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Trust UPDATE

Stillman BANK

Q&A on living trusts

Living trusts are an exceptionally useful way to manage family finances today. Unfortunately, trusts are also a mystery to most people, as evidenced by the variety of questions fielded by our specialists. The more people know about trusts, how they work and what their benefits are, the happier we are. Accordingly, here are some of the questions we get most often, and the answers.

What is a living trust?

A living trust is a legal mechanism for property management, embodied in a *trust agreement*. The *grantor* creates the trust and transfers property to a *trustee*, who manages the property, according to the terms of the trust, for *trust beneficiaries*. The grantor may also be a beneficiary. Trusteeship is governed by a well-established body of law that includes *fiduciary duties* owed by the trustee to the beneficiaries.

Fiduciary duties? What does that mean?

Stated most simply, a trustee has a duty to put the interests of the trust beneficiaries ahead of his or her own. Self-dealing is not allowed.

For example, an irrevocable trust set up for Walt Disney's grandchildren was recently in the news. One of the private trustees had used trust assets for real estate transactions from which he personally profited. In a lawsuit to remove him as trustee for violating his fiduciary duty, he initially defended his actions by arguing that the trust had profited as well; it was not harmed by his actions. That's not the test, under the well-established law of fiduciary duty. The private trustee resigned before the case went to trial.

What are the advantages of a living trust?

Key living trust benefits include:

- financial protection in the event of incapacity—conservatorship may

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be avoided.
- probate avoidance—uninterrupted financial protection for beneficiaries.
- professional asset management—provided a professional trustee, such as us, serves as trustee.

Are there any disadvantages?

A living trust is more complicated to execute than is a will—assets must be retitled in order to be owned by the trust, for example. The cost to create an estate plan that includes a living trust will be higher than the fee for drafting a routine will. There may be trustee's fees to be paid. For many families, the benefits of the living trust are well worth the costs.

What kind of investment return can I expect from a living trust?

The fact that portfolio assets are managed in a trust has no direct impact upon the investment return of those assets. We work with our trust clients to develop an investment plan that balances risks and rewards so as to meet the overall objectives of the trust. Some trusts are oriented toward capital growth, some toward asset preservation, others toward a balance of various objectives.

Will a living trust reduce my income taxes? How about estate taxes?

No, a living trust is not a tax-reduction strategy, for either income or estate taxes. Be suspicious of anyone who says otherwise. On the other hand, a living trust may be integrated into an estate plan; it may become irrevocable at the owner's death, with the assets held in further trust. In that situation, no estate taxes will be saved at the owner's death, but additional taxation of the family wealth may be avoided down the road. An estate planner can tell you more.

How does a living trust avoid probate?

A living trust is an independent legal entity. As such, the trustees do not require court supervision to carry out their duties.

Why is avoiding probate a good idea?

Time and money are the two factors that concern most families. There are no court-related delays or administrative hassles with a living trust delivering financial protection to beneficiaries. Probate fees may apply to even modest estates, and they are separate from any "death taxes" (estate and/or inheritance taxes) that may be imposed. The paperwork and fee burdens vary widely around the country.

Can I still qualify for Medicaid if I have a living trust?

Having a living trust won't affect your Medicaid qualification one way or the other. Living trust assets are a countable resource, treated the same as if you owned it outright. If your wealth level is suitable for a living trust, the odds are you won't be a candidate for Medicaid.

An *irrevocable trust* established more than five years before the Medicaid application is another matter. Irrevocable trusts are beyond the scope of this article—see an elder law attorney if you want to learn more about them.

When should I update my living trust?

As versatile as it is, a living trust isn't a "file and forget" strategy. You'll want to revisit the trust terms when:
- marital status changes;
- a child is born or adopted into the family;
- a beneficiary dies;
- you move to another state; or
- your financial situation undergoes a significant change.

Who should be my trustee?

Trusteeship is our business, so we're naturally biased in answering this question. *We* should be your trustee. We have the people, the professionalism, the systems and the experience needed to make your trust-based wealth management plan successful. Call on us soon to learn more! ☐

Choice of trustee

To unleash the power of a living trust as a wealth management tool, you need to select the best trustee for your family. Here are seven good reasons to place your trust in our care.

1. Group judgment.

Our trust investment committee monitors the investments in the trusts in our care.

2. Reliability.

We understand the special responsibilities of a trustee. All trust funds in our care are safeguarded by both internal and external audits.

