Insight on Estate Planning

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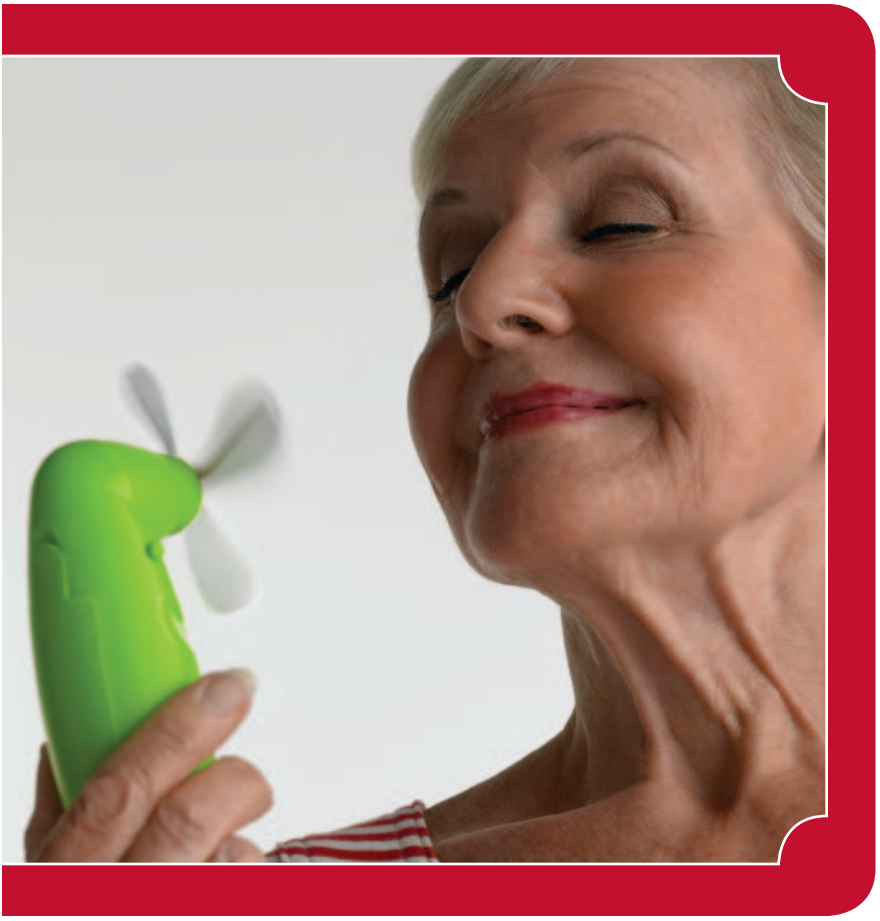

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Decanting breathes new life into an old trust

Decanting a bottle of wine — that is, pouring it into another container — helps to remove sediment and allows the wine to "breathe." In the same vein, decanting can breathe new life into an irrevocable trust. This process, which is permitted in many states, allows a trustee to use his or her distribution powers to "pour" funds from one trust into another trust with different terms.

Decanting provides the trustee with added flexibility to adapt a trust in light of changing tax laws or family circumstances. But decanting laws vary dramatically from state to state, so it's important to familiarize yourself with the differences and evaluate their effect on your estate planning goals.

Potential benefits

Depending on the language of the trust and applicable state law, decanting may let the trustee:

- Correct errors,
- Take advantage of new tax laws,
- Eliminate or add a beneficiary,
- Extend the trust term,
- Modify the trust's distribution standard,
- Add spendthrift language to protect the trust assets from creditors' claims,
- Move funds to a special needs trust to preserve a disabled beneficiary's government benefits, and
- Take advantage of another state's more favorable tax or asset protection laws.

If you're in the process of planning your estate, consider including trust provisions that specifically authorize your trustee to decant the trust. Even for an existing irrevocable trust, however, your trustee may be able to take advantage of decanting laws to change its terms.

