Insight on Estate Planning

February/March 2012

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Estate Planning Pitfall

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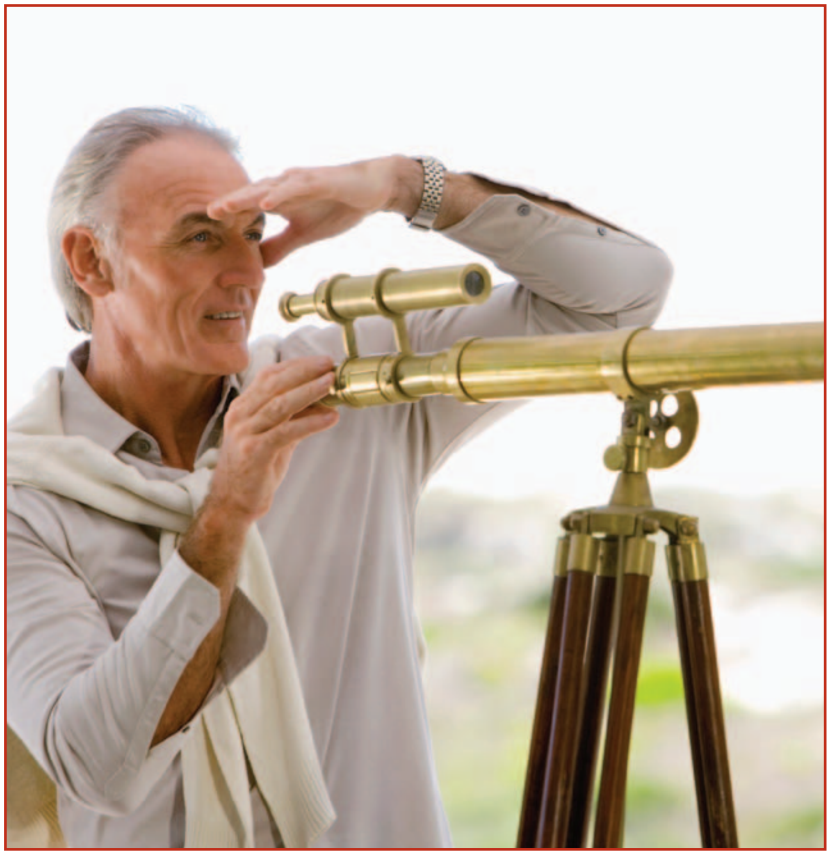
Does your trust need a protector?

Trusts can serve a variety of tax and estate planning purposes, such as avoiding probate and minimizing gift and estate taxes. Typically, to achieve the greatest tax savings, trusts must be irrevocable. But it can be disconcerting to relinquish control over assets you place in a trust, particularly if you believe Congress will continue to modify the tax laws.



One potential solution is to appoint a "trust protector" to oversee the trustee's activities and to provide flexibility to adapt the trust to changing laws and circumstances.

The protector's role

A trust protector is to a trustee what a corporate board of directors is to a CEO. A trustee manages the trust on a day-to-day basis. The protector oversees the trustee and weighs in on critical decisions, such as the sale of closely held business interests or investment transactions involving large dollar amounts.

There's virtually no limit to the powers you can confer on a trust protector. (See "What a trust protector can do" on page 3.) But it's important to clearly define the protector's role in the trust documents.

It may be tempting to provide a protector with a broad range of powers, but this can hamper the trustee's ability to manage the trust efficiently. The idea is to protect the integrity of the trust, not to appoint a co-trustee.

Many trusts limit a protector's power to removing and replacing the trustee or acting as the "tie-breaker" in the event of a deadlock between co-trustees. Another approach is to limit the protector's authority over investment decisions to transactions above a specified dollar amount.

Benefits offered

Trust protectors offer many benefits. If the trustee develops a conflict of interest or fails to manage the trust assets in the beneficiaries' best interests, for example, a protector can remove and replace the trustee. The protector may even have the authority to step in as trustee until a permanent replacement can be found.

A protector with the power to modify the trust's terms can correct mistakes in the trust document or clarify ambiguous language. Or, if you desire, you can give a protector the power to change the way trust assets are distributed if necessary to achieve your original objectives.

Suppose, for example, that your trust provides that assets will be distributed to your son after he graduates from college and is gainfully employed. After college, however, your son decides to spend two years in the Peace Corps. If that doesn't meet the trust's strict definition of "gainfully employed" because he isn't earning a certain amount, yet your son did well academically and has demonstrated an ability to manage money responsibly, the trust could authorize the protector to modify the trust to allow for early distributions.

What a trust protector can do

Trust protectors can be given a variety of powers. Examples include the power to:

- Remove or replace a trustee,
- Appoint a successor trustee or successor trust protector,
- Change the trust's "situs" — that is, its home state for legal purposes,
- Amend the trust terms to correct administrative provisions, clarify ambiguous language or alter beneficiaries' interests to comply with new laws or reflect changed circumstances,
- Direct, approve or veto investment decisions,
- Resolve deadlocks between co-trustees or disputes between trustees and beneficiaries, and
- Terminate the trust — for example, if Congress were to repeal the estate tax.

