THE REVOCABLE OR LIVING TRUST APPROACH

In working with innumerable clients over the years we have reviewed all types of estate planning documents. From simple Wills that were done just after a couple married, to the "quickie" Will put in place just before a long trip to "make sure we at least have the Guardians selected", we have seen Wills of all types and all ages.

We have also seen many many trust-based plans that worked well at the time of execution, but would none-the-less fail to meet a client's expectations. In reviewing estate planning documents, we typically come across a number of areas that need to be addressed.

Invariably, we see that the following issues present with most plans:

1. The lack of fully funded trusts;
2. The lack of disability planning;
3. Exposure to the Massachusetts Estate tax;
4. Exposure to IRD (Income in Respect to a Decedent);
5. Structure of the Family and Marital Trusts (Issues of assets protection);
6. Structure of the Trust for Children; and,
7. The need to Update Supporting Documents.

Background

In Massachusetts there are four ways to pass property. They are: jointly owned property which passes automatically to the surviving owner; contract assets (such as 401ks, IRA's) which pass automatically to the named beneficiaries; individually owned assets that pass via the terms of a person's Will and go "through" probate; and, individual assets <u>owned by a Trust</u> that pass via the trust and avoid probate.

As will be discussed, we recommend using the Revocable or Living Trust approach to address the above noted issues.

Probate Issue

From a probate perspective, <u>only</u> individual assets owned by a Trust, avoid probate. Under Will based plans, upon husband's passing, and again on wife's passing, many assets will have to go through probate. In Massachusetts, the probate process typically takes between 24 and 30 months and is quite costly. In Massachusetts the typical cost of probate is somewhere between 4% to 6% of probate assets.

In our approach, we prefer to have the Revocable Trusts own assets from the beginning. This allows for faster transfer to the surviving spouse and allows us to do tax planning through the

Trust as opposed to through the Will. As will be discussed, our preferred method to is to have "funded" Revocable Trusts, thereby avoiding the cost and delays of probate.

Most trust-based plans that we review also fail to fund the Trusts to the extent that we would like. As such, most of a client's assets will pass via joint ownership or through their pour-over Wills (i.e. thru Probate). Instead of having assets owned jointly, it is much more advantageous to have the Revocable Trusts own assets. This allows for faster transfer to the surviving spouse and allows us to do much better tax planning.

Disability Planning

Another area of concern in most plans is the lack of attention to a potential disability. There is a great likelihood that one or both spouses will face a period of disability during their lifetimes. The goal, again, is to provide a mechanism where someone can step in and "run" things if a Trustmaker does become disabled. Most plans, in our opinion, do not adequately address this issue.

First, in most cases we suggest a better mechanism for determining disability. Many existing Trusts indicate that the Trustmaker will be "disabled" if their attending Physician finds that they are "incapable of managing their affairs." We would defer to the client of course, but our experience has shown that doctors often disagree on disability. Doctors are also often hesitant to make a decision on disability, fearing that they may later be sued, if the successor Trustee absconds with Trust assets.

The approach we prefer is to have a panel of people who know the Trustmaker well, determine disability. This "panel" is often composed of the spouse, and two other family members. The disability panel allows for a more sound determination and one that would be difficult to challenge.

Second, our Trusts provide a better management mechanism for disability. If, for example, the disability panel determines that husband is unable to handle his financial affairs, the Disability Trustee steps in to manage his Trust assets.

Clients with an old Power of Attorney, or no Power of Attorney at all, would have significant problems down the road should either become disabled. If, for example, one spouse becomes disabled and the other seeks to refinance the home, there is no way that it can be done without judicial interference.

If the non-disabled spouse wanted to sell or refinance the home, the sale or refinance would require two signatures for the jointly owned home. Because one of the spouses is disabled, the only way to legally sign that person's name is via a Probate Court order. This order is obtained via a Guardianship, which is time consuming, costly, and very intrusive.

The way to avoid this is to have the Trust(s) own the properties and to have the Disability Trustee manage things upon a finding of disability by the disability panel. If the panel finds that the Trustmaker is disabled, the panel signs a Certificate of disability. The Trustee then takes that Certificate and the Trust to the bank. The bank then sees that the person has been found disabled by the panel and the bank then allows the sale. The non-disabled spouse acts as disability Trustee and then has the ability to sign for the disable spouse, without court involvement.

