Since You Can't Take It With You: First Thoughts on Planning Your Estate[1]

Death and taxes are, proverbially, the only two certainties in life. Most people would rather avoid thinking about, let alone planning for, either of these two inevitabilities. And yet doing so — actually getting the decisions made — can be a liberating experience. Freeing heirs from the chore of determining how to dispose of possessions and assets can also be a demonstration of consideration, kindness and love.

Estate-planning advice often revolves around the choice and creation of legal structures and legal documents, such as wills and trusts. Indeed, these are critical tasks, and everyone reading this article is urged to consult a knowledgeable trusts and estates attorney for guidance in these matters.

However, starting with estate-planning *structures* may be putting the cart before the horse. Before determining which structure(s) to use in order to accomplish estate-planning goals, we first need to figure out exactly what those goals are. The most basic estate-planning issues to address are *who* gets your assets (and ultimately your estate); *when*, (either during your lifetime or after your death); and *how* (outright or in trust).

Creating a framework for thinking through these issues is the topic of this article. For this reason, the process of estate planning is often iterative: If you change one aspect of your plan, this will trigger changes in other aspects, too.

Three categories of questions for asset owners to address:

I. How much:

1. Do you have?
2. Do you need to support your own life?
3. Is your "surplus"?

II. Who will get your money?

1. Creditors
2. The government
3. Charity
4. Heirs

III. When will they receive it?

1. During your lifetime
2. As a bequest
3. Trade-offs

A few words of caution (and encouragement) before beginning: Estate planning is a highly personal endeavor, with many moving parts that involve complicated trade-off decisions. It's usually best to proceed methodically, breaking down the project into manageable steps and then completing one at a time.[2]

I. How much?

This first category of questions itself addresses several interconnected issues.

First, how much do you have? That is, what is your ***Net Worth*** — The total value of what you own, minus the total amount you owe to creditors? Your net worth is the value for which you will be creating a disposition plan.

Second, how much do you need to live your life? That is, what is the value of assets that is likely to be needed to generate sufficient total returns (including, but not limited to, income) to pay for your spending needs during your lifetime? We will refer to this amount as your ***Required Base***.

Third, does your Net Worth exceed your Required Base, and, if so, by how much? This amount is your ***Asset Surplus***. Conceptually, it represents the amount of assets that can be given away during your lifetime without impairing

[1] This article is an outgrowth of discussions with actual Beekman Wealth Advisory clients. They had been widowed; had inherited substantial assets; had adult children with some degree of incapacity in managing their own financial affairs; had grandchildren; had charitable interests. They were at a loss to know how to begin thinking about planning for their assets and their eventual estates. That is to say they had specific concerns that were entirely typical of the range of issues to be addressed.

[2] To paraphrase a very old joke: The way to eat this elephant is one bite at a time.

your ability to support your own lifestyle. Alternatively, this represents the amount to be left in your estate if you *don't* plan to give the excess away during your lifetime.

Even if you don't have an asset surplus, you may still have an ***Income Surplus***. This is the amount by which your ongoing annual income exceeds your spending requirements. Conceptually, it represents the amount of annual gifts that can be made from current income without impairing your ability to support your lifestyle.

Here's what these relationships look like in mathematical terms:

1. **Assets – Liabilities = *Net Worth***
2. **Total Spending – Earned Income = *Portfolio Spending***
3. **Portfolio Spending/Sustainable Spending Rate = *Required Base***
4. **Net Worth – Required Base = *Asset Surplus***
5. **Earned Income – Spending = *Income Surplus***

With respect to determining your Net Worth, the first thing to do is to gather the most recent records of what you own and what you owe. On the asset side (what you own), these records include bank statements, investment statements (such as from mutual fund accounts and retirement plans), trust asset statements, business interest valuations, appraisals of personal property, if appropriate, and estimates of the value of other tangible property, such as real estate. On the liability side (what you owe), the relevant documents include credit card statements, mortgage statements, tax bills, student loan statements, and any other evidence of indebtedness.

