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Trust UPDATE

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Emerging ideas in estate planning

The paradigm shift that leaves many things just the same

Addressing a conference of estate planners in 2013, attorney Jonathan Blattmachr warned that certain legislation, which had just been recently enacted, portended two paradigm shifts for estate planners. The first was that the demand for estate *tax* planning would be going down, indefinitely. When George W. Bush became President in 2001, there were 120,000 estate tax returns, of which 60% were taxable. By 2012, as a result of the basic $5 million federal estate tax exemption, the number of estate tax returns was down to 6,000, and just 4,000 were taxable. That shrinkage has to translate to less tax work for estate planners.

The welcome news that so many affluent families will no longer need to worry about death taxes does not reduce the essential need for estate planning itself, however. Thorough estate planning covers a lot of non-tax territory. It includes end-of-life health care planning, as well as the appropriate disposition of assets at death. For many families it also includes creation of a structure to protect assets for the family's long-term financial security. That structure usually includes a trust—a family trust, a marital deduction trust, a spendthrift trust—there are many variations possible.

The new choice

The other paradigm shift noted by attorney Blattmachr is the permanent availability of something known among estate planners by the shorthand term "portability." More formally, the IRS refers to it as the Deceased Spouse's Unused Exemption, or DSUE.

Before 2010 one bread-and-butter estate planning recommendation for affluent married couples was the creation of a "bypass trust," sometimes called a "credit shelter trust." The problem with creating a simple, "all to spouse" will to govern an estate plan was that it would needlessly sacrifice one federal estate tax exemption. The trust plan preserved the exemption from both the husband and the wife, doubling the death tax protection for the family fortune.

Continued on next page

Which is right for your family?

To double the federal estate tax exemption, married couples may choose between the traditional bypass trust and the new portability election. Each approach has advantages and disadvantages.	Bypass Trust	"All to spouse" with portability election
Creditor protection	X	
Basis step-up at spouse's death		X
No estate tax on asset appreciation	X	
Spouse has access to all assets	X	X
Professional asset management	X	
Can be utilized even in the absence of a will or other planning		X
Fiduciary income tax filings required	X	

Source: M.A. Co.

Beginning in 2011, the estate tax exemption was made portable for married couples. That cured the tax defect inherent in an "all to spouse" will. The new rule was set to expire at the end of 2012, but Congress made it permanent shortly before Blattmachr's address. Now that portability is permanent, estate planners are going to have to weigh the circumstances in which it is preferable to the traditional bypass trust approach.

Example. Rob and Laura's total assets, including their two homes and several retirement accounts, come to $8 million. For the sake of illustration, assume that the federal estate tax exemption is $5 million and the tax rate is 40%. In the absence of the portability rule, what happens if Rob has an "all to Laura" will? There will be no estate tax at his death, because there is no limit to the marital deduction. But when Laura dies, her $8 million estate will be reduced by $1.2 million (40% of $8 million less her $5 million exemption). The old remedy would be to have a two-trust plan, a marital trust and a bypass trust. Each could be funded at $4 million, or the bypass trust might be maximized to provide for inflation protection. The estate tax at Laura's death disappears.

Now, however, the same result may be had with an all-to-spouse will. The executor will have to file an estate tax return for the first spouse to die, in order to let the IRS know that the estate did not use its available exemption to avoid taxation, relying instead upon the marital deduction.

There are pluses and minuses with each of these approaches. See "Which is right for your family?" for a brief comparison. If you are married, and your total marital estate is likely to be larger than $5 million, you should hash out the alternatives with your estate planning advisors.

We can help

We offer two important services in the estate planning area. First, we settle estates. We will act as the executor (or personal representative) under a will. The job is more complicated than most people appreciate—it should not be considered simply an "honorary" position, because too much can go wrong when an amateur tries to be an executor for the first time.

The second service is as the trustee of trusts created during life or under a will. We have extensive experience in asset management, trust administration and exercise of fiduciary judgment. All of these are essential to a successful estate plan.