Altered states

Differences in state law complicate the decanting process. In some states, decanting is authorized by common law. But in recent years, more than a dozen states have enacted decanting statutes.

Will decanting affect your tax bill?

One of the risks associated with decanting is uncertainty over the tax consequences. Late last year, the IRS issued Notice 2011-101, seeking comments on the tax implications of decanting. Potential tax issues include whether:

- A beneficiary whose interest is reduced has made a taxable gift or other transfer,
- Existence of a decanting power endangers a trust's qualification for the marital deduction,
- Decanting of certain trusts triggers generation-skipping transfer tax liability,
- Existence of a decanting power requires a trust to be treated as a grantor trust for tax purposes, and
- Distribution of assets from one trust to another results in taxable gain to the trust or its beneficiaries or in other income tax consequences.

The IRS will likely provide guidance on these issues in the near future.

Several other states are considering similar laws. A detailed discussion of the various decanting laws is beyond the scope of this article, but here are several issues that you and your advisor should consider:

If your trust is in a state without a decanting law, can you take advantage of another state's law? Generally, the answer is "yes," but to avoid any potential complaints by beneficiaries it's a good idea to move the trust to a state whose law specifically addresses this issue. In some cases, it's simply a matter of transferring the existing trust's governing jurisdiction to the new state or arranging for it to be administered in that state.

Will the trustee need court approval? Most states' laws permit decanting without court approval. If the trustee anticipates beneficiary objections, however, he or she may want to seek court approval voluntarily.

Will the trustee need to notify beneficiaries or obtain their consent? Decanting laws generally don't require beneficiaries to consent to a trust decanting and several don't even require that beneficiaries be notified. Where notice is required, the specific requirements are all over the map: Some laws require notice to current beneficiaries while others also include contingent or remainder beneficiaries. Even if notice isn't required, notifying beneficiaries may help stave off potential disputes down the road.

What is the trustee's authority? When exploring decanting options, trustees should consider which states offer them the greatest flexibility to achieve their goals. Generally, decanting authority is derived from a trustee's power to make discretionary distributions. In other words, if the trustee is empowered to distribute the trust's funds among the beneficiaries, he or she should also have the power to distribute them to another trust. But state decanting laws may restrict this power.

Some decanting laws, for example, require the trustee to act in the best interests of certain beneficiaries or heirs or to meet certain standards of care. Also, while decanting laws generally allow

decanting when the trustee has complete discretion over distributions of principal and income, their rules differ for trustees whose powers are restricted. Some allow decanting only if the trustee has the authority to distribute principal, while others allow it even if the trustee has only income distribution authority.

Some state laws prohibit decanting if distributions are limited by an "ascertainable standard" — such as a beneficiary's health, education, maintenance and support — but others don't. Laws in several states permit a trustee with ascertainable standard authority to decant a trust even if there's no current need for a distribution. Decanting laws in other states generally don't address this issue.

State laws differ on the extent to which decanting can eliminate a beneficiary. Decanting laws generally don't permit decanting to add a new beneficiary. But a trustee may achieve this goal indirectly if he or she has the authority to grant a power of appointment to an existing beneficiary. Again, the law varies from state to state as to whether — and to what extent — a trustee can use decanting to add a power of appointment.

Unanswered questions

These are just a few of the many differences among the state decanting laws. One question that remains unanswered is the potential tax impact of decanting. (See "Will decanting affect your tax bill?" on page 2.)

In light of the complexities and uncertainties surrounding decanting, it's critical for you and your trustees to consult with your estate planning advisor before "popping the cork." ▮

Estate planning 101

Choosing a trustee for your living trust

A living trust (also referred to as a "revocable trust," "inter vivos trust" or "declaration of trust") is a cornerstone of many estate plans. The reason for its popularity is that, in most states, by transferring assets to such a trust you can help ensure your estate will avoid the time-consuming, potentially expensive and public process of probate.

During your life, you can serve as the trust's trustee and manage the assets just as you would if you owned them outright. However, you must choose a trustee to oversee and administer the trust after your death (and during your lifetime, should you become unable to act as trustee).