3. Experience.

Trusteeship is our business.

4. Responsiveness.

Financially successful individuals and their families expect personal attention and responsive service. We deliver.

5. Objective investment guidance.

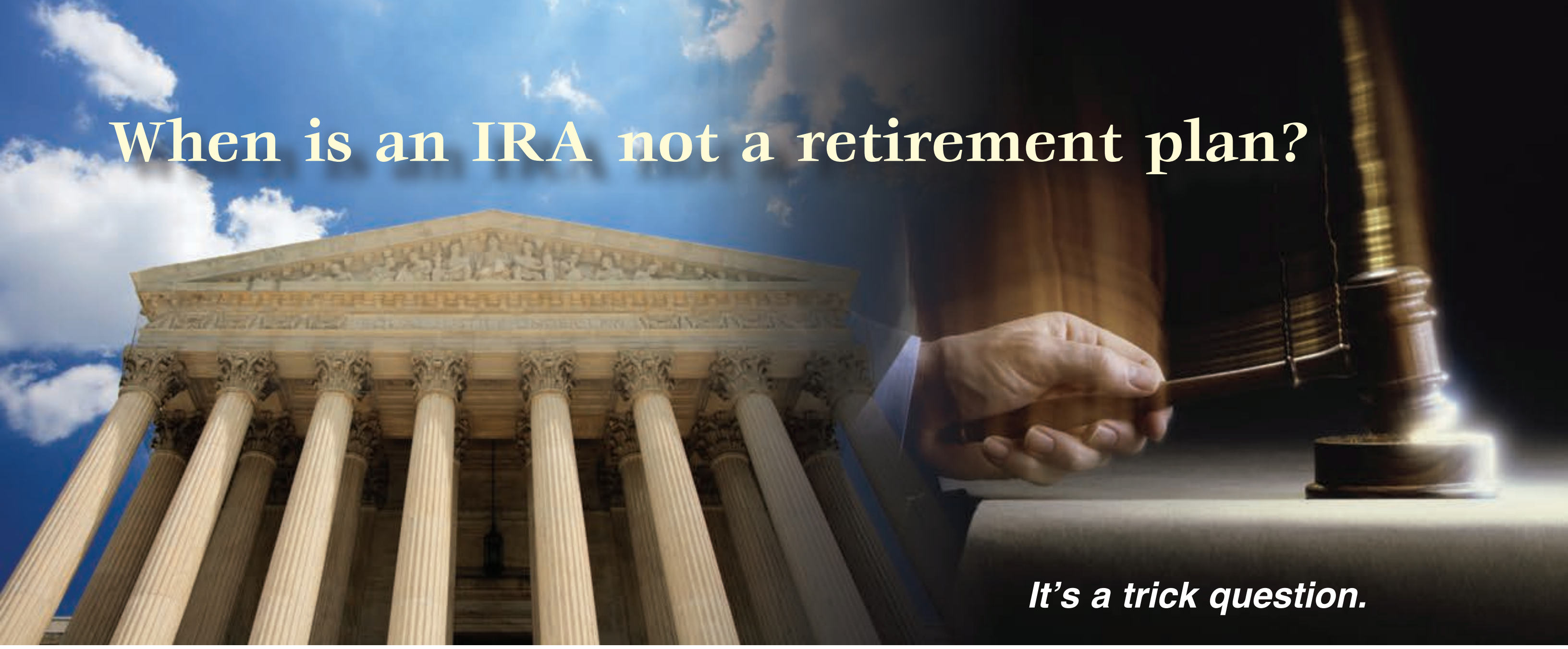
Unlike investment advisors who are compensated mainly by sales commissions, we earn our trustee's fee by providing our trust clients with unbiased, personalized guidance.

6. Convenience.

From bill paying to retirement planning, we can provide or obtain just about any convenience or special service that our trust clients desire.

7. Neutral arbiter.

When trust provisions permit discretionary invasions of principal in specified circumstances, our neutral judgment in exercising fiduciary powers may help smooth disagreements among beneficiaries.



In 2000 Ruth Heffron established a traditional IRA, probably by rolling over a lump sum distribution from her employer's retirement plan. At her death the next year, the IRA was worth $450,000. Heidi Heffron-Clark, Ruth's daughter, was the sole beneficiary of the account. She began taking monthly distributions from it.

