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HOW CAN YOU MEND A BROKEN TRUST? TRY DECANTING

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Estate Planning Red Flag

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How can you mend a broken trust? Try decanting

An irrevocable trust can be a powerful estate planning tool, but in some cases irrevocability could be a disadvantage. For example, you might discover a drafting error that makes the trust inconsistent with your original purposes. Or perhaps changing tax laws or family circumstances render the trust ineffective or obsolete. The risk that a trust will cease to serve its purpose is greater if it's designed to operate over several generations.

One strategy that may allow you to fix a broken trust is decanting. The ability to decant a trust depends on several factors, including the trust's terms and the law of the state in which it resides.

What is decanting?

Decanting is pouring wine or another liquid from one vessel into another. In the estate planning world, it means "pouring" assets from one trust into another with modified terms. The rationale underlying decanting is that, if a trustee has discretionary power to distribute trust assets among the beneficiaries, it follows that he or she has the power to distribute those assets to another trust.

Depending on a trust's language and the provisions of applicable state law, decanting may allow the trustee to:

- Correct errors or clarify trust language,
- Move the trust to a state with more favorable tax or asset protection laws,
- Take advantage of new tax laws,
- Remove beneficiaries,
- Change the number of trustees or alter their powers,
- Add or enhance spendthrift language to protect the trust assets from creditors' claims, or
- Move funds to a special needs trust for a disabled beneficiary.

In light of the recent doubling of the gift and estate tax exemption and generation-skipping transfer tax exemption, many irrevocable trusts formed to shield assets from these taxes no longer serve that purpose.

In fact, unlike assets transferred at death, assets that are transferred to a trust don't receive a stepped-up basis, so they can subject the beneficiaries to capital gains tax on any appreciation in value. One potential solution is to use decanting. Decanting can authorize the trustee to confer a general power of appointment over the assets to the trust's grantor, or to name the grantor as successor trustee. Such actions cause the assets to be

included in the grantor's estate and, therefore, to enjoy a stepped-up basis.

Can you decant?

Many states have decanting statutes and in some states decanting is authorized by common law. Either way, it's critical to understand your state's requirements, such as, in some states, the trustee being required to notify the beneficiaries or even obtain their consent to decanting; others require neither. And some states prohibit decanting if the trustee has discretion over distributions of income but not principal, or if distributions are limited by an "ascertainable standard," such as a beneficiary's health, education, maintenance or support.

Even if decanting is permitted, there may be limitations on its uses. Some states, for example, prohibit the use of decanting to eliminate beneficiaries or add a power of appointment, and most states will not allow the addition of a new beneficiary. If your state doesn't authorize decanting, or if its decanting laws don't allow you to accomplish your objectives, it may be possible to move the trust to a state whose laws meet your needs.

If the trust instrument includes decanting provisions, it may be possible for the trustee to decant the trust without the need to rely on state law.

Should you seek court approval?

Typically, state laws permit decanting without court approval, although some states require court approval for modifications that, for example, have an adverse impact on a beneficiary or on the tax treatment of the trust. Even if court approval isn't required, trustees often seek such approval voluntarily if they anticipate objections from the trust's beneficiaries.

Are there tax consequences?

One of the risks associated with decanting is uncertainty over its tax implications. Let's say a beneficiary's interest is reduced. Has he or she made a taxable gift? Does it depend on whether the beneficiary has consented to the decanting? If the trust language authorizes decanting, must the trust be treated as a grantor trust? Does such language jeopardize the trust's eligibility for the marital deduction? Does distribution of assets from one trust to another trigger capital gains or other income tax consequences to the trust or its beneficiaries?

Several years ago, the IRS issued a notice raising some of these questions, but has yet to provide any answers.

Get help

If you have a trust in need of repair, consider decanting or other tools for modifying it. These techniques can be complicated, however, so consult your estate planning advisor to review the benefits and potential risks. ▮

Other options

In addition to decanting, there are several other potential options for amending an irrevocable trust, including:

Reformation. Many states permit you to seek a court order rewriting a trust's terms to conform to the grantor's intent if its original terms were based on a legal or factual mistake.

Modification. Court-ordered modification may be available if required by changing circumstances to fulfill the trust's purposes.

Division or combination. Some states permit a trustee to combine multiple trusts into one or to divide a trust into several trusts, under certain circumstances.