Once you have the documents collected[3], you create an organized listing of assets and liabilities. Your net worth is amount by which your assets exceed your liabilities. Please note: Re-creation of the wheel is not necessary! There are many net worth calculation tools available online for free. Alternatively, you may use the work sheet that appears on the last page of this article.

There is one nuance to be aware of in calculating your net worth. This is the possible existence of "contingent" assets and liabilities. A contingent asset is an asset that doesn't yet exist, but would exist, given the passage of time or of a specified event. A contingent liability is similar.

Life insurance is the most important contingent asset for most people planning their estates. The death benefit[4] does not yet exist — obviously! — when you are calculating your own net worth. It will be an amount that accrues to the benefit of heirs, however, and should be included in your thinking about how much to leave.

Once you have your net worth calculated, and you know how much of a portfolio you *have,* the next step is to figure out how much of a portfolio you *need*, in order to support your life. The first step in this calculation is to determine how much you spend.

This is another example of where an online search can help — this time just Google the search term "Budget Calculator" or "Spending Calculator." For example, the web address http://finance.yahoo.com/calculator/saving-spending/bud02/ will take you to a well-organized tool for categorizing your spending. You enter in your monthly or annual spending by category (housing, food, clothing, insurance, entertainment, and so on), and the calculator totals it up for you.[5] Be sure to include an estimate for foreseeable, but lumpy, amounts, such as for home maintenance needs (new furnaces, new roofs), new cars and the like.

Now that you have calculated your total spending, the next step is to figure out how much of that spending needs to be funded by your portfolio. This is a straightforward calculation, requiring that you subtract the amount of earned income (e.g., wages, salaries, pension, Social Security) and other ongoing cash inflows (e.g., financial gifts received, alimony) from the required spending. The amount left over is the value that will need to come from your portfolio.

[3] If you don't have all the required documents, just use your best estimates. It is better to go ahead and create your plan using *some* values, even if they are approximations, than it is to wait for 100% accurate values.

[4] The value to be paid to the owner of a life insurance policy when the insured person dies. Proper titling of life insurance policies is critical in order to maximize the value passing to heirs. An estate attorney can advise on this.

[5] This obviously does require that you keep track of these amounts. Your checkbook, bank statements, and credit card statements should have all of the information required. If this information is not easily accessible, estimates are enough to get started.

The next step is to calculate the size of the portfolio you must have to support your spending. This is the Required Base amount, and it is determined by dividing the *Required Portfolio Spending* amount by the *Sustainable Spending Rate.*

Conceptually, the rate is the percentage of a portfolio that may be withdrawn for spending each year while still keeping the portfolio value whole, after spending, taxes, and inflation. Many practitioners use a rate of 4% as a general guide, but this can vary from person to person. A more-detailed description of spending issues, including calculation of the sustainable spending rate, is published in BWA's article entitled *How Not to Become a Bag Lady*, available at www.beekmanwealth.com.

Thus, if 4% is the sustainable target spending rate, and your spending needs from your portfolio are $100,000 per year, you will need a portfolio of at least $2.5 million to support your spending. If you spend more than 4%, or your starting portfolio is less $2.5 million, you will almost certainly diminish the value of your portfolio over time.

Armed with all of these numbers, you can now approximate the amount of your portfolio that can be given away during your lifetime without impairing the quality of your own life.

For example, if your Net Worth is $4 million and your Required Base is $2.5 million, it may be reasonable for you to consider gifting up to $1.5 million during your life. On the other hand, if your Net Worth is $2 million and your Required Base is $2.5 million, you may need to think more about gifts in the form of bequests.[6]

Finally, if you can't or don't wish to give away your assets (i.e. any portion of your Net Worth), you may still wish to gift a portion of your annual income. If your annual spending needs total $100,000, for example, and your annual income is $125,000, you can give away up to $25,000 per year without impairing your quality of life.

