Why an Estate Plan is Essential to Every Financial Plan

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An estate plan is essential for anyone with assets. Regardless of your age and financial situation, estate planning will protect the people you love most down the road. It also averts taxes and legal tie-ups and ensures funds are distributed according to your wishes. In addition to simplifying the distribution of your assets after you're gone, an estate plan can make difficult decisions so your loved ones aren't burdened with them.

While we all love our families, charities, and friends, only about 33% of U.S. adults have a formalized estate plan[1]. The usual excuses include perceived costs and complexity and the notion that "my assets aren't large enough for an estate plan." However, estate planning critically allows you to choose who will inherit what[1] and allows you to name your children's guardians in the event of premature death. Reducing taxes on what you leave behind is a common estate-planning goal[1], and estate planning minimizes the chances of family strife and ugly legal battles.

The Basics for Every Estate Plan

For most, a "basic" estate plan is sufficient. Every estate should have three simple documents:

1. **Will:** A legal document that coordinates the distribution of your assets after death and can appoint guardians for minor children, a will allows you to communicate your wishes clearly and precisely and generally includes:
   – Designation of an executor who carries out the provisions of the will.
   – Beneficiaries — those who are inheriting the assets.
   – Instructions for how and when beneficiaries will receive the assets.
   – Guardians for any minor children.

2. **Power of Attorney:** This document gives another individual the authority to make legal decisions and act on your behalf in accordance with the document. This person is known as the "attorney in fact" or "agent" and can be your spouse, partner, or anyone you trust. A power of attorney can apply to all your affairs or only to particular assets or accounts.

3. **Healthcare Directive:** This gives another individual legal authority to make healthcare decisions for you if you become incapacitated. The objectives are to appoint a person you trust to act on your behalf for healthcare decisions when you cannot and to ensure your intentions are well understood.

These three documents allow you to pass your assets to your heirs, provide you with an advocate who will act in your best interest if you are not able to, and give direction in any catastrophic medical event so your loved ones are not forced to make difficult decisions.

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In addition, there is one simple thing that you can do that will cost you nothing and only take a few minutes: Update your investment and insurance beneficiary designations.

All financial accounts and insurance policies with named beneficiaries supersede any language in a will. With that in mind, it is important to regularly review your investment account (IRAs, 401(k)s, brokerage accounts, bank accounts) and insurance policy beneficiaries to make sure they are aligned with your wishes.

It is not uncommon for account beneficiaries to be outdated (directed to an ex-spouse, a deceased person, or someone who is no longer part of the family) and not in line with the language of a will. In that case, the named beneficiary on any account will always supersede the language in a will.

Trusts Provide an Additional Layer of Control

A trust can also be a key part of your estate plan: Do you have young children who may not be capable of caring for themselves after you're gone? Do you have heirs who you wish to provide for but are not responsible enough to manage a large transfer of assets? Do you have specific assets, such as a family cabin, that you would like to ensure are enjoyed after you're gone?

For all of these reasons and more, a trust can provide additional control over how your assets are passed on.

The most common type of trust is a *living trust* or *revocable trust,* which is created while the person establishing the trust is still alive. In this case, a parent could establish a trust for a child during his or her lifetime, designating himself or herself as trustee and the child as beneficiary. As the beneficiary, the child does not own the property but receives income derived from it.

With a revocable living trust, the trustee can make changes during his or her lifetime. A revocable trust usually directs the trustee to pay all income to the settlor for life and to pay the trust assets to named persons after the settlor's death. Revocable living trusts avoid the often lengthy probate process but, by themselves, don't provide shelter for assets from federal or state taxes. These trusts are often considered tax-neutral since the tax consequences for the grantor are usually the same whether or not the property is placed in a trust.

On the other hand, irrevocable trusts are often used for high-net-worth estates to reduce estate or income taxes. For tax purposes, the trust becomes a separate entity; the assets cannot be removed nor can changes be made by the trustee. In most cases, the trustee cannot be the sole trustee of an irrevocable trust without losing the intended tax benefits.

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Currently, the federal estate tax exemption is $12.92 million per person ($25.84 million per married couple). While there may be lower exemptions in many states, the federal exemption is currently high enough that most of us won't need to worry about it. In 2020, less than 0.1% of the 2.8 million people who died in the United States paid estate taxes.

Minnesota Estate Tax Exemption

The Minnesota estate tax exemption is $3 million per person. Unlike the federal exemption, it is not transferrable to the surviving spouse. This means that if a person dies with an estate worth more than $3 million, the excess above that amount will be subject to estate tax.

For example, if Mrs. Smith dies with an estate worth $5 million, the excess $2 million will be taxed at approximately 15% ($300,000). Even if Mr. Smith's total estate is only $1 million at the time of death, Mrs. Smith's estate will still be taxed. Then, when Mr. Smith passes away a few years later with an estate worth $5 million, the $2 million excess will be taxed at 15% again (another $300,000).

In this example, the Smiths would pay a total of $600,000 in estate taxes since Mrs. Smith's estate is in her name and her assets go to Mr. Smith upon death. Minnesota taxes each person separately so he will pay tax on the value of their total assets upon death.