Relocation. State law may allow a trustee to move a trust to a jurisdiction with more favorable tax or asset protection laws.

Now may be the time to forgive intrafamily loans

If you have outstanding loans to your children, grandchildren or other family members, consider forgiving those loans to take advantage of the record-high gift and estate tax exemption and the generation-skipping transfer (GST) tax exemption. Currently, the two amounts are an inflation-adjusted $11.4 million ($22.8 million for married couples), but the increase is only temporary. In 2026, the exemptions will revert to $5 million ($10 million for married couples), indexed for inflation.

Under the right circumstances, an intrafamily loan can be a powerful estate planning tool because it allows you to transfer wealth to your loved ones free of gift or GST taxes — to the extent the loan proceeds achieve a certain level of returns. But an outright gift is a far more effective way to transfer wealth, provided you don't need the interest income and have enough unused exemption to shield it from transfer taxes.

Do intrafamily loans save taxes?

Generally, to ensure the desired tax outcome, an intrafamily loan must have an interest rate that equals or exceeds the applicable federal rate (AFR) at the time the loan is made. The principal and interest are included in the lender's estate, so the key to transferring wealth tax-free is for the borrower to invest the loan proceeds in a business, real estate or other opportunity whose returns outperform the AFR. The excess of these investment returns over the interest expense is essentially a tax-free gift to the borrower. Intrafamily loans work best in a low-interest-rate environment, when it's easier to outperform the AFR.

Why forgive a loan?

An intrafamily loan is an attractive estate planning tool if you've already used up your exemption or if you wish to save it for future transfers. But if you have exemption to spare, forgiving an intrafamily loan allows you to transfer the entire loan principal plus any accrued interest tax-free, not just the excess of the borrower's returns over the AFR. It can be a strategy for taking advantage of the increased exemption amount before it disappears at the end of 2025. Of course, if you need the funds for your own living expenses, loan forgiveness may not be an option.

What about income taxes?

Before you forgive an intrafamily loan, consider any potential income tax issues for you and the borrower. In most cases, forgiving a loan to a loved one is considered a gift, which generally has no income tax consequences for either party.

Although forgiveness of a loan sometimes results in cancellation of debt (COD) income to the borrower, the tax code recognizes an exception for debts canceled as a "gift, bequest, devise or inheritance." There's also an exception for a borrower who's insolvent at the time the debt is forgiven. But be careful: If there's evidence that forgiving a loan is not intended as a gift — for example, if the borrower doesn't have the cash needed to make the loan payments, but isn't technically insolvent — the IRS may argue that the borrower has COD income.

To ensure the desired tax outcome, an intrafamily loan must have an interest rate that equals or exceeds the applicable federal rate at the time the loan is made.

One thing you should avoid is forgiving accrued interest on an intrafamily loan *every* year. For one thing, doing so may give the IRS ammunition to argue that the *original* loan was a disguised gift, which can trigger gift taxes, depending on the exemption amount in the year the loan was made.

Also, even if the original loan isn't treated as a gift, forgiving interest each year can subject you to income tax on imputed interest — in other words, you'll owe tax on interest that you didn't even receive. You can avoid taxes on imputed interest, however, if you also forgive principal "in substantial part."

A limited-time opportunity

The temporary (until 2026) increase in the gift and estate tax exemption amount provides a valuable opportunity to transfer wealth tax-free. In addition to making extra lifetime gifts, consider taking advantage of this opportunity by forgiving outstanding intrafamily loans. Your estate planning advisor can assist you in determining whether forgiving loans is a good strategy and, if it is, he or she can help in implementing that strategy without triggering unwanted tax consequences. ▮

Decisions, decisions

Personal circumstances figure into when to begin taking Social Security

There are several individual factors that go into the determination of when the best time is to begin collecting Social Security benefits. Among those factors are the size of your estate, the amount of money you and your spouse may need to continue your desired lifestyle in retirement, and last, but not least, your estate planning goals.

Age affects benefits

The Social Security Administration (SSA) says you're entitled to receive 100% of the benefits based on your earnings history at full retirement age (FRA). The FRA, which is based on the year of your birth, ranges from age 65 for those born in 1937 or earlier to age 67 for individuals born in 1960 or later. For Baby Boomers born between 1943 and 1954, the FRA is age 66.