Like to learn more? Give us a call at your earliest convenience. ☐

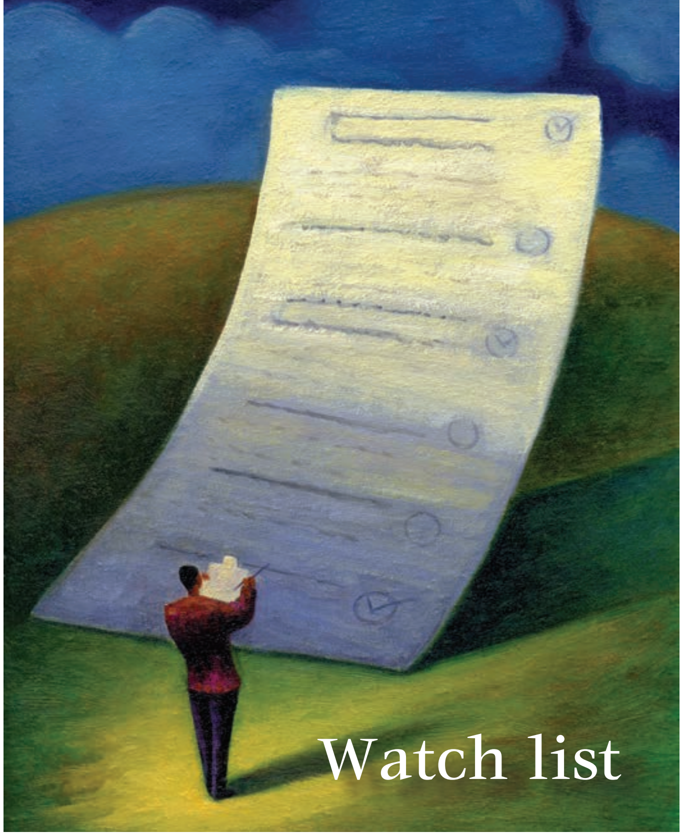
Do it yourself? Maybe not.

This is, unfortunately, a true story. Anne Aldrich wrote her will on an "E-Z Legal Form" on April 5, 2004. Ms. Aldrich carefully inventoried all of her property on the preprinted form, and she left all of her possessions to her sister. She also provided that if the sister died before she did: "I leave all listed [property] to James Michael Aldrich," her brother. The will was duly signed and witnessed. It was legal and unambiguous. However, it did not contain a "residuary clause" for disposing of any property not specifically mentioned in the will. Ms. Aldrich may not have appreciated the importance of that omission. Had she died soon thereafter, it might not have made any difference.

But as it happened, her sister died first. Ms. Aldrich inherited a considerable amount of property from the sister. The property so acquired was not, of course, mentioned in the will. Ms. Aldrich wrote an addendum to her will that acknowledged her sister's death and said, "I reiterate that all my worldly possessions pass to my brother." Alas, under local law the note could not be considered a valid will or codicil, because it lacked the signature of a witness.

After Ms. Aldrich died, two nieces challenged the will. They argued that the brother's inheritance must be limited to the items named in the first will, and that the balance of the estate must pass under the laws of intestacy (the rules that govern inheritance in the absence of a will). The Courts, with some regret, sided with the nieces, although they acknowledged that this almost certainly was not Ms. Aldrich's intention.

The Florida Supreme Court summed up the outcome with these words: "Obviously, the cost of drafting a will through the use of a pre-printed form is likely substantially lower than the cost of hiring a knowledgeable lawyer. However, as illustrated by this case, the ultimate cost of utilizing such a form to draft one's will has the potential to far surpass the cost of hiring a lawyer at the outset." The costs of litigation, and having the estate tied up for years, as well as the possibility of failing to have one's intentions accurately carried out, make the investment in consulting an estate planning attorney a wise one indeed.



The Obama administration would like to end some high-end estate planning strategies.

Most affluent families no longer have to be concerned about federal estate taxes, given today's $5.34 million exemption amount. President Obama would like to roll that back to the regime in place in 2009, with a $3.5 million exemption. That would also kick the tax rate up from today's 40% to 45%.

Still, most of the revenue from the estate tax comes from estates of $20 million and up. In that rarified atmosphere, the estate tax is sometimes called a "voluntary tax," because there are so many opportunities for planning to avoid it. The President has taken aim at some of those strategies as well. Here are three of them.

Walton GRATs

GRAT stands for Grantor Retained Annuity Trust. The idea is that the grantor places an asset in a trust for a term of years, receiving income from the trust during its existence. At the end of the term, the trust terminates, and the remaining assets pass to the heirs. When the trust is created, there is a gift tax due on what the heirs will receive, discounted to reflect the value that the grantor retained for himself or herself.

