# The Estate Planner

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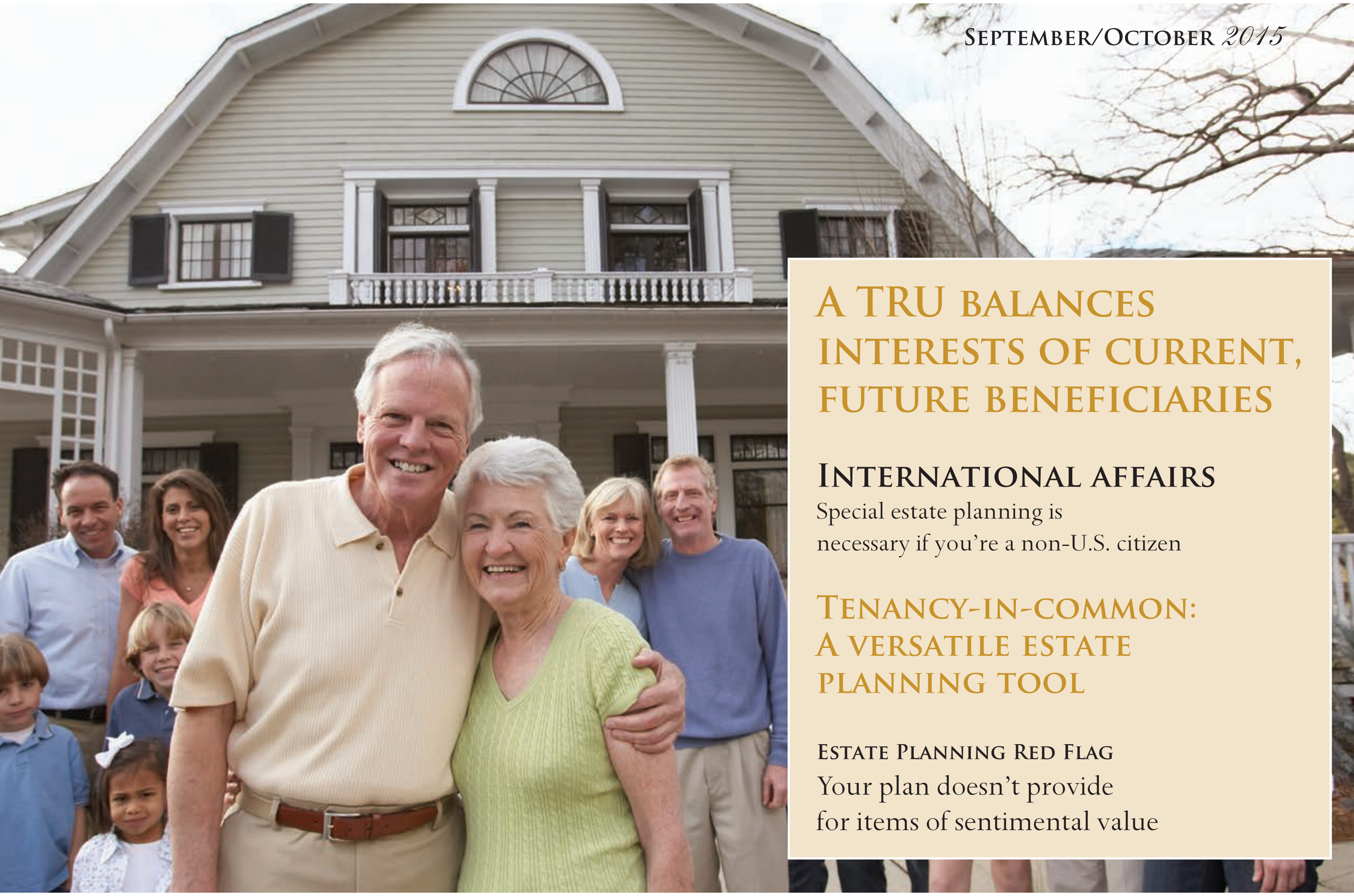

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# A TRU balances interests of current, future beneficiaries

Trusts often create conflicts between current beneficiaries, who receive the income that the trust generates, and remainder beneficiaries, who receive what's left at the end of the trust's term. Income-producing investment strategies favor the current beneficiaries, while growth strategies favor the remainder beneficiaries. A total return unitrust (TRU) can better balance both current and remainder beneficiaries' interests.

## The trustee's dilemma

When a trust is designed to provide benefits for two generations of beneficiaries, it presents a difficult challenge for the trustee. Consider this example: Adam's will establishes a trust that pays all of its income to his wife, Kristen, for life, and then divides the trust assets equally among his three children from his first marriage. The trust names Adam's friend, Roger, as trustee. Kristen outlives Adam by 10 years.