Job description

Before you select a trustee, consider the duties associated with managing a living trust. For example, the trustee must manage all trust assets, perhaps including securities and business and real estate interests, until they're distributed; maintain detailed records and prepare transaction statements; handle collections, distributions and payments; ensure all tax returns are prepared and filed; and, ultimately, settle the trust.

In addition, the trustee must be available to respond to all inquiries from beneficiaries.

Trustee types to consider

You generally have two types of trustee to choose from. The first is an individual trustee. This person may be a family member or close friend, a business advisor, an attorney, or another professional. A family member or friend may seem like the natural choice because of the trust, common bond and likelihood that he or she understands your wishes for your family's future. It's also likely that he or she will charge little or nothing in trustee fees.

But keep in mind that, ideally, a trustee should have financial knowledge, be familiar with taxes and accounting, and have good business sense. So it's essential that individual trustees without professional expertise in managing trusts consult with accountants, attorneys and investment advisors to help them get the job done effectively.

The second choice is a corporate trustee. This trustee typically is a financial institution, a bank trust department or a trust company. A corporate trustee specializes in managing estates and trusts and generally is free of conflicts of interest, allowing it to carry out its duties impartially.

A corporate trustee usually has direct access to investment advisors, tax planners and other financial experts. Most institutional trustees charge fees based on a percentage of the trust's assets. An institutional trustee also can be beneficial because you don't have to worry about whether the trustee will outlive you.

Keep in mind that, ideally, a trustee should have financial knowledge, be familiar with taxes and accounting, and have good business sense.

In some cases, you can create a hybrid trustee by appointing an institution and an individual as co-trustees. The institution provides the professional experience and skills needed to effectively oversee the trust assets, while the individual is someone you can trust to act in your family's best interests.

Provide guidance

After you choose a trustee, it's important to determine the amount of control he or she will have over the trust assets and distributions to beneficiaries. Consider giving your beneficiaries the power to remove an institutional trustee and replace it with another that's a better fit as needs change or evolve. This provides an extra layer of protection from a trustee charging exorbitant fees or mismanaging the trust.

In addition, make your trustee aware of the liabilities involved. For example, the trustee may be held personally liable in instances of poor investment decisions, not exercising discretion or inappropriate allocation of assets.

Making the right choice

As you're drafting your living trust, discuss with your estate planning advisor your trustee options. The more confidence you have in your trustee, the better you'll feel about your final wishes being carried out as you intended. ▮

Is your estate liquid enough to cover estate taxes?

In estate planning, as in business, cash is king. You may have invested a great deal of effort in designing a plan that provides financial security for your family, motivates your children to excel and provides for a smooth transition of your business to the next generation. But unless your plan also provides sufficient liquidity to pay estate taxes and other expenses, it may be at risk.

If the bulk of your wealth is tied up in a closely held business, for example, it may be difficult for your heirs to pay estate taxes without being forced to sell the business. In addition, your family may need funds to keep the business going after your death.

Liquidity tools

For many people, the primary source of liquidity is life insurance, which creates an instant source of cash that your heirs receive income-tax-free. To maximize the value of a life insurance policy, it's important to plan carefully.

First, consider setting up an irrevocable life insurance trust (ILIT) to purchase and hold the

policy, and then contribute funds to the ILIT to cover the premium payments. An ILIT keeps the policy out of your estate and avoids estate taxes on the proceeds, leaving more for your family.

Your contributions to the ILIT generally are treated as taxable gifts. But you can reduce or even eliminate gift tax by using your annual exclusions and lifetime exemption.

If you already own a policy, it's a good idea to remove it from your estate as soon as possible. If you qualify for a new policy at a reasonable price, consider cashing in or terminating your current policy and using an ILIT to purchase a new one.

Otherwise, you can transfer your current policy to an ILIT (subject to gift tax on its cash value). Keep in mind, however, that you must survive for at least three years after the transfer to avoid estate taxes on the proceeds.

