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Trusts that flex, wills that pour

Estate plans today often combine flexible living trusts with simplified wills.

Here are three fictitious, modern estate planning examples with one common denominator.

• *Sam and Janet want to make their estate plans as simple and workable as possible, minimizing estate settlement worries for whoever lives longer. They didn't just create simple wills; they also set up flexible living trusts.*

• *If anything happens to him, Harry wants his entire estate to be readily available for the support and education of his two young daughters. Therefore, when he placed his investments in our care recently, he set up his account as a revocable living trust. To complete Harry's estate plan, the attorney who drew up the living trust arrangement also drafted a simple "pourover" will.*

• *Brooke, who doesn't look a day over 60, is a widow in her 70s. She wants to protect her financial independence in the event of a serious illness or incapacity. She also wants to leave her unmarried niece with a reliable life income, then have the estate divided among several relatives and charities. Her trust-based estate plan is designed to achieve both objectives.*

The common denominator in all three of these examples is the revocable living trust.

Long, complicated wills have been losing popularity for years. In their place, affluent men and women have been creating revocable living trusts to serve as the core of their estate plans.

With a trust-based estate plan, directions for the care and management of the estate are set forth in an attorney-drawn trust agreement. Any of the tax-saving trust provisions traditionally included in a will can be incorporated into the trust agreement. However, living trusts aren't complete substitutes for wills. It's seldom practical for a person to place everything in a trust. So, the attorney also drafts a short will, often of the "pourover" type. A pourover will simply directs that any money or property not placed in trust during the estate owner's lifetime is to be "poured over" into the trust following death to be managed and distributed under the terms of the trust agreement.

Proponents of avoiding probate at any cost may wince at the thought of any assets passing by will. Doesn't that mean there's still a "probate estate"?

Yes. But the costs of processing a *small* probate estate are usually low, and the possible advantages are significant.

When there's a probate estate, for example, creditors or disgruntled heirs must present their claims within a specified time. All subsequent claims are barred. Without any probate proceedings at all, beneficiaries of estates transferred primarily by means of living trusts might be exposed to later claims.

Continued on next page.

Four core advantages

Estate planning experts say that living trusts offer a number of advantages. Among the most important benefits are:

• ***Continuity.*** Estate planning is not some exotic, isolated task. It is the natural extension of other aspects of personal financial planning. Trustworthy investment supervision, for example, is both a present need and a future need. You want competent, objective investment guidance today, and someday so will the beneficiaries of your estate.

The chief estate planning advantage of a living trust is the way it can serve both present and future needs. You can set up a sound investment program that outlives you. Without interruption for probate, your living trust can continue as a source of income and support for your spouse, your children or other beneficiaries.

• ***Flexibility.*** Paired with a simple pourover will, a living trust offers extraordinary planning flexibility. Like a will, the terms of the living trust agreement can be revised and updated as needed. One example is to accommodate the arrival of new children or grandchildren.

Similarly, the creator of a living trust can adjust our services as trustee as needs or circumstances change. Some of our trust clients rely on us for full personal financial management, everything from portfolio supervision to bill-paying. We take pride in tailoring our services to each trust client's specifications.

• ***Privacy.*** When shares of a family business are transferred by will, anyone can look at the probated will and find out who received how much. By contrast, in most jurisdictions, the terms of a living trust agreement do not become a matter of public record at the death of the creator of the trust. As a result, many men and women use living trusts in their estate planning to keep their estate arrangements private.

• ***Simplicity.*** Modern estates usually consist of more than stocks, bonds, savings, real estate and business interests. There are valuable collections, pets, memorabilia and other special assets.

Living trusts have proved immensely useful as a way to unify and simplify the estate management of modern estates. Life insurance proceeds, for example, can be made payable directly to the trust, to be managed along with other assets for the successor beneficiaries designated by the creator of the trust.

What do these three men have in common?

Dwight Eisenhower
Frank Sinatra
Michael Crichton

All three used a living trust to secure financial privacy for their heirs. You don't have to be a celebrity to enjoy trust benefits, and you don't need remarkable amounts of wealth either. We'd be pleased to tell you more.

Start your planning now

Estate planning is a highly personal matter. No two peoples' goals and circumstances are exactly alike. Therefore, say estate planning experts, one cannot advise all affluent men and women to use a living trust.