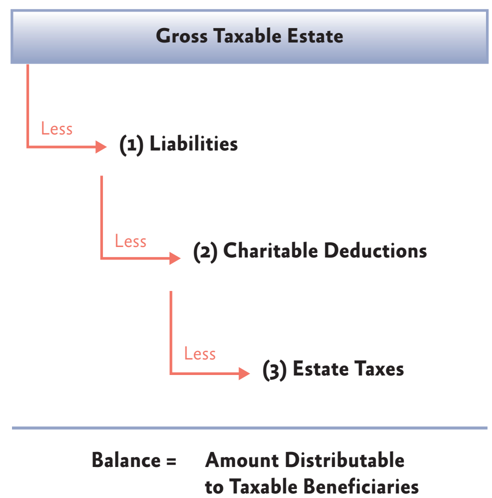
If so, note that the government sets an amount, called the annual exclusion amount, that may be gifted to individuals each year before gift taxes are imposed. At the time of this writing (April 2013), the annual exclusion amount is $14,000 from each giver per recipient (not per giver) per year. Consult your tax advisor or trusts and estates attorney about gifts exceeding this amount.

II. Who will get your money?

Now that you have estimated the amount you have to give, most of the math is over. The rest of the math has to do with who will get what proportion of your assets.

This is not entirely yours to determine. There is a legally-determined order of payments out of a personal taxable estate,[7] which may be thought of as a "waterfall" of cash. A very general form of the waterfall is below.

The Basic* "Waterfall" in a Taxable Estate*



*Though highly oversimplified.

Note that other legal structures, such as trusts and IRAs, have their own rules, but the essential idea is that various liabilities (applicable taxes, any debts owed, adminstrative expenses, etc.) must be satisfied before heirs receive their inheritances.

As indicated, the starting point for the waterfall is the total amount of your assets. From this amount, your liabilities must first be satisfied. This includes any final income taxes owed, debts owed, funeral expenses, expenses of administering your estate, and so on. The next set of de-

[6] Gifts made at death, usually by will.

[7] Assets that are owned in forms other than personal taxable accounts, such as through corporations, trusts, and IRAs, have different requirements and different waterfalls. A trusts and estates professional will be indispensable in creating estate plans that include such vehicles.

ductions from a taxable estate is the gifts made to charity. Once these are satisfied, the amount of estate taxes owed, if any,[8] are deducted. What is left over after payment of estate taxes is the amount you can give to taxable heirs.

Keep in mind that there *many* nuances to these calculations that are beyond the scope of this article. Most importantly, gifts and assets left by one spouse to another are exempt from transfer taxes,[9] so long as both are U.S. citizens.[10] This is called the "marital deduction". Estate taxes on assets transferred between spouses are deferred until the death of the second spouse to die.

As a sample of other nuances, some assets are more efficiently used to fund charitable gifts than others; the estate tax regime is subject to change by Congress; asset values may not be clear-cut; additional transfer taxes may be imposed on gifts to people two generations or more below the giver. Expert guidance from a trusts and estates attorney is essential for investors with substantial means.

You should be noticing that there are two levels of the waterfall for which you'll need to make decisions: Charitable gifts and bequests to taxable heirs. In both of these areas, you'll need to decide exactly who gets how much, and on what basis.

III. When and how will they get it?

Up to now, this article has focused on numbers. Calculating them might be tedious, but the process is reasonably straightforward.

When it comes to addressing this final set of issues, things get murkier, because decisions are driven by emotional factors, as well as numbers. In deciding when and how to distribute your assets to your heirs, there is no objectively "correct" answer. There are, instead, a series of considerations and trade-off decisions. The list below is not exhaustive, but it may help frame your thinking.