But you don't have to wait until your FRA to receive benefits. In fact, you can elect to begin taking benefits as early as age 62, although monthly benefits will be reduced. The monthly reduction can be as much as 25% of the FRA amount, and even higher for those born after 1954. The closer

you are to your FRA when you apply for benefits, the smaller the reduction.

Conversely, if you choose to delay benefits, you'll receive a higher monthly amount than the FRA amount. Essentially, your benefits are increased by 8% for each year you delay taking benefits until age 70. Thus, the maximum increase for Baby Boomers with an FRA of 66 is 32%, and for those born after 1954 the maximum increase is less. Once you reach age 70, the benefits are maxed out.

If you choose to delay Social Security benefits, you'll receive a higher monthly amount than the full retirement age amount.

Assessing your situation

Should you opt to begin receiving benefits before your FRA or hold off? One thing to consider is the fact that you may live longer than you initially thought because of medical advances. If this occurs, it'll further stretch the resources needed to sustain a comfortable retirement. On the other hand, you might decide to retire early and rely on benefits while you're still enjoying good health. Applying for benefits at your FRA may be a reasonable compromise.

Let's take a look at key factors that may affect your decision:

Accumulated assets. Do you have enough funds to live on if you choose to apply for benefits early? You may have heard horror stories about people outliving their savings late in life. However, if you'll be spending less in retirement, it's possible that your needs won't be as great.

Breakeven point. At some point, you'll come out ahead dollar-wise if you delay benefits (and you live long enough). This "breakeven point" depends on the amount of your benefits and the assumptions used to account for taxes and investment opportunities.

Earnings test. If you receive Social Security benefits before your FRA, and you continue to work, they'll be reduced. Under this "earnings test," you must forfeit $1 in benefits for every $2 earned above an annual limit ($17,640 for 2019) divided by 12. Thus, if you earn more than $1,470 per month your benefits will be phased out. In the year in which you reach your FRA, the reduction is $1 in benefits for every $3 over another limit ($46,920 for 2019), although it applies only for earnings prior to reaching your FRA. After you reach your FRA, there's no reduction in benefits. Thus, in that year, if you earn $46,920 prior to your FRA and another $46,920 after your FRA, there's no reduction.

Estate planning consequences

Don't discount the impact that Social Security choices can have on your estate plan. Notably, a surviving spouse may be entitled to benefits based on his or her deceased spouse's history. And in limited cases, adult children may claim benefits based on a deceased parent's Social Security choices.

Talk to your estate planning advisor about how best to coordinate your decisions regarding Social Security with other aspects of your estate plan. ▮

ESTATE PLANNING RED FLAG

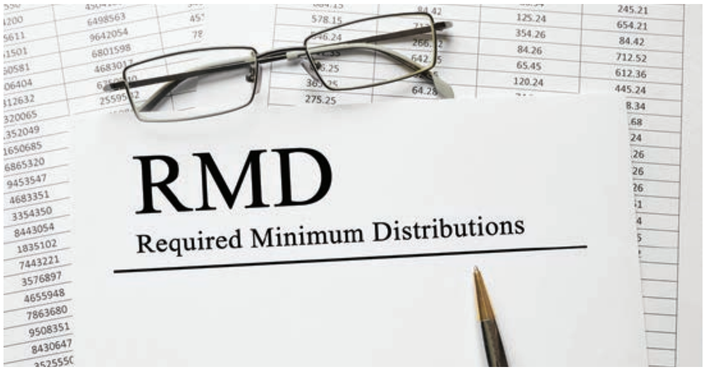
You missed a required minimum distribution

The penalty for missing a required minimum distribution (RMD) from an IRA or qualified retirement plan is one of the harshest in the tax code: 50% of the amount you should have withdrawn. Generally, you're required to take RMDs from traditional IRAs and most employer-sponsored retirement plans beginning in the year you reach age 70½. RMDs are due by December 31 each year, although you may delay your first RMD until April 1 of the following year.

Given the severity of the penalty, it's critical to ensure that you take RMDs on a timely basis. If you miss a distribution, however, you should act quickly to address the issue. The tax code provides for waiver of the 50% penalty if 1) missed RMDs were due to "reasonable error" and 2) you take "reasonable steps" to remedy the shortfall.

