involves deciding who will get your assets and when they will get them—during your life or after your death.
- *To determine various fiduciary roles.* This includes determining who will be the executor of your estate, who will be your trustee, and who will be the guardian of minor children.
- *To avoid (or minimize) the estate tax.* A well-crafted estate plan can make an enormous difference in the amount of taxes saved.

Decisions on these matters are interconnected. Specifically, choices about how your assets will be transferred will have a significant impact on the estate taxes paid.

Creating a well-planned estate involves creating four important documents. These are:

- *A will.* This is the document that appoints the executor and guardian. In a well-planned estate, a will won't have much more in it; it will say, "Look in my trust." (A will is filed in the probate court and is open to public scrutiny, which is not the case for a trust.)
- *A revocable trust.* This is where the real action is. It contains provisions for assets remaining in trust or being distributed; it may contain provisions related to a spouse, children, grandchildren, or charity.
- *A durable power of attorney.* This is a document that names someone to make financial decisions for you if you are not able to do so. It doesn't require that a person be incompetent for the agent to act. An agent has the authority to act in some way if a person is not available or would be inconvenienced.
- *A health care proxy.* This involves naming a person to make decisions if you become incompetent. In Massachusetts, many health care proxies have a living will that provides non-binding guidance to an agent about what actions to take if a person is in a persistent vegetative state.

A revocable trust is the most common way to decrease or eliminate the amount of estate tax paid.

An estate tax is a tax imposed on the transfer of wealth from one person to another. The estate tax is the same as the gift tax; the gift tax applies if a person is alive when transferring assets and the estate tax applies if a person has died. The estate tax applies to all assets a person owns, including cash, retirement benefits, a brokerage account, real estate, life insurance, a business, and other liquid or illiquid assets.

There is a federal estate tax and 23 states, including Massachusetts, have a state estate tax. The rate of the federal estate tax is 35%; the rate of the Massachusetts estate tax ranges from 5% to 16%.

Several exemptions apply:

- *Annual exclusion.* A person may give another person up to $13,000 per year, exempt from the gift tax.
- *Spousal exemptions.* There is never a gift or an estate tax on a transfer between a person and his or her spouse, during life or after a person's death.
- *Federal estate tax exemptions.* There is currently a federal estate tax exemption of $5 million. So, the first $5 million of a person's estate is not subject to the estate tax and for assets greater than $5 million, a person's estate would pay taxes of 35%.

The current $5 million exemption, which lasts through 2012, is the highest exemption in history. About 15 years ago the estate tax exemption was $600,000; this was increased to $1 million and then gradually to $5 million. (In 2010, there was no federal estate tax.) What happens after 2012 is uncertain. At this exemption level, it is expected that only 3,300 estates will be subject to the estate tax. This is in comparison to 52,000 who paid estate tax when the exemption was $1 million.

- *State estate tax exemptions.* States have different exemption levels. In Massachusetts the estate tax exemption is $1 million. Individuals with assets in multiple states may need to pay estate taxes in each state.

One of the purposes of an estate plan is to minimize what the government gets through taxes and maximize what a person's family or charity receives. An important way to maximize what a person's family or charity receives, and to minimize the taxes paid, is through creation of a trust. Ms. Connolly shared a simple example explaining how a trust can decrease or eliminate payment of taxes:

- *Without a trust.* In this example, a husband and wife in Massachusetts each has assets worth $1 million. When the husband dies, his assets are transferred to his wife, with no estate tax. When she dies, her assets are valued at $2 million. Of this, $1 million is exempt from the state estate tax, but $1 million is subject to the state estate tax, resulting in payment of approximately $100,000 in estate taxes.

> *"The $100,000 that her estate is paying on her death is being paid completely needlessly. With a good plan, it will be a zero tax result."*
> — Sarah Connolly

- *With a trust.* If prior to his death, the husband had created a trust, upon his death his assets could have been transferred to the trust, not to the spouse. Upon the spouse's death, the assets in the trust are not counted as part of the estate and are not subject to the estate tax. So, $100,000 in estate taxes is saved.

  When a trust is created, all types of assets can be put into the trust, instead of provided to beneficiaries, where they must be taxed. This includes putting IRAs or 401ks into a trust, as well as the assets from a life insurance policy.