Further, for assets that will remain outside the trust such as IRA's, we also have the Power of Attorney spring to life. In most plans, the Powers of Attorney give the Attorney in Fact immediate signing authority. Most powers of Attorney are also quite old, having been signed with the "quickie" Will. A Power of Attorney that was put into effect many years ago could be viewed as "stale" in the eyes of many financial institutions. Financial institutions would be weary of a Power of Attorney that is of this vintage. As such, by having a springing Power of Attorney, the date of the signing of the power becomes less relevant as the power is not active until the disability occurs.

Tax Planning

Lack of proper planning can also result in poor tax consequences. Without a proper plan in place jointly owned assets can cause problems for tax planning, because joint assets can not utilize an individual's Estate tax exclusion. Under Federal law in 2012, the exclusion allows each individual to pass $5,000,000 worth of assets estate tax free. There are things to consider however. First, in 2013 this number reverts back to $1,000,000, and the tax rate increases to 55%. Second, this exclusion typically applies only for individually owned and segregated assets.

For an example of how a federal estate taxation problems arises, assume we have a husband and wife, both US Citizens, with $2,000,000 in assets, all owned jointly. If the husband passes, all the assets go immediately to the wife. Because the assets are going to the wife, there is no tax imposed. As discussed, married US citizens can pass an unlimited amount of assets to their surviving spouse, either during life or at death. This is referred to the Unlimited Marital Deduction, and it is what causes excessive taxation.

No taxes are due at the husband's passing, but when the wife dies we have a problem. After the husband's passing, the wife now has $2,000,000 in individual assets. Assume that she dies in 2013 and wishes to pass those individual assets to the children. The first $1,000,000 of individual assets are passed tax free, the second $1,000,000 worth of assets, however, are (excessively) taxed. Because the "second" million exceeds the exclusion, the assets are **taxed at 55%.** So, in this scenario, nearly $550,000 of the family assets go to the IRS.

The way around this is to "split" assets, i.e. to make sure that both the husband and the wife can attach their individual exclusions to the family assets. In the above case, we would put $1,000,000 in the husband's Trust, and the other $1,000,000 in the wife's Trust. The husband's trust uses the husband's social security number for all tax purposes, and the wife's uses her

social security number for all tax purposes. As such, when the husband dies, his Trust can use his individual exclusion to pass his $1,000,000 in assets estate tax free. When the wife later dies, her Trust uses her exclusion, and an additional $1,000,000 is passed estate tax free. So by allocating assets to both Trusts, this allows us to pass up to $2,000,000 free of tax.

Massachusetts Taxes

In addition to the federal issue, many Trust documents tend to be insufficient in avoiding Massachusetts Estate taxes. This results from the fact that the Massachusetts estate tax is fairly new. As such, many older trusts are simply silent on the issue.

Just like the federal tax outlined above, the Massachusetts estate tax is imposed on all assets above the applicable exclusion amount. Currently in Massachusetts, an Estate tax is imposed on all assets in excess of $1,000,000. (This is the highest the exclusion will ever be under current law).

A typical goal is to avoid as much state estate tax as possible, but unfortunately many plans seem to fall short. Much like the federal estate tax example above, the way to avoid a Massachusetts estate tax is to ensure that both spouses use the full Massachusetts Estate tax exclusion of $1,000,000. All assets above $1,000,000 are exposed to a tax on a scale of 0-16%, with an effective rate of about 15%. Because many Trusts do not have this language many clients are exposed to the Massachusetts tax.

IRA's and IRD

As many clients understand, Individual Retirement Accounts (IRA's) and other retirement plans are quite complicated from an income and estate tax perspective.

From an income tax perspective, IRA's left to a spouse can take advantage of some very favorable treatment under the Internal Revenue Code. First, a surviving spouse, can roll IRA assets over into their own IRA, and delay taking distributions until after they have reached age 70 1/2. This means that if something happened to the husband, the wife could roll over his IRA into her name and have several more years during which the IRA can grow income tax free. The year in which the surviving spouse reaches age 70 1/2, they would then start taking distributions.