Roger has a fiduciary duty to act in the best interests of all the beneficiaries, but traditional trust design makes it difficult for him to be impartial. Suppose Adam leaves $2 million to the trust. In order to provide Kristen with a steady income stream, Roger places the trust assets in fixed-income investments that generate a 5% return. Kristen receives income of $100,000 per year, and when she dies the trust's principal — still $2 million — is distributed to Adam's children. Not a bad inheritance, but its value has been eroded by 10 years of inflation.

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Suppose, instead, that Roger invests the trust assets in growth stocks that earn a 9% annual return. Ten years later, the trust's value has appreciated to more than $4.7 million. That's good news for Adam's children, but this approach generates little or no income for Kristen.

In an effort to make everyone happy, Roger comes up with a compromise: He invests half of the assets in growth stocks and the other half in fixed-income vehicles. The $1 million in fixed-income investments generates $50,000 per year for Kristen, and at the end of the trust term the principal is worth nearly $3.4 million.

## A better approach?

The advantage of a TRU is that it frees the trustee to employ investment strategies that maximize growth (total return) for the remainder beneficiaries without depriving current beneficiaries of income. Rather than pay out its income to the current beneficiary, a TRU pays out a fixed percentage (typically between 3% and 5%) of the trust's value, recalculated annually, regardless of the trust's earnings.

Going back to our previous example, suppose Adam's trust is designed as a TRU that makes an annual payout to Kristen equal to 3.5% of the trust's value, recalculated annually. Roger, relieved of the duty to generate income for Kristen, invests all of the trust assets in a diversified portfolio of growth stocks that yield a 9% annual return. Kristen's payments from the trust start at $70,000 and grow steadily over the trust's term, reaching more than $113,000 by year 10.

At the same time, the value of the trust principal grows to more than $3.4 million, which is distributed to Adam's children at the end of year 10. Thus, the current beneficiary and the remainder beneficiaries are better off with a TRU than they would have been under the compromise approach described earlier.

## Careful planning required

If you're considering implementing a TRU, it's important to plan carefully. Ask a financial advisor to project the benefits your beneficiaries will enjoy under various scenarios, including different payout rates, investment strategies and market conditions. Keep in mind that, for a TRU to be effective, it must produce returns that outperform the payout rate, so don't set the rate too high.

Also, be sure to investigate your state's trust laws. Some states disallow TRUs (although it may be possible to achieve similar benefits if the trustee has the authority to make "equitable adjustments" to income and principal). Also, many states establish payout rates (or ranges of permissible rates) for TRUs, so your flexibility in designing a TRU may be limited.

Finally, if a trust is required to pay out all of its income to a current beneficiary, be sure that unitrust payouts will satisfy the definition of "income" under applicable state and federal law.

## Many happy returns

If you're setting up a trust for two or more generations of beneficiaries, consider a TRU. Designed properly, it allows the trustee to maximize benefits for both current and future beneficiaries. ✤

## Can you convert an existing trust into a TRU?

If you're concerned that an existing, irrevocable, income-only trust may be unfair to certain beneficiaries, it may be possible to convert it into a TRU. In order to do so, however, such a conversion must be permitted by applicable state law.

A recent IRS private letter ruling clarifies that converting a trust into a TRU according to state law shouldn't have any negative tax implications. It doesn't cause the trust to lose its grandfathered status for generation-skipping transfer (GST) tax purposes. (GST tax doesn't apply to irrevocable trusts in existence on Sept. 25, 1985, so long as no additions, actual or constructive, are made to the trust after that date.)

The ruling also states that switching from one method of determining trust income to another, according to state law, doesn't result in any taxable gifts or income recognition events.

# INTERNATIONAL AFFAIRS
## SPECIAL ESTATE PLANNING IS NECESSARY IF YOU'RE A NON-U.S. CITIZEN

Juanita is a citizen of the United States; however, her spouse, Esteban, is a U.S. resident, not a U.S. citizen. Thus, not all of the estate planning strategies that Juanita has in place are available to him. Because Esteban isn't a U.S. citizen, he must consider additional planning because special rules apply to him.

### DIFFERENCE BETWEEN RESIDENT AND CITIZEN

If you're a U.S. resident, but not a citizen, you're treated similarly to a U.S. citizen by the IRS. You're subject to federal gift and estate taxes on your worldwide assets, but you also enjoy the benefits of the $5.43 million exemption and the $14,000 annual exclusion. And you can double the annual exclusion to $28,000 through gift-splitting with your spouse, so long as your spouse is a U.S. citizen or resident. Special rules apply to the marital deduction, however, as will be discussed.