Use of a trust is the most common type of tax-avoidance technique. Types of common trusts include credit shelter trusts, family trusts, bypass trusts, and A-B trusts. Once assets are in a trust, they never get taxed. However, to transfer assets into a trust, the trust must be created before a person's death.

Other considerations related to a trust are:

- *Titling of assets.* If the assets of a husband and wife are not explicitly titled in the name of either the husband or wife, then when one of them dies, the ownership of the assets transfers to the other. Titling assets separately is necessary so that assets can be transferred into a trust.
- *Portability.* A feature of the current federal estate laws is that the $5 million federal exemption is portable. For example, if a husband dies, his exemption for $5 million transfers to his spouse, who has her own exemption. Therefore, the spouse now has a $10 million exemption. However, as with the entire federal estate tax and exemption, the future of portability is uncertain.

In addition to minimizing estate taxes, a trust provides an individual with control of his or her assets even after his or her death. A trust allows a person to control who receives the assets, when they are received (for example, a child may not receive assets before age 25), and for what purposes the assets can be used (such as for education or to start a business). Trusts can be helpful in second marriage situations to ensure a person's assets are directed as desired. Also, assets in a trust are creditor protected and can be professionally managed.

> *"A trust can really be an incredibly powerful tool."*
> — Sarah Connolly

Creating a trust can be done through a one-time charge by a lawyer; the cost might be $3,000 to $7,000. There is no ongoing cost to maintain a trust.

Life insurance is a tool to mitigate financial risks. Having the right amount and right type are important.

No one wants to buy life insurance, and young, healthy people never think they will need it. But people want what life insurance does, which is provide liquidity when needed after someone dies. Life insurance is an important tool that can mitigate risks. These risks include providing for young children in the event of an untimely death, and paying for estate taxes after a person's death. Important considerations are how much life insurance to have, and what type of life insurance.

How Much Life Insurance?

There is no right answer to "how much insurance?" The right amount will differ for each person based on their personal situation. Many employers provide life insurance for a person's annual salary, with an option to purchase insurance for up to seven times their salary. Is seven times enough? If a person has a two-year-old child, their annual salary enables the same lifestyle for seven years, but what happens when the child is nine years old? Additional insurance may be necessary. Some people think about having insurance for 10 or 20 times their annual salary.

> *"In the life insurance industry, the most important thing you can do for somebody is making sure they have the right amount of death benefit, regardless of what type of insurance they have."*
>
> — Jay Moriarty

What Type of Life Insurance?

The three types of life insurance are:

- *Term insurance.* This provides the highest amount of death benefit, but only provides this benefit for a finite period, such as a 20-year term. Someone in their thirties may not think they will need a death benefit later in life, but life has unexpected events, and there may be reasons why a death benefit would be desired later in life. Having the flexibility to convert term insurance to a more permanent type of policy can have benefits.
- *Universal life.* This is a permanent type of insurance that is meant to be kept forever. It involves accumulating cash that is used solely for a death benefit.
- *Whole life.* This is also a permanent type of insurance with a cash accumulation. Unlike a universal life policy, people often use this cash accumulation for purposes other than a death benefit, such as for emergencies, college expenses, or to supplement retirement.

In addition to deciding on the amount and type of insurance, it is also necessary to decide who the primary and secondary beneficiaries are. In many instances a person's spouse is the beneficiary, but a secondary beneficiary must be named in case the spouse is not alive. This is especially important for people with young children. When there are young children, having a trust as a secondary beneficiary can be a good strategy.

Other uses for life insurance include:

- *Covering estate taxes.* At times, people's estates lack adequate liquidity to pay their estate taxes. A life insurance policy can provide liquidity.
- *Converting a traditional IRA to a Roth IRA.* Upon a person's death, an individual's retirement plan transfers to their spouse or beneficiary. There can be advantages to the beneficiary to convert a person's traditional IRA to a Roth IRA. But doing so means incurring a one-time tax payment, which can be significant. A life insurance policy can be used to cover the costs of this payment.