Second, instead of rolling over, the surviving spouse could choose to remain the beneficiary of deceased spouse's IRAs. When the survivor chooses to remain the beneficiary, they must start taking distributions, the year following death. These distributions are based on the life expectancy "chart" that the IRS uses. The benefit to the spouse is that when the spouse "remains" the beneficiary, the spouse is required to take a smaller distribution each year, than would a "non-spouse" of the same age. By being required to take less each year, the surviving spouse gets to keep more money growing income tax free.

Offset against this income savings are potential estate taxes and asset protection issues. For example, if the husband passes first and his IRA went directly to surviving spouse, a second husband could come into the picture. If the wife in turn, rolled the IRA over and then made the second husband the primary beneficiary, the children would in essence be disinherited. (This does not seem likely in most families, but we have seen this very scenario play out.)

Also, if the IRA is rolled over to the surviving spouse, any future growth might be subject to an estate tax when the wife passes. For example, assume that husband has a $1,000,000 IRA and that the spouses have another $2,000,000 in assets. (including the home, the wife's IRAs, and life insurance). In total the couple has about $3,000,000 in assets.

If husband leaves the IRA to wife, and she rolls over, all of the family assets have shifted to wife and her estate is now $3,000,000. If she were to pass in 2013 or beyond, under current law, the first $1,000,000 in assets would be free of Federal estate tax, but the $2,000,000 would be taxable at 55%. Her estate would also be exposed to a Massachusetts Estate tax on the remaining $2,000,000. Even worse, if the IRA assets grew, at the wife's passing, her estate would face even more taxation.

One solution is to have the IRA assets "take" the husband's exclusion, either by going into his trust, or having them go down the to children directly. The problem there is two fold. If the IRAs go into husband's trust, the assets are protected from a future spouse, but some of the income tax advantages are lost. The money is available to wife, but the optimal income tax deferral is not. Giving the IRA assets to the children is also a way to avoid estate taxes, but obviously this creates another problem, namely that the wife doesn't have the money.

Long story short is that IRAs are a dilemma. The way we "solve" this dilemma is to provide options. "Options" in this case may mean naming several beneficiaries and contingent beneficiaries on the IRA forms. Options may also mean creating several "stand-alone" IRA inheritance trusts.

Options are the best way to proceed, because the Internal Revenue Code allows these options to be exercised AFTER the IRA owner dies. This means that with the proper planning, if husband passes, we can then do an analysis of what option makes the most sense. The law also changes quite frequently in this area, so we want to be a flexible as possible.

Family and Marital Trusts - Asset & Remarriage Protection

As discussed above, most estate plans we review do not offer sufficient protection after the first passing. Joint assets automatically vest in the survivor, and contract assets are typically payable to the spouse. So if wife were to pass first, all joint assets would vest immediately in husband's name. Most clients have estate planning goals of taking care of each other, and then taking care of their children.

If wife dies first, all joint assets and many contract assets end up in the husband's individual name. If husband were to remarry and then divorce, all the assets that came into husband's name at wife's passing are now susceptible in a divorce. These family assets are now owned individually by the husband and are fair game for the new wife and her divorce attorney. In a divorce the new wife could take one-half of the family assets.

One solution to this issue is to create two Revocable Trusts, one for each spouse. If we create two Revocable Trusts, and split the assets into the husband and wife's respective trusts, this asset protection problem can be avoided. Instead of owning assets jointly (with right of survivorship) assets are transferred to (i.e. funded) – one-half into the husband's trust and one-half into the wife's trust as tenants-in-common.

In the above scenario, if wife passes away, her Trust survives her. Wife's Trust would now have husband as the primary Trustee and there would be a friendly Co-Trustee also serving. The splitting of the assets and the addition of a Co-Trustee will provide asset protection in the case of a new marriage and subsequent divorce.

Assuming again that wife passes first, her Trust has half of the family assets in it (including the fact that her life insurance pays into her trust at her death). Husband is a Co-Trustee of the wife's Trust and has access to the money for his care, and the care and support of the kids. If husband remarries and the new spouse later seeks a divorce, the assets in wife's Trust are off the table. The wife's Trust is the owner of those assets and as such those assets are not part of the marital property of the second marriage.