A trust protector is to a trustee what a corporate board of directors is to a CEO.

Who should act as protector?

Choosing the right trust protector is critical. Given the power he or she has over your family's wealth, you'll want to choose someone you trust and who's qualified to make investment and other financial decisions. Many people appoint a trusted advisor — such as an accountant, attorney or investment advisor — who may not be able or willing to serve as trustee but can provide an extra layer of protection by monitoring the trustee's performance.

Appointing a family member as protector is possible, but it can be risky. If the protector is a beneficiary or has the power to direct the trust assets to him- or herself (or for his or her benefit), this power likely will be treated as a general power of appointment, exposing the protector to gift and estate tax liability and potentially triggering other negative tax consequences.

Plan carefully

If you're considering a trust protector, ensure that his or her powers and duties are consistent with your estate planning objectives. Trust provisions should be drafted carefully so that there are no misunderstandings regarding the protector's role and authority and to avoid the need to resolve any uncertainties in court.

It's also important to consider relevant state laws, if any. Although protectors are common in offshore trusts, their use with domestic trusts is a relatively recent phenomenon. Some states' laws expressly contemplate trust protectors, but many are silent on the issue. Talk to your advisor about whether a trust protector can help you achieve your goals.

Privacy, please!

Keep family matters out of the public eye by avoiding probate

Although probate can be time consuming and expensive, perhaps its biggest downside is that it's public — anyone who's interested can find out what assets you owned and how they're being distributed after your death. The public nature of probate can also draw unwanted attention from disgruntled family members who may challenge the disposition of your assets, as well as from other unscrupulous parties.

The good news is that, by implementing the right estate planning strategies, you can keep much or even all of your estate out of probate.

Probate, defined

Probate is a legal procedure in which a court establishes the validity of your will, determines the value of your estate, resolves creditors' claims, provides for the payment of taxes and other debts and transfers assets to your heirs.

Is probate ever desirable? Sometimes. Under certain circumstances, you might feel more comfortable having a court resolve issues involving your heirs and creditors. Another possible advantage is that probate places strict time limits on creditor claims and settles claims quickly.

Choose the right strategies

There are several tools you can use to avoid (or minimize) probate. (You'll still need a will — and probate — to deal with guardianship of minor children, disposition of personal property and certain other matters.)

The right strategies to avoid probate depend on the size and complexity of your estate.

The right strategies depend on the size and complexity of your estate. (See "Larger estates can benefit from a living trust" on page 5.)

The simplest ways to avoid probate involve designating beneficiaries or titling assets in a manner that allows them to be transferred directly to your beneficiaries outside your will. So, for example, be sure that you have appropriate, valid beneficiary designations for assets such as life insurance policies, annuities and retirement plans.

For assets such as bank and brokerage accounts, look into the availability of "pay on death" (POD) or "transfer on death" (TOD) designations, which allow these assets to avoid probate and pass directly to your designated beneficiaries. However, keep in mind that, while the POD or TOD designation is permitted in most states, not all financial institutions and firms make this option available.

For homes or other real estate — as well as bank and brokerage accounts and other assets — some people avoid probate by holding title with a spouse or child as "joint tenants with rights of survivorship" or as "tenants by the entirety." But this has three significant drawbacks: 1) Once you retitle property you can't change your mind, 2) holding title jointly gives the joint owner some control over the asset and exposes it to his or her creditors, and 3) there may be undesirable tax consequences.

A handful of states permit TOD deeds, which allow you to designate a beneficiary who'll succeed to ownership of real estate after you die. TOD deeds allow you to avoid probate without making an irrevocable gift or exposing the property to your beneficiary's creditors.

Larger estates can benefit from a living trust

For larger, more complicated estates, a living trust (also commonly called a "revocable" trust) generally is the most effective tool for avoiding probate. A living trust involves some setup costs, but it allows you to manage the disposition of all of your wealth in one document while retaining control and reserving the right to modify your plan.

To avoid probate, it's critical to transfer title to all of your assets, now and in the future, to the trust. Assets outside the trust at your death will be subject to probate — unless you've otherwise titled them in such a way as to avoid it (or, in the case of life insurance, annuities and retirement plans, you've properly designated beneficiaries).

Discuss your options

Because of probate's public nature, avoiding the process to the extent possible is a goal of many estate plans. Implementing the proper strategies in your plan can protect your privacy and save your family time and money. Discuss your options with your estate planning advisor.

Consider a "stretch" to maximize and preserve IRA benefits

One of the great benefits of an IRA or a qualified retirement plan, such as a 401(k), is that your contributions can grow and compound on a tax-deferred basis for years. Distributions are taxable, but if you don't need the money right away, you're not required to withdraw any funds until April 1 following the year in which you turn age 70½.