1. **How much would you like to give to charity, and how much to your family (or other taxable beneficiaries)?**
    - Are there specific charities you wish to benefit with specific amounts?
2. **Will you give to your children (or other family members) equally, or on some other basis?**
    - For example, might you give on the basis of need, instead?
    - What behavior will you be encouraging, or rewarding in the amounts you give?
3. **Will you give to your children (or other family members) outright, or in trust?**
    - Can your heirs handle the responsibility of managing their own finances, or will they need help?
    - Do you wish to keep all assets protected from creditors, and/or in the hands of your lineal descendants only?
    - If you give in trust, what provisions will you make? How long will the trust last, whom will it benefit, and who will be legally responsible for it (the trustee)?
4. **Will you make current gifts, or bequests?**
    - Do you have a Surplus? (See above)
    - Would moving assets out of your taxable estate during your lifetime reduce your ultimate estate and/or gift tax bill?
    - Would you enjoy seeing the effects of your gifts during your lifetime?
5. **How will you handle gifts of tangibles (art, jewelry, furniture, and the like?**
    - Are there items that are of particular sentimental value to particular heirs?
    - Conversely, are there items that your heirs might find particularly burdensome to use or dispose of?

[8] At the time of this writing, the first $5.25 million of a taxable estate is exempt from estate taxation.

[9] Gift, estate, and generation-skipping taxes are collectively referred to as transfer taxes.

[10] Tax-free gifts to noncitizen spouses are limited by the tax code. The 2013 annual allowance for tax-free gifts, which must be present-interest gifts, is $143,000.

6. **How and when will you communicate your plans to your heirs?**
   - Are there any legally-required or -advised disclosures?
   - What kinds of communications will best support your family relationships?

A few points to think about as you work through these decisions:

First, your assets are yours, and you are free to dispose of them as you see fit, within the limits imposed by estate law. These limits include, primarily, the right of a spouse to a share of any estate, and the obligation to pay any debts and estate taxes due.

Second, while you can control what and how you give, you cannot control the reactions of the recipients; how they treat the assets; or how they treat each other.[11] Gifting equally to heirs who are very differently situated financially may, for example, seem fair to all of them — or it may cause the richer heirs to feel guilty and the poorer ones to feel resentful. All you can do is try to lay the groundwork for healthy family relationships in advance.

Finally, as with most aspects of the estate-planning process, the decision on when and what to communicate to heirs involves trade-offs that must be weighed in light of individual personal circumstances. There is no one "right" answer about the timing and content of communications.

For some heirs, knowledge of a future inheritance may act as a disincentive to provide for themselves, or create expectations that may not be fulfilled if you change your mind about the disposition of assets. In other cases, heirs who are responsible and mature can and should be brought into the process early on.

Conclusions

Making decisions about the disposition of your assets can be an emotionally fraught and time-consuming process. As this article has stressed, it is also an area in which expert guidance is essential. At Beekman Wealth Advisory, we routinely work with our clients' other trusted advisors, including attorneys and trustees, to help clients realize their goals and plans for the financial care of their families.

We would be pleased to discuss any questions or concerns you may have on this important topic.

Elizabeth P. Anderson, CFA, is the founder of Beekman Wealth Advisory LLC, a boutique financial consultancy providing highly customized services to families and individuals. Founded in 2003, Beekman Wealth Advisory's business model reflects its unwavering commitment to the best interests of its clients.

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[11] The classic cautionary tale on this score is, of course, King Lear.

Beekman Wealth Advisory

Net-Worth Worksheet

Assets (What You Own)

Cash:

Cash On Hand
Checking Account
Savings Account
Money Market Funds
Cash Value of Life Insurance
Other

Investments (Market Value):

Certificates of Deposit
Stocks
Mutual Funds
Annuities
IRAs
401(k), 403(b), 457 Plans
Pension Plan
Business Property
Other

Real Estate/Property:

Home
Land
Other

Personal Property (Current Value):

Automobiles
Recreational Vehicle/Boat
Home Furniture
Collections (Art, Automobiles)
Jewelry and Furs
Other

Total Assets

Liabilities (What You Owe)

Current Debts:

Household
Medical
Credit Cards
Department Store Cards
Taxes
Legal
Other

Mortgages:

Home
Land
Other

Loans:

Business
Bank/Finance Company
Bank/Finance Company
Automobile
Recreational Vehicle/Boat
Education
Life Insurance
Personal (from family or friends)
Other

Total Liabilities

Total Assets Minus Total Liabilities = Net Worth