Residency is a complicated subject. IRS regulations define a U.S. resident for federal estate tax purposes as someone who had his or her *domicile* in the United States at the time of death. One acquires a domicile in a place by living there, even briefly, with a present intention of making that place a permanent home.

Whether you have your domicile in the United States depends on an analysis of several factors, including the relative time you spend in the United States and abroad, the locations and relative values of your residences and business interests, visa status, community ties, and the location of family members.

### PLANNING FOR A NONRESIDENT ALIEN

If you're a nonresident alien — that is, if you're neither a U.S. citizen nor a U.S. resident — there's good news and bad news in regard to estate tax law. The good news is that you're subject to U.S. gift and estate taxes only on property that's "situated" in the United States. Also, you can take advantage of the $14,000 annual exclusion (although you can't split gifts with your spouse).

The bad news is that your estate tax exemption drops from $5.43 million to a miniscule $60,000, so substantial U.S. property holdings can result in a big estate tax bill. Taxable property includes U.S. real estate as well as tangible personal property — such as cars, boats and artwork — located in the United States.

Determining the location of intangible property — such as stocks, bonds, partnership interests or other equity or debt interests — is more complicated. For example, if a nonresident alien makes a gift of stock in a U.S. corporation, the gift is exempt from U.S. gift tax. But a bequest of that same stock at death

is subject to estate tax. On the other hand, a gift of cash on deposit in a U.S. bank is subject to gift tax, while a bequest of the same cash would be exempt from estate tax.

Your estate planning advisor can help you determine which property is situated in the United States and explore strategies for minimizing your tax exposure. For example, it may be possible to avoid U.S. estate taxes by setting up a foreign corporation to hold U.S. property.

### Options for making tax-free transfers

The unlimited marital deduction isn't available for gifts or bequests to noncitizens. However, there are certain options for making tax-free transfers to a noncitizen spouse. For example, you can use the transferor's $5.43 million exemption (provided the transferor is a U.S. citizen or resident). You can also make annual exclusion gifts. (Currently, the limit for gifts to a noncitizen spouse is $147,000.) And last, you can bequeath assets to a qualified domestic trust, which contains provisions designed to ensure that the assets are ultimately taxed as part of the recipient's estate.

Know that the marital deduction *is* available for transfers *from* a noncitizen spouse *to* a citizen spouse.

### What are the right strategies for you?

If you have a family situation similar to Juanita and Esteban's, where one spouse is a U.S. citizen and the other is a U.S. resident, traditional estate planning strategies may not be applicable. Your estate planning advisor can help you understand your options and identify strategies for minimizing your tax liability. ✤

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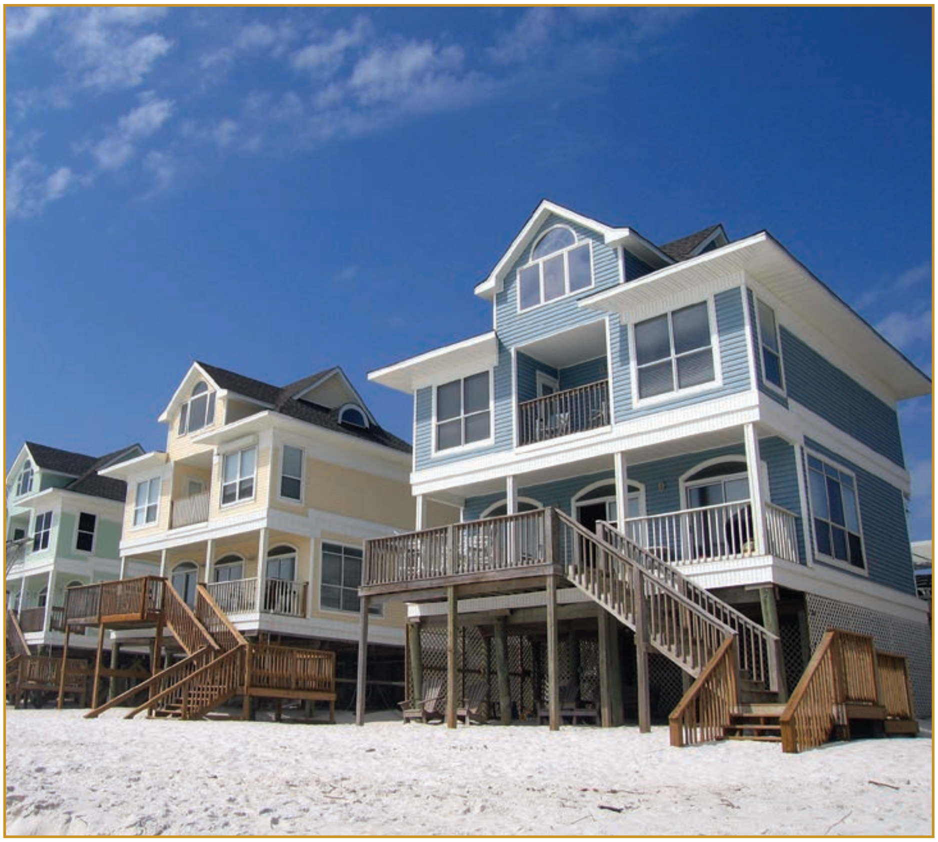
# Tenancy-in-common: A versatile estate planning tool