Other liquidity tools include:

- Buy-sell agreements, under which the business or its surviving owners purchase some or all of your shares from your heirs — typically, these agreements are funded by one or more life insurance policies,
- IRAs, 401(k) plans and other tax-advantaged retirement plans — but bear in mind that there may be severe income tax consequences from liquidating these assets, and there's the risk that you'll be forced to sell the underlying investments at a time when you'd prefer not to do so, and
- Traditional investments in stocks, bonds and mutual funds — here, too, it's important to consider the investment consequences of a forced sale. In addition, there could be potential income tax consequences.

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And of course there are bank accounts, money market funds and shorter-term CDs.

Postmortem strategies

If those liquidity tools fail to meet your family's liquidity needs, there are several postmortem strategies your heirs can use to soften the blow of estate taxes. These include:

Borrowing. It may be possible for your representatives to borrow the funds needed to pay taxes and other expenses from a bank, family members or a family business. If the estate's illiquidity makes borrowing necessary, and certain other requirements are met, it may even be able to deduct projected interest payments.

Applying for an extension. Estates with liquidity challenges may qualify for extensions as long as 10 years

on hardship grounds. Often, an estate can establish hardship by demonstrating that it would be required to sell assets at a loss to pay the taxes when due.

Deferring taxes. Your estate can defer taxes attributable to a qualifying closely held business by paying interest for only five years and then paying the tax and additional interest in 10 annual installments. This option is available if one or more closely held businesses account for more than 35% of your estate and certain other requirements are met.

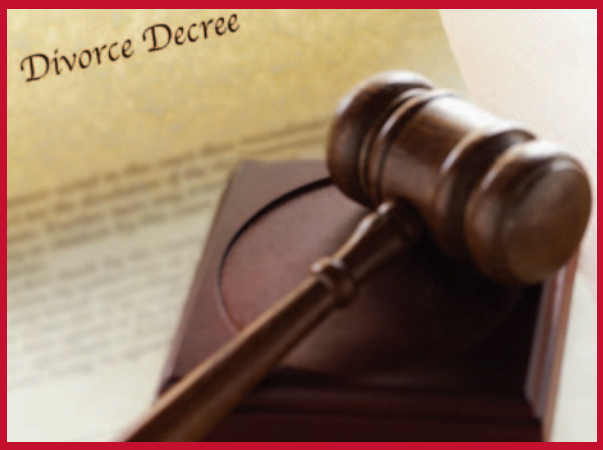
Don't delay

Providing liquidity for your estate plan takes time. The earlier you start planning, the greater the chances that you'll succeed. ▮

Estate Planning Pitfall

You haven't covered all your bases since your divorce

People generally remember to amend their wills or revocable trusts after a divorce, but there are many other estate planning and financial arrangements you should address that are easily overlooked. These include:



Jointly owned assets. Be sure your former spouse doesn't retain access to joint assets, such as bank accounts, investments or real estate. Most likely, ownership of these assets was addressed by the divorce settlement, but it doesn't hurt to double check.

Retirement accounts. Did you designate your former spouse as beneficiary of any IRAs, 401(k) plans or other retirement accounts? If so, amend the beneficiary designations for those accounts.

Life insurance. If your former spouse is the beneficiary of your life insurance policy, you'll likely want to update the beneficiary designation. Also, consider whether your life insurance needs have changed in light of the divorce.

Powers of attorney. Is your former spouse still named as your representative in any financial or health care powers of attorney or similar documents? In some states, divorce automatically nullifies powers of attorney, but in others you may need to rewrite them. Either way, review these documents to ensure they name a trusted person (even your former spouse if appropriate) to act on your behalf in the event you become incapacitated.

Safe deposit boxes. If you haven't already done so, go through the contents of any jointly owned safe deposit box.

It's important to take action quickly after a divorce to avoid inadvertently enriching a former spouse at the expense of your children, new spouse or other family members.