Reducing (or Even Avoiding) Estate Taxes

The good news is that there are several ways to reduce or avoid estate taxes. One option is to ensure that assets are equally divided between spouses upon the first death. This will allow the surviving spouse to use their own exemption to shelter the assets from estate tax. Lifetime gifts present another possibility, however, gift tax limits must be considered.

It is important to consult with an estate planning attorney to discuss your specific situation and options for reducing or avoiding estate taxes.

In summary, here are some top tips for estate planning in Minnesota:

- Keep track of how assets and accounts are titled between spouses since the Minnesota estate tax is per person — dividing them equally is important to avoid taxes, if possible.
- Make sure that your will is up-to-date and reflects your current wishes.
- Consider creating a trust to protect your assets from creditors and lawsuits.
- Talk to your attorney about estate planning strategies that can help you save money on taxes.

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Your IRAs Will Be Taxes No Matter What: *Strategies for Maximizing Wealth Transfer*

Most individuals and couples hold their largest balances in tax-deferred accounts, such as IRAs, 401(k)s, and other retirement accounts. These accounts will be fully taxable as ordinary income.

With the passage of the Secure Act in 2019, all tax-deferred accounts that pass to non-spouse beneficiaries (i.e., your kids) must be distributed within 10 years of the decedent's date of death. This means that if Mr. Smith passes away and leaves his remaining balance of $500,000 to Mrs. Smith, she will be able to continue that IRA as if it were her own until she dies. Let's assume that Mrs. Smith also had a $500,000 IRA. After inheriting Mr. Smith's $500,000, her total IRA will be $1 million. When Mrs. Smith passes away, her kids will be required to distribute their share of the $1 million over no more than 10 years.

If there are two beneficiaries and each of them inherits half, they each need to take $500,000 over 10 years and will pay income tax on at least $50,000 (assuming additional growth) per year over 10 years. This will be taxed at their marginal income tax level. For example, if they are being taxed at 24% federal and 7.85% state tax rates, nearly 32% of their "inherited" IRA value will be taxed as it is withdrawn over 10 years.

To minimize the amount of assets in an inherited IRA and maximize the eventual value of the transfer of wealth, retirees may want to consider the following strategies:

Roth conversions: Develop a plan to systematically convert IRA assets to Roth IRAs on an annual basis. Roth IRA assets will transfer tax-free to beneficiaries.

Charitable giving: Utilizing the Qualified Charitable Distribution (QCD) rule after age 70½ will help reduce taxes on IRA distributions throughout retirement. It will also reduce the eventual taxes on the overall estate as well as the taxable beneficiary IRA amount for heirs.

Donor-advised funds: Gifting highly appreciated assets in conjunction with Roth conversions can result in significant tax savings if structured properly.

Gifting to heirs: If you know your assets will eventually go to your heirs, it may be beneficial from both a financial and philosophical standpoint to distribute some of their inheritance while you are alive. They may find more meaning in the gift at a younger age when they need it more. You might also appreciate seeing them enjoy the gift.

Upcoming Changes

There are some upcoming changes that investors and property owners should pay attention to, particularly, the estate tax exemption sunsetting in 2026. The current lifetime estate and gift tax exemption is $12.92 million for 2023. However, this exemption is set to sunset on January 1, 2026, and revert back to the 2017 amount of $5 million, adjusted for inflation.

This means that if a person dies with an estate worth more than $5 million in 2026, the excess amount will be subject to estate tax.

Families that may face estate tax liability in 2026 may benefit from transferring assets and their appreciation out of their estate sooner rather than later. There are several ways to do this, such as:

–Making lifetime gifts

–Establishing trusts

–Using charitable remainder trusts

It is important to consult with an estate planning attorney to discuss your specific situation and options for minimizing estate taxes.

In addition, there is also a possibility that the "step up in basis" could be eliminated or reduced.
The step up in basis is a tax rule that allows the heirs of a deceased person to inherit assets with a new, stepped-up basis equal to the fair market value of the assets at the time of death. This means that the heirs are not taxed on any unrealized capital gains that have accrued on the assets since they were purchased by the deceased person.

If this were to be eliminated or reduced, it would have a significant impact on estate planning since heirs would be taxed on any unrealized capital gains that have accrued on the assets since they were purchased. This could result in a significant tax bill.

This is currently just a proposal, however, it should be considered by anyone who is currently developing an estate plan.

Why You Should Work with an Estate Planning Attorney

If you don't have an estate plan, there is no time like the present. It is one of the most important things you can do for yourself and your loved ones. Whether you have a large estate or are just starting out, a formalized estate plan will give you peace of mind and greater control over your financial future as well as that of your heirs.

A fiduciary advisor can give you suggestions that may benefit you and your family, but you will need to work with an estate planning attorney to determine your best path forward and create your estate planning documents.

Estate planning is a complex process, and it is important to consult with an attorney. Regardless, the extensive benefits of an estate plan are well worth the time and effort. In a nutshell, an estate plan is a critical component of every financial plan.

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