If you hold significant real estate investments, tenancy-in-common (TIC) ownership can be a powerful, versatile estate planning tool. Let's take a closer look at a few common questions regarding this strategy.

### What is tenancy-in-common?

A TIC interest is an undivided fractional interest in property. Rather than splitting the property into separate parcels, each owner has the right to use and enjoy the entire property. An individual TIC can't sell or lease the underlying property, or take other actions with respect to the property as a whole, without the other owners' consent. But each owner has the right to sell, mortgage or transfer his or her TIC interest. This includes the right to transfer the interest, either directly or in trust, to his or her heirs or other beneficiaries.

Someone who buys or inherits a TIC interest takes over the original owner's undivided fractional interest in the property, sharing ownership with the other tenants in common. Each TIC interest holder has a right of "partition." That is, in the event of a dispute among the co-owners over management of the property, an owner can petition a court to divide the property into separate parcels or to force a sale and divide the proceeds among the co-owners.



## How is it used in estate planning?

Here are a few of the ways TIC interests can be used to accomplish your estate planning goals.

**Distributing your wealth.** If real estate constitutes a significant portion of your estate, dividing it among your heirs can be a challenge. If you transfer real estate to your heirs — your children, for example — as joint tenants, their options for dealing with the property individually will be limited. What if one child wants to hold on to the real estate, but the other two want to cash out? Transferring TIC interests can avoid disputes by giving each heir the power to dispose of his or her interest without forcing a sale of the underlying property.

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**Reducing gift and estate taxes.** Fractional interests generally are less marketable than whole interests. Plus, because an owner must share management with several co-owners, they provide less control. As a result, TIC interests may enjoy valuation discounts for gift and estate tax purposes.

**Equalizing estates.** Historically, an important estate planning strategy for affluent married couples was to "equalize" their estates. In other words, if one spouse owned a disproportionate amount of the couple's wealth, transferring assets to the "poorer" spouse could significantly reduce their estate tax bill. Why? Because if the poorer spouse died first, his or her exemption would be wasted. If the "richer" spouse's estate exceeded his or her exemption amount, the excess would be exposed to estate taxes.

Higher exemption amounts and portability of exemptions have made estate equalization less important than it used to be. But if you and your spouse have wealth that substantially exceeds your combined exemptions (currently, $10.86 million), equalization continues to provide a tax advantage.

One effective way to equalize your ownership of real estate is to convert it into TIC property and then transfer a TIC interest from one spouse to the other.

### Get an appraisal

If you're considering using TIC interests as part of your estate plan, it's critical to obtain an appraisal to support your valuation of these interests. Keep in mind that appraising a TIC interest is a two-step process: an appraisal of the real estate as a whole, followed by an appraisal of the fractional interest. In some cases, it may be desirable to use two appraisers: a real estate appraiser for the underlying property and a business valuation expert to quantify and support any valuation discounts you claim. ✤

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**Estate Planning Red Flag**

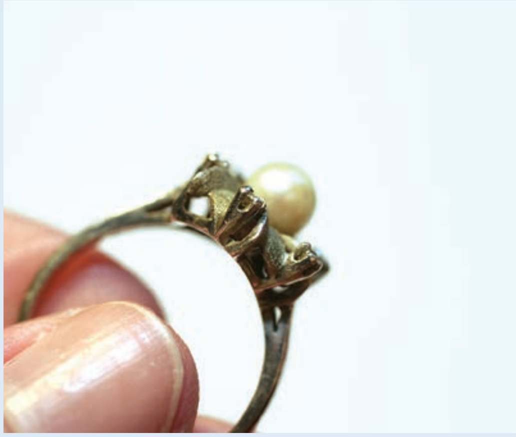
## Your plan doesn't provide for items of sentimental value

If you're like most people, your estate plan focuses on high-value assets, such as real estate, business interests and investments. But don't overlook personal property. Items with relatively low monetary values — such as jewelry, antiques, artwork, collectibles, photographs and automobiles — can have significant sentimental value. And failure to plan for these items can lead to hurt feelings and even disputes among your heirs.