Fast forward to October 2010, when Heidi and her husband filed for bankruptcy. Some assets are exempt from creditor claims in a bankruptcy proceeding, among them "retirement funds" from qualified plans, as enumerated in the tax code. Because inherited IRAs are among these, the couple identified the inherited IRA, then worth $300,000, as an exempt asset. In so doing, they set off a legal controversy that ultimately landed in the U.S. Supreme Court.

Different courts, different answers

The bankruptcy court rebuffed the claim for protection of the inherited IRA, because those funds are not distributed during retirement. In fact, such funds are required to be distributed, regardless of the age or the wishes of the beneficiary. The district court reversed the decision of the bankruptcy court, ruling that the language of the bankruptcy law covers any account containing funds "originally" "accumulated for retirement purposes." Then the Seventh Circuit Court of Appeals reversed that ruling, stating that "inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings." However, in a similar case in another part of the country, the Fifth Circuit Court of Appeals reached the opposite conclusion. The U.S. Supreme Court stepped in to resolve the ambiguities.

Unanimous decision

Although it may seem obvious to nonlawyers that something called an "Individual Retirement Account" is for retirement, whether inherited or not, words can be slippery things in the hands of lawmakers. In June the high court ruled unanimously that, in the context of a bankruptcy proceeding, an inherited IRA is not a retirement fund. Three characteristics distinguish inherited IRAs from other tax-favored retirement accounts:

- ***Contributions of new money to inherited IRAs are prohibited.*** All other retirement funds encourage more saving.
- ***Distributions from inherited IRAs are required, regardless of how far off retirement may be.*** Either minimum distributions must be made over the life of the beneficiary, or the entire fund must be disbursed within five years of the death of the owner.
- ***No penalty on withdrawals.*** Most retirement plan distributions trigger a 10% tax penalty if made before the owner reaches age 59½. That tax provision encourages IRA owners to wait until retirement for their distributions. In contrast, there is no 10% penalty for withdrawals from inherited IRAs, regardless of the age of the beneficiary. Accordingly, this is a pot of money that can be used freely for current consumption.

A trust alternative

For those who are concerned about protecting inherited IRA funds from the creditors of beneficiaries, there is an alternative to consider. The IRA may be made payable to a qualified trust for the benefit of the heir, rather than to the beneficiary directly. The minimum distribution rules still will apply, but such an arrangement may provide for stronger asset protection. ☐

How to give your house to your kids

One strategy for keeping your home in the family on a tax-preferred basis is the Qualified Personal Residence Trust, or QPRT. One can think of a QPRT as a major gift scheduled for a future date. The home is placed in a special trust that lasts for a specific number of years. The homeowner retains the right to live in the home, and the children (or other beneficiaries) receive the home when the trust terminates.

The home transferred to a QPRT must be a personal residence, but it does not have to be a primary residence. Vacation homes and associated property, for example, are eligible for this estate planning strategy. And the trust may include other structures on the property if they are suitable for a personal residence, taking into account the neighborhood and the size of the house.

This strategy has returned to the news pages with the revelation that Bill and Hillary Clinton transferred their New York residence to just such a trust in 2011. The specific terms of the trust are not publicly available.

A gift tax return will be required when the home is placed in the QPRT. However, the value of the gift will be discounted to reflect the delay until the gift takes effect. The discount can be very substantial, and it is a function of current market interest rates as well as how many years will elapse before the gift takes effect.

The second benefit of the QPRT is that once the arrangement is established, the value of the home is locked in for estate tax purposes. Subsequent appreciation may avoid gift and estate tax. For estate tax advantages to be secured, the homeowner must survive to the end of the trust. Should the homeowner die during the trust term, the full value of the house is included in the taxable estate—but the homeowner is no worse off than if the QPRT had not been attempted. Heads you win; tails you break even.

Still, it's important that the trust term be realistic, given the homeowner's life expectancy. One way to hedge against the risk of dying too soon is to divide the ownership of the home into portions and transfer the portions to laddered trusts. For example, one third might be given to a three-year QPRT, another third to a seven-year trust, and the balance to a ten-year trust. Should the homeowner survive ten years, the full value of the home will be removed from his or her estate. Reportedly, the Clintons divided ownership of their New York home in half and used two trusts to receive the two portions.

What happens if the trust termination date arrives, and the homeowner isn't ready to move out? Relocation isn't necessary. The homeowner simply will need to pay a fair market rental to the new owners—payments that may further deplete the taxable estate. ☐