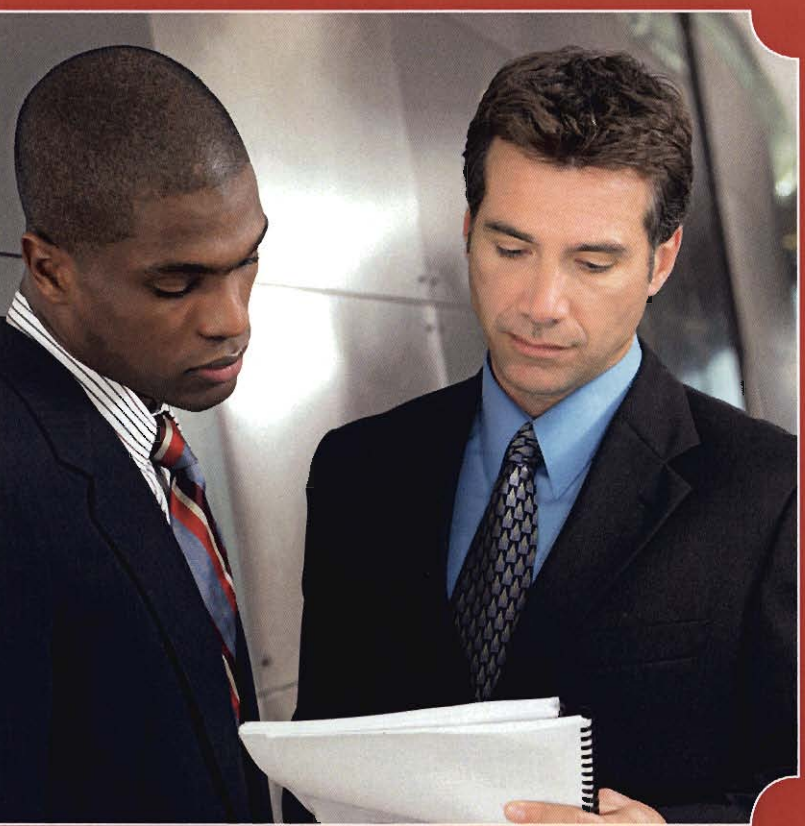
Insight on Estate Planning

Year End 2008



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Estate planning pitfall

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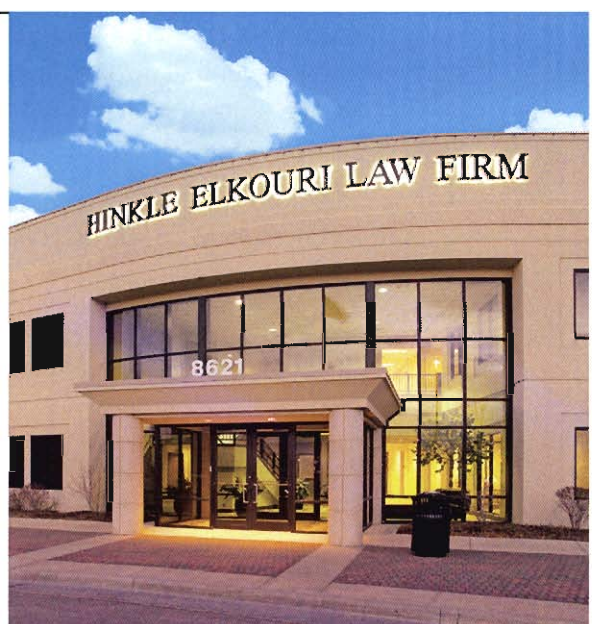


Does your trust need protection?

A trust protector may be the answer

Designing an estate plan can be a delicate balancing act. On the one hand, you want to preserve as much wealth as possible for your family by protecting it from estate taxes and creditors' claims. On the other hand, you want to have some control over your assets during your life.

Unfortunately, these two goals often conflict with each other. Generally, the most effective way to remove wealth from your taxable estate and shield it from creditors is to place it in one or more irrevocable trusts. But, as the name suggests, an irrevocable trust requires you to relinquish control over the trust assets. One potential solution to this problem is to appoint a trust protector.

A trust protector's specific powers are set forth in the trust document.

What is a trust protector?

A trust protector is often compared to a member of a corporation's board of directors. A trustee manages the trust's day-to-day affairs while the trust protector serves in an oversight capacity to prevent trustee mismanagement and to participate in certain major decisions.