> *"What we are trying to do with life insurance is identify the bad things that can happen and use the life insurance to mitigate that risk, and depending on the risk, decide what life insurance you should buy."*
>
> — Jay Moriarty

Most people give to charity, but they often choose the least tax-advantaged assets to donate and do so inefficiently.

The American tradition of philanthropy is alive and well in 2011, as people continue to support charitable causes despite economic and legislative uncertainty. Charitable giving can be an important part of one's overall financial plan and tax strategy. Individuals should talk to their trusted financial planners, legal and tax advisors, and wealth and investment managers about how to achieve their philanthropic goals, including what to give and how to give it.

How to Give

Most Americans make direct donations to one or more charities. Other individuals establish private foundations to facilitate their charitable grantmaking. Increasingly individuals are establishing donor-advised funds (DAFs) to simplify and streamline their charitable giving. DAFs are charitable giving vehicles administered by a public charity that invest assets and make grants to eligible charities based on donor recommendations. DAFs have no start-up costs, no ongoing compliance burdens and can be established immediately often with as little as $5,000.

What to Give

All types of assets can be used to support an individual's charitable giving. Many Americans are purely "checkbook givers," making direct cash donations. Increasingly donors are choosing to contribute publicly traded securities including stocks and mutual fund positions. By donating their highly appreciated publicly traded assets (held for more than one year), taxpayers are eligible for a charitable deduction of the fair market value of the stock/fund on the date of the donation and have the potential to eliminate capital gains tax on the sale of the asset. Still other strategic philanthropists contribute non-publicly traded complex assets, like C- and S-Corp stock, partnership interests, real estate, etc., in their portfolio to leverage these same tax advantages. In some cases these non-publicly traded assets are their lowest cost basis asset and, therefore, cost donors the "least" to donate.

> *"Cash may not always be the most tax-efficient asset to give to charity; it costs you the most to give it away . . . there's a better way out there."*
>
> — Karla Valas

By unleashing the power of their most appreciated assets, donors can "afford" to give more to the charities they support. Donating complex assets a public charity with a DAF program is a powerful way to supercharge and diversify your philanthropy from a single asset donation.

Suggested Actions

- *Create an estate plan and prepare the basic documents*. (Get the advice of an estate planning expert.)
- *Determine if a trust is appropriate and beneficial*. (Get the advice of a trust expert.)
- *Assess what type of life insurance is most appropriate and what the necessary amount of insurance is*. (Get the advice of an insurance expert.)
- *Consider the role that charitable giving plays* in your financial/retirement plan. *Decide how and what to give;* think beyond cash donations to leverage privately held business interests or seemingly illiquid assets. (Get the advice of a charitable giving expert).
- *Review your retirement plan regularly*. Things change, including laws, your financial and personal situation, and thoughts about potential beneficiaries. Therefore, it is essential to regularly (at least yearly) review the decisions reflected in your will and other documents.

Speaker Biographies

Sarah Connolly

Partner, Nixon Peabody

Sarah Connolly is a partner at Nixon Peabody specializing in estate planning and trusts. Sarah has been recognized for exceptional standing in the legal community in *Chambers USA: America's Leading Lawyers for Business 2010 and 2011* for estate planning. For the past six years, Sarah has been named a "Rising Star" by Law & Politics Media, Inc., based on a peer review survey of attorneys in Massachusetts. The "Rising Stars" are published annually in the *Massachusetts Super Lawyers Rising Stars Edition* and in *Boston* magazine.

Karla Valas

Managing Director of the Complex Asset Group,
Fidelity Charitable

Karla brings deep knowledge and technical expertise to donors who wish to contribute complex assets, such as privately held C-corp. or S-corp. shares, to charity. Ms. Valas and her team work directly with donors, their advisors, and corporate and business lawyers to facilitate charitable transfers of these assets to achieve the most favorable tax treatment with the greatest charitable impact. Fidelity Charitable is an independent public charity with a donor-advised fund program.

Jay Moriarty

Senior Development Manager
New York Life Insurance Company

Jay is a registered agent with NY Life Securities, LLC, and holds Industry designations of CPA, CLU, ChFC and LUTCF. He is a member of FINRA (Financial Industry Regulatory Agency) and a former member of the Million Dollar Round Table, whose members are at the top of the Financial Services Industry.