What can be said is that everyone should explore the advantages. If you have not yet done so, contact one of our trust and investment specialists soon. □

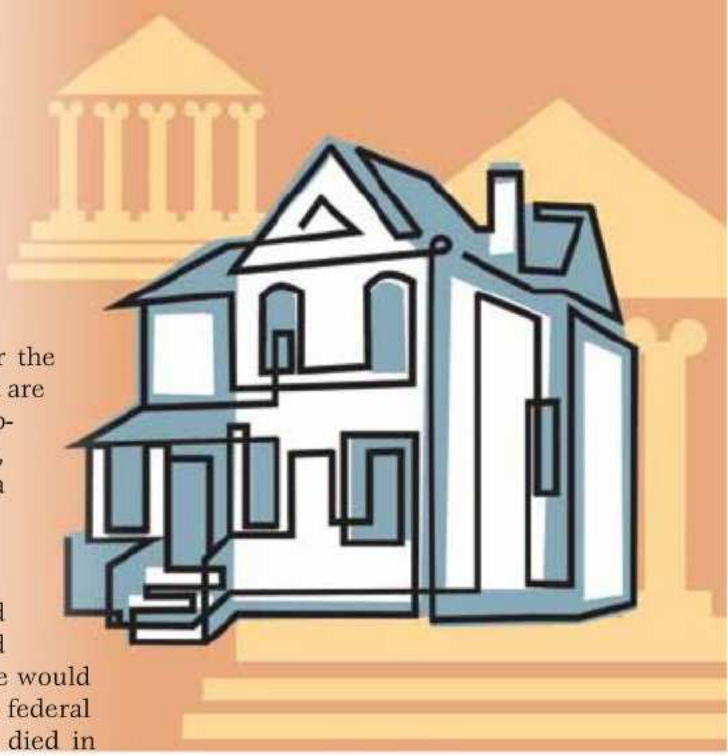
Who will you trust?

One critical question for anyone contemplating trust-based wealth management must the choice of trustee. Who is best suited to handle the many details in a sensitive, appropriate manner?

For many families, we are the answer to that question. Here's why:

- We treat estate and trust administration as a full-time job.
- We have facilities and systems for asset management that individuals lack.
- Estate assets and trust funds in our care are doubly protected, by both internal audits and regulatory oversight by state or federal officials.
- We will be available indefinitely, while an individual may die, become incapacitated or disappear.
- We bring extensive experience and group judgment to the job of investment management.
- We will treat all beneficiaries impartially, and most beneficiaries will appreciate that.
- We can withstand pressure when a wayward beneficiary asks for more from a trust than was intended, while an individual trustee might give in to requests for "more."

About those 2010 estates



The December compromise on extending the "Bush tax cuts" included dramatic changes to the federal estate tax law. Press coverage generally was limited to reporting the bump in the amount exempt from estate tax to $5 million and the drop in the top tax rate to 35%. In addition, the estate tax was restored retroactively for 2010, so as an initial matter, it also applies to the estates of billionaires who died in 2010, such as George Steinbrenner.

However, the executors of estates for those who died in 2010 have been given the choice of opting out of the federal estate tax. They have the opportunity to preserve the law as it was, which means that the heirs will have to take a carryover basis as the price of avoiding an immediate death tax. The carryover basis regime includes $3 million in basis step-ups for property passing to a surviving spouse and $1.3 million in step-ups for the executor to allocate.

Generalizations are dangerous, but it seems safe to say that the estates of the billionaires will be opting out of the estate tax. Estates under $5 million would, in most cases, prefer to have the estate tax apply so as to secure a full basis step-up at no tax cost. An estimated 71,000 estates in 2010 were projected to be affected by the carryover basis rules, and the vast majority of these estates now have been excused from this burden.

In estates above $5 million to perhaps $20 million or so, the picture is less clear. The executor will have to weigh many factors, including:

- how much unrealized appreciation is present in the estate, which means that both the decedent's adjusted basis and the fair market value of all assets must be determined;
- the distribution of $1.3 million in basis step-ups;
- if there is a surviving spouse, the effect of the additional $3 million in basis step-up, whether the estate includes assets that are not eligible for basis step-up, such as QTIP interests, income in respect of a decedent or IRA.