The same type of scenario can play out with other creditors as well. For other creditors, when assets vest solely in the surviving spouse, all the assets are susceptible in a law suit. For example when wife dies all joint assets vest in the husband. If the husband causes a car accident or is sued for other reasons, 100% of the family assets are owned by him, and reachable in the lawsuit. In the two Revocable Trust approach, when the wife passes, her assets remain in her Trust and are insulated in that lawsuit.

Trusts for Children

Many Estate plans indicate that, if both the husband and wife die while the children are under twenty-five, that all property will be held in Trust for their benefit. If, however, a child is over twenty-five, all assets will be distributed outright to the children.

We do not advise leaving assets for a child to receive when they are only twenty-five. We would rather see the money held in Trust for a much longer period of time and in some cases for the child's entire life. This will help to ensure proper financial management, and potentially provide estate tax savings. This will be covered in greater detail below.

Before we address the Distribution Pattern of the individual Trusts, we should first cover the "Common" Trust. Under our typical set up, at the second passing, there would be one "Common" or "Pot" Trust for the benefit of all minor children. This Common Trust is used to care for minor children until they all graduate college or all reach a certain age. The benefit of the Common Trust is that it gives the Trustee the discretion to spend money on the children as needs arise, and as the situation warrants. This allows the Trustee to be more of a surrogate parent.

Individual Trust for Children

In our plans, after all the children graduate college, or reach a default age, the Common Trust splits into separate Trust shares for each child. The question then becomes how those individual Trust shares should be managed moving forward.

First Approach – Incremental Distributions:

With this method the children eventually receive all the assets and can manage them accordingly. This method allows the Trustees to manage the Trust shares for an extended period, but then allows the children to take control of the funds incrementally.

A common scheme under this approach is for the distributions to work as follows: 10% at age 30; followed by 25% of the trust balance at age 35; 25% of the trust balance at age 40 and, then the final distribution at age 45.

The advantage here is that the people you wish most to benefit, eventually have full control of the money. The downside is that, because the money actually vests in their names, the money is reachable by creditors, and by divorcing spouses. The funds would also be included in their estates.

Second Approach – Continued Trust Management (Asset Protection Trust):

The other common approach is to put in place "Asset Protection" sub-trusts. These sub-trusts would not be distributed to the children, and could last beyond the life of each child. These sub-trusts would have a Trustee who works to ensure that the assets are spent on the child in a manner described in the Trust.

At a specified time in the future the child could become a Co-Trustee of their Trust share. The requirement of the Co-Trustee ensures that the assets are not "owned" by the child in the eyes of the law. If the child needs a Co-Trustee to approve all spending, then the child does not have full control of the assets, and as such, the child is not the legal owner of the assets.

One of the main benefits of this approach, is that the creditors of the children, including divorcing spouses, will not be able to reach the money. Since the Trust owns the assets, a child's

creditors cannot make a valid claim against the Trust. The structure is also beneficial from an estate tax perspective because the money in those Trusts will not be included in the child's estate. Because the child does not own the assets, they are not taxed on the assets at their death.

One way to craft this option, to provide the look and feel of ownership, would be to allow children to be the "primary" Trustee of their individual Trusts, along with a Co-Trustee of their choosing. The Trustmaker (the parents) can set the Co-Trustees ahead of time. The Trust can contain language that creates a "pick list" of acceptable Co-trustees. The pick-list could include siblings, other relatives including aunts and uncles, cousins, friends, and professionals such as Attorneys and CPAs.

Maintenance

Finally, many, if not most, estate plans fail to have a set schedule of maintenance. Life changes, assets change and the law changes. The failure of many estate plans is the lack of updating and the changing of assets. If a plan is put in place and assets are moved into each trust to accomplish tax planning and asset protection, that plan can easily be disrupted.

If a client has an investment account that we re-title in the name of the trust, the client may move that account to another investment firm. If the client opens the new account in their individual name, the estate plan has now been disrupted. That asset would now need to go through probate with its associated cost and delay.

We use a maintenance plan where we typically see our clients every few years. We have an updating breakfast and invite our clients to join us. Clients can then set an individual meeting That meeting allows us to review asset allocations between the trusts, talk about the Trustees and add any new assets to the trust in the proper way.