One of the Walton heirs pushed this strategy farther. A GRAT was set up to last for just two years, funded with Walmart stock. The annuity was set so high that essentially the entire value of the transfer had to be returned to the donor, so the value of the gift was "zeroed out," and no gift tax would be due. What's the point? If the stock transferred to such a trust zooms in value during the two years, the excess appreciation passes to heirs entirely free of gift taxes, and the asset has been removed from the estate of the donor.

Reportedly, casino magnate Sheldon Adelson has used multiple GRATs to transfer more than $7 billion to his children, saving nearly $3 billion in gift taxes. Although IRS filings are confidential, SEC filings are not. They reveal that hundreds of executives, including high-profile entrepreneurs such as Facebook's Mark Zuckerberg, have employed GRATs in recent years.

President Obama proposes to have a minimum 10-year term for future GRATs. Should the donor to a GRAT die before the end of the term, the value of the asset would be subject to the estate tax.

Crummey *trusts*

An annual exclusion from the federal gift tax, set at $14,000 this year, allows an individual to make gifts of this much or less to as many different individuals as one cares to. A grandmother might, for example, give each of five grandchildren $14,000, for total gifts of $70,000, and owe no gift tax.

What if, instead of a direct gift to the grandchildren, the money is put into a trust for their benefit? If the children have a "present interest" in the trust, the annual exclusion still applies. All the children must be granted is the power, even temporarily, to withdraw assets from the trust. As this conclusion was reached in the case of *Crummey v. Commissioner,* such trusts are now known among estate planners as *Crummey* trusts.

President Obama's proposal would limit such trusts to a single beneficiary and require that trust assets be includable in the beneficiary's estate at death, an outcome not required under current law.

Dynasty trusts

Until relatively recently, private trusts could not be perpetual trusts; only charitable trusts could be permanent. The advent of the generation-skipping transfer tax created a demand for longer-lived trusts, so as to avoid repeated imposition of estate and gift taxes on the family fortune every generation. A number of states have responded by repealing their "rule against perpetuities," allowing for perpetual family trusts, more commonly marketed as "dynasty trusts."

President Obama's proposal would not change the permanence of these trusts, but the shield against imposition of the generation-skipping transfer tax would end 90 years after the creation of the trust. This provision of the budget proposal was scored as raising a negligible amount of revenue.

When to act?

None of these proposals are likely to become law in the near term. Many Congressmen, on both sides of the aisle but especially Republicans, today would rather kill the estate tax entirely. Still when there is talk of tax reform in the air, one never knows what compromises might be reached. Who knows when the political winds might shift again? Although these strategies seem safe for now, affected families should not take their availability for granted. ☐

Madoff update

Just over five years ago, Bernard Madoff pled guilty to 11 federal felonies, admitting that his wealth management firm was nothing more than an enormous Ponzi scheme. How enormous? Actually, we still can't answer that question.

There are two trustees charged with recovering money for those who had the misfortune to invest with Mr. Madoff. The first, Irving Picard, focused on those who had invested directly with Madoff. The pool of customers with potential claims started at 16,519, but it has been winnowed down to 2,518. One reason for the shrinkage is that the defrauded investors can't claim more in damages than they contributed. They can't try to recover the "investment earnings" that weren't really there, even if they reported them and paid taxes on them.

The second trustee, Richard Breedan, has been accepting claims from Madoff's victims, a group that is larger than the pool of direct Madoff customers (who were, of course, also victims). This group includes people who were working with an investment advisor or other intermediary, such as a feeder fund. In May Breedan reported that there are 51,700 claims, totaling more than $40 billion dollars. Some 62% of the claimants live outside the U.S. Most observers expect that it will be many years before the Madoff litigation is completed.

Madoff did not attract investors by promising sky-high returns. To those who understand the markets, his promise was even more outlandish—modestly above-market returns, but with no down years, ever. That sounds too good to be true—and it is!

EITC update

The IRS has been directed to keep the error rate for the Earned Income Tax Credit (EITC) below 10%. They've missed the mark for three years running, and the problem is getting worse. A May report by the Treasury's Inspector General concluded that between 22% and 26% of EITC payments in 2013 were improper, with a loss to the federal Treasury estimated at between $13.3 billion and $15.6 billion, just for that one year.

The tax reform ideas introduced earlier this year in the House of Representatives included a conversion of the EITC to a credit against the payroll tax, as a mechanism for reducing the amount of fraud. ☐