The first step is to calculate the correct amount and withdraw it from the account as soon as possible. Next, file Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts," with the IRS, either with your return or separately if you aren't filing a return. There's no need to pay the 50% penalty when you file the form, so long as you attach a letter (if the form is being filed independently of your tax return) or a statement (if the form is being filed with your tax return) requesting that the penalty be waived and explaining the reasons for the error and the steps you're taking to correct it.

The IRS hasn't provided formal guidance on what constitutes "reasonable error," but potential excuses include financial institution error, serious illness and mental incapacity. It may also be possible to obtain a waiver for an IRA that's inherited late in the year or that's embroiled in a dispute over the rightful beneficiary.



Even if you take your RMDs on time, you may consider filing Form 5329, showing a penalty of zero. Doing so triggers the three-year statute of limitations and prevents the IRS from imposing penalties years or decades later on the grounds that you miscalculated an RMD.

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Understanding the Job of a Trustee Under Florida Law

Under Florida law, a trustee has a fiduciary responsibility to implement the terms of a trust in good faith and solely in the interest of the trust beneficiaries. Interpreting what that responsibility means and how to comply with it can be difficult tasks for anyone serving as a trustee. In order to fulfill this fiduciary responsibility, a trustee must understand the terms of the trust, locate and protect the trust assets, ascertain and pay debts as they become due, notify beneficiaries and make appropriate distributions to them, prepare accountings, and deal with tax issues. Below is an outline which provides more detail of what is required of a trustee under Florida law.

Read the Trust Agreement: A trustee should read the trust agreement and understand all provisions, especially those concerning the payment of taxes and expenses, the powers provided to and the obligations imposed upon the trustee, and the distribution provisions for the trust beneficiaries. A trustee should obtain the assistance of a lawyer who specializes in estate planning for guidance, if necessary. A trustee must adhere to the terms of the trust to ensure that the grantor's intent is fulfilled.

Trust Assets and Liabilities: A trustee must ascertain all of the assets owned by the trust, as well as their values. Furthermore, a trustee must understand the current obligations of the trust, including its debts and liabilities. Once the assets and liabilities have been ascertained, it is the duty of the trustee to take control of those trust assets and to manage them as a prudent investor would manage them. In general, this means that an investment strategy should be established and the assets should be invested with reasonable care and caution. The investment portfolio should be considered as a whole in keeping with the needs of the income and remainder beneficiaries, the need for diversification, the maintenance of real estate, and the payment of taxes, debts, fees and reasonable expenses of the trust. If a trustee needs assistance in managing the investment of trust assets, the trustee may seek the assistance of an investment advisor or may delegate investment functions to an investment agent.

Responsibility to Beneficiaries: A trustee must keep qualified beneficiaries reasonably informed of the administration of the trust. Upon request, a trustee must provide beneficiaries with a copy of the trust, relevant information regarding the trust assets and liabilities, and the particulars of its administration. A beneficiary is also entitled to timely distributions from a trust as directed by its terms. Further, the reasoning behind distributions made in the trustee's discretion should be documented by the trustee.

Accountings: A trustee must provide the qualified beneficiaries with trust accountings each year, when a new trustee begins serving, and when the trust terminates. With this in mind, accurate records should be kept regarding the assets and liabilities and income and expenditures related to the trust. Trust assets must be kept separate and apart from a trustee's personal assets. In addition, good records should be kept regarding the time involved in completing the duties of a trustee to help justify any compensation received and expenses incurred in order to protect a trustee in the event either is contested by a beneficiary.

Taxes: A trustee must ascertain the tax liabilities related to the trust and all tax returns that must be filed or elections made on a state and federal level. Such returns may include federal and/or state estate tax returns (including potential out-of-state reporting related to non-Florida assets), a federal gift tax return, fiduciary federal and/or state income tax returns, state and/or federal corporate/partnership tax returns, disclaimers, elections related to sub-chapter s stock, elections to combine a trust and estate return, and elections regarding the payment of taxes in installments. A trustee should obtain the assistance of a certified public accountant who is experienced in the area of trust administration for guidance in the preparation of the accountings and tax returns, if necessary.

It is essential for a trustee to understand his or her obligations as a trustee as mandated under the terms of the trust agreement and Florida law. Furthermore, the fiduciary responsibilities of a trustee should be carefully considered and met successfully to prevent liability on the part of the trustee and to ensure that those for whom the trust was created fully benefit from it, as intended by the grantor of the trust.