By structuring your IRA as a "stretch IRA," you can allow it to last as long as possible, preserving its benefits for many years and turning it into a powerful estate planning tool. This principle applies to many qualified plans as well, but for the sake of simplicity we'll refer only to IRAs here.

Making benefits last

Setting up a stretch IRA is simple: You designate a young person — a child or grandchild, for example — as the IRA's beneficiary. After you die, your beneficiary must begin taking annual required minimum distributions (RMDs), but distributions generally can be spread over his or her life expectancy, minimizing the amount that must be withdrawn each year and maximizing the IRA's growth potential.

For example, Adam, a widower, dies at age 76 with a prior year-end IRA balance of $1.2 million, and his granddaughter, Anna, is the designated beneficiary. Before his death, Adam hadn't taken his RMD for the year. Because, according to the applicable IRS table, the distribution period for someone age 76 is 22 years, his RMD for the year would have been $1.2 million divided by 22 — or $54,545. Anna, as beneficiary, will be required to take the distribution and pay tax on it.

Anna's future RMDs, however, will be significantly smaller: According to the applicable IRS table, for the first RMD based on her *own* life expectancy, her life expectancy is 63 years. Her RMD will be determined by taking the balance in the account at the end of the year of Adam's death and dividing that amount by 63.

For comparison, suppose the IRA balance is the same $1.2 million at that time. Anna's RMD for the year following Adam's death will be $1.2 million divided by 63, or only $19,048. Although the divisor will go down each year, for many years to come the RMDs still will likely be much smaller than what Adam's would have been, allowing the IRA to be stretched over a much longer period, continuing to grow and compound tax-deferred.

Of course, Anna's RMD amount each year is included in her taxable income. But an added benefit of a stretch IRA is that a younger beneficiary may be in a lower tax bracket. If Anna is in the 15% marginal tax bracket, she'll owe only $2,857 of federal income taxes on the first RMD based on her own life expectancy. If Adam were still alive, he'd not only have a larger RMD, but, presuming he was in the 35% tax bracket, he would owe significantly more tax.

Using a trust

One drawback of this strategy is that nothing prevents your beneficiary from withdrawing more than the RMD, or even emptying the account, defeating the purpose of a stretch IRA. To avoid this result, you can designate a trust as beneficiary.

Not all trusts qualify, however. You'll need to design the trust as a "see-through" trust, which means that the trust beneficiaries — all of whom must be individuals — are treated as the designated beneficiaries for purposes of calculating RMDs.

The easiest way to qualify is to set up the trust as a "conduit trust," which requires the trustee to pass all RMDs from the IRA to the trust beneficiaries. Typically, trusts designate one or more "primary beneficiaries" (those who are first in line to receive the trust benefits) as well as "residual beneficiaries" (those who receive the benefits if a specified event occurs, such as the primary beneficiary's death).

Conduit trusts qualify as see-through trusts even if they have a nonindividual residual beneficiary, such as a charity. Also, RMDs are calculated based on the primary beneficiaries' life expectancies, even if the residual beneficiaries are older.

It's also possible to use an "accumulation trust," which, as the name suggests, allows the trust to retain the RMDs while still qualifying for see-through status. But the requirements for these trusts are stricter. If there's a chance that nonindividuals or older individuals will receive any of the trust assets, the stretch benefits may be diminished or even lost.

Stretching it out

If you have IRAs or qualified plan accounts with significant balances, consider strategies for stretching out their benefits as long as possible. You'll also need to consider the potential estate and generation-skipping transfer tax consequences. Consult your estate planning advisor to determine if a stretch IRA is right for you.

Estate Planning Pitfall
You own a high-cash-value insurance policy on your own life

If you own a life insurance policy that has built up a sizable cash value, it's important to be aware that the death benefit will be included in your taxable estate. Depending on the size of the policy and the applicable estate tax exemption when you die, the tax bill could be substantial.

What can you do? One option is to transfer the policy to an irrevocable life insurance trust (ILIT). The death benefit will be paid to the trust and distributed to the trust's beneficiaries, bypassing your taxable estate. The downside is that the transfer is considered a taxable gift, based on the policy's cash value. However, with a current lifetime gift tax exemption of $5.12 million (scheduled to drop to $1 million in 2013 if Congress doesn't take action), now may be an ideal time for this strategy.

Don't overlook the "three-year rule," though. This rule provides that, when you transfer a life insurance policy to an ILIT, the death benefit will be "pulled back" into your estate if you die within three years — all the more reason to transfer a policy sooner rather than later.

Alternatively, if you're currently in good health, consider using your existing policy's cash value to fund a replacement policy that can be purchased and held by an ILIT. This strategy may be cheaper and less risky from a gift and estate tax perspective, but tapping your policy's cash value may have significant income tax implications. In addition, be aware that the cash value is accessed through withdrawals or policy loans (with loans accruing interest at the current rate), both of which will decrease the policy's cash surrender value and death benefit.

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