Simplified example

John, a single person, had a $15 million estate. Had he died in 2009, his estate would have owed $5,175,000 in federal estate taxes. Because he died in 2010, the potential estate tax will be only $3,500,000.

Let's say that John's tax basis in all his property comes to $8.7 million. His executor adds $1.3 million, bringing it to a total of $10 million. If the executor opts out of the estate tax, John's heirs will owe tax on capital gains of $5 million when they sell the assets. Still, at 15%, that comes to just $750,000, so John's estate would likely prefer to opt out of the estate tax.

Assume that John has a zero tax basis, the worst case. His heirs get the benefit of only the $1.3 million elective step-ups. The heirs' potential capital gain tax, assuming application of the 15% tax rate in force for the next two years, comes to $2,055,000. That's still a better number than the estate tax, and it doesn't have to be paid within nine months of John's death.

Will interpretations

There could be more than tax consequences to making the election of carryover basis instead of estate tax. An entire estate plan could be upended. For example, assume that a will provided for a bypass trust funded by an amount equal to the "applicable exclusion amount" under the old law, with the balance passing to a QTIP trust for a surviving spouse. Assume further that children from the decedent's prior marriage are the beneficiaries of the bypass trust.

If the executor chooses to have the estate tax apply, presumably that sets the bypass trust at $5 million. What if the estate is only $4 million? Then the spouse would be disinherited by such a decision. What if the will were drafted in a year when the exemption was $2 million, suggesting that the decedent intended to divide the estate equally? What if one of the children has been named executor, and so could profit from this tax decision?

If the executor opts out of the estate tax, then there is no applicable exclusion amount at all. Does that mean the bypass trust goes unfunded, disinheriting the children? What happens if the will refers not to the applicable exclusion but to a formula that reduces estate taxes to zero?

Some states already have adopted special rules of will interpretation for 2010 decedents. One difficult problem that executors face will be in getting finality from a court over the meaning of a will in time to make the necessary election, whatever seems best for tax purposes.

Even with the higher exempt amounts, it appears that estate planners will be having a busy year. □

Extended

Along with heading off higher top tax rates, the December tax compromise extended many tax breaks that had expired at the end of 2009. The extension is for two years only — that is, 2010 and 2011. Among the renewed tax breaks:

- estate and local sales tax deduction;
- teacher's classroom expense deduction;
- higher education tuition deduction; and
- tax-free distributions from IRAs to charity.

One tax break that didn't make the cut was the $500 real property tax deduction ($1,000 for joint filers) that was available to homeowners who do not itemize their deductions.

The Alternative Minimum Tax (AMT) was "patched" again, providing temporary inflation protection and saving thousands of middle-class taxpayers from being snared by a provision originally targeted at the rich. In 2011, the AMT exemption is set at $74,450 for married couples filing a joint return, $48,450 for singles, and $37,225 for marrieds filing separately. The patch boosts the exemption by over 50%. Without it, for example, couples would be exposed to the AMT if their income were in excess of just $45,000!

One might wonder why the patch has to be temporary when it is reenacted every year. The problem is that the "scoring" of tax bills tabulates as future revenue amounts theoretically to be collected in an unpatched AMT regime. The President's deficit commission report in December called for an overhaul of the income tax and abandonment of the AMT.

No flash relief

On May 6, 2010, U.S. stock markets experienced a very severe price drop in an afternoon, an event that has come to be known as the "flash crash." With the Dow Jones Industrial Average already down about 300 points, an abrupt slide began at 2:42 pm. Some 600 points were lost in the next five minutes. However, much of the loss was recovered 20 minutes later.

To protect their portfolios, some investors employ automated "stop-loss" orders, selling securities when prices fall to a designated level. Many of these orders were triggered by the flash crash, and in many cases, taxable gains were created for the portfolio owners.

When taxpayers sought relief, the IRS was forced to say no. It had no authority to provide for nonrecognition of gain from execution of stop-loss orders during the flash crash. Such relief would have to come from Congress, but that was not included in the December tax bill.

New "circuit breaker" rules have been implemented that, we hope, will minimize the chance of a future flash crash. □