Ideally, you should provide for the disposition of personal property with specific bequests to specific recipients. But spelling out every gift in your will or revocable trust can be unwieldy and would require you to revise your estate planning documents every time you want to add or change a gift.

One attractive alternative is to create a "personal property memorandum," which provides instructions to your executor on the disposition of personal property not covered by your will or trust. You're free to change or add to the memorandum as you see fit, without the need to formally amend your will or trust. Personal property memoranda can be used for most tangible personal property, including automobiles in many states. But they can't be used to dispose of bank accounts, stocks, bonds or other financial instruments.

In most states, a personal property memorandum is legally binding so long as you refer to it in your will and meet certain other requirements. Even if you live in a state that doesn't recognize them, the memorandum will provide an effective vehicle for expressing your wishes and explaining the reasoning behind them, which can help prevent disputes.



If you'd like to use a personal property memorandum, be sure to check with your estate planning advisor to see whether it's recognized in your state and to find out what types of property it may cover.

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It is no secret that technology continues to advance at a rapid pace. Technological evolution constantly changes how we communicate, how we conduct business and how we move through our daily lives. The proliferation of email, mobile computing, social networking, photo-sharing sites, cloud-based data storage and a multitude of other online services has forever changed the way we interact with the world around us.

The truth is, we now live digital lives and our digital footprints continue to grow. These digital footprints can have significant value, both sentimental and economic. Whether you invest using an online broker, upload photographs to the web through Instagram, share family recipes through a service like Dropbox or publish a blog related to your business or hobbies, your online presence is extremely important to you and your family.

As your digital life becomes more prominent, have you considered what will happen to your digital footprint upon your incapacity or death? Will your online activity be secure? Will your loved ones be able to access and retrieve what you have stored online? Will your digital memories be preserved?

As online activity increases, the estate and financial planning world has come to identify an individual's online presence as "digital assets." Although digital assets are not tangible and may only have sentimental value to the individual, it has become apparent that we must plan for the transition of digital assets just as we would for any other type of asset. You would not neglect to include your home or brokerage account in your estate plan. In the same way, you should not neglect your digital assets.

The rapid development and adoption of technology has left the law a bit flat-footed. Policy makers, service providers and legislatures are grappling with solutions to profound questions regarding how to facilitate the transition of digital assets from one person to the next. In the meantime, families are left scratching their heads as they try to locate and access a loved one's digital assets.

Without much legal guidance right now, there are still steps you can take to help make the transition easier for your family. To begin planning for your transition, you should do the following three things:

1. **Create an inventory of digital assets.** The first step in planning your digital transition is to create awareness of the scope of your digital assets. Take the time to make a list of all your online accounts and include every type of internet service you use including: email, social networking, financial accounts, data storage services, etc. Be exhaustive. This inventory will decrease the burden on your family when you are no longer able to manage your digital assets and will allow you to establish a more comprehensive plan for your digital assets.

2. **Create a secure list of account usernames and passwords.** This might be the most difficult step psychologically. Online security is extremely important and password security is one of the most basic aspects of online security. However, creating an account inventory will not be of much use to your family members if they cannot access the accounts. Consider keeping a list of usernames and passwords in a secure location. You can keep a hard copy in a home safe or a safe deposit box. There are also services that keep password lists for a fee. With research and due diligence, you can strike a balance between password security and access for your family.

3. **Update your estate planning documents.** Possession of a password may not be enough to give your family authorization to access your online accounts. Various laws and terms of service agreements may still restrict access to your accounts. You can help your family overcome these obstacles by explicitly designating representatives to act on your behalf within your estate planning documents. In particular, you should consider revising or creating a power of attorney to give your agent the authority to access your accounts if you are incapacitated. If you have a trust, it should be updated to grant your trustee the authority to access accounts related to assets held by the trust. Finally, your will should be updated to give your personal representative authority to access your online accounts upon your death.

The law in this area is still developing and there will likely be many changes in the coming years. But you should be proactive and make a plan for your digital assets. You are creating an online legacy. Take steps now to ensure that your family can keep your legacy alive.