A trust protector's specific powers are set forth in the trust document. They may include the power to:

- Add, remove or replace a trustee,
- Appoint a successor trustee or successor trust protector,
- Add, change or eliminate beneficiaries' interests,
- Amend the trust or redirect distributions to comply with new laws or reflect beneficiaries' changing circumstances,
- Change the trust's governing law or jurisdiction,
- Consent to the exercise of a power of appointment,
- Direct, consent to or veto investment decisions,
- Interpret ambiguous terms in the trust agreement,
- Resolve deadlocks between co-trustees, and
- Terminate the trust.

One advantage of using a trust protector is that you can confer powers on the protector that you wouldn't be able to hold yourself without

exposing your assets to creditors or triggering gift or estate taxes.

Bear in mind that a trust protector should be distinguished from a trust *advisor*, who is available to advise the trustee but has no power to make binding decisions on trust matters.

What are the benefits?

Trust protectors offer two primary benefits:

1. They provide a check against mismanagement, fraud or abuse by the trustee. A trust protector might have the power to remove or replace the trustee, or veto certain decisions, if the trustee isn't acting in the beneficiaries' best interests.

2. They allow you to build some flexibility into an otherwise rigid estate planning tool. Many people are reluctant to transfer assets to an irrevocable trust for fear that changing tax laws or changing circumstances years or even decades later may affect the trust's ability to achieve their original goals. At the same time, they may be hesitant to provide the trustee with too much discretionary authority over the trust. A trust protector can step in when circumstances change and modify the trust or take other actions to ensure that the trust continues to accomplish your estate planning objectives.

For example, suppose you establish a trust for the benefit of your 5-year-old daughter. The trust agreement provides for the assets to be distributed when she turns 25. At 19, however, she demonstrates maturity and financial discipline beyond her years and could really use the money to help pay her college expenses. A trust protector could modify the trust to allow earlier distributions. On the other hand, if your daughter turns out to be a spendthrift, the trust protector could modify the trust to delay her receipt of the funds.

Or, what if your main purpose in establishing a trust is to reduce or eliminate estate taxes and, ten years from now, Congress permanently repeals the estate tax or doubles the exemption so that your estate is no longer exposed to the tax? You could give your trust protector the power to terminate the trust under those circumstances and return the funds to you.

Whom should you appoint as trust protector?

Technically speaking, you can appoint anyone — other than yourself or the trustee — as a trust protector. In most cases, however, it's preferable to select an independent, trusted advisor, such as a lawyer, accountant or financial advisor.

If you choose your spouse or another family member — especially one who is a potential beneficiary of the trust — there's a risk that the exercise of certain powers will trigger unexpected and unwelcome gift or estate tax consequences.

Whomever you choose, consider including a "savings clause" in the trust agreement that prohibits the trust protector from taking any action that would result in adverse tax consequences.

Which powers should your trust protector have?

There's no one right answer to this question. It depends on the nature of your estate plan, your family's situation, the capabilities of the trustee and your specific estate planning objectives. But in most cases, it's advisable to limit the trust protector's authority to relatively narrow circumstances.

For one thing, if the trust protector's power over day-to-day management of the trust is too broad, he or she will effectively serve as a co-trustee. Then the question becomes "Who will protect your trust from the protector?"

Is a trust protector a fiduciary?

Another issue is whether the trust protector is considered a fiduciary. Fiduciaries are held to a higher standard of care than nonfiduciaries and, therefore, may be exposed to liability if a court determines that they failed to act in the best interests of the trust and its beneficiaries.

There's some uncertainty about whether a trust protector is a fiduciary. In some states, for example, a trust protector is presumed to be a fiduciary unless the trust agreement specifies otherwise. But many states' laws are silent on the issue. Arguably, the broader a trust protector's powers,

the more difficult it will be to argue that he or she is not a fiduciary.

Trust protectors may be more valuable if they're *not* considered fiduciaries. There are two reasons for this: First, without fear of liability, a nonfiduciary is free to make major decisions without the added expense and delay of seeking court approval. Second, it's easier to attract qualified trust protectors if liability isn't a big concern.

However, keep in mind that, unless your state's law specifically addresses the role of trust protector, there may be some uncertainty over a trust protector's legal obligations. Some commentators argue that a trust protector should be considered a fiduciary regardless of the language of the trust agreement or the extent of his or her authority. A fiduciary can be defined as someone in whom another has placed the utmost trust and confidence to manage and protect property or money. A trust protector seems to fit that description.

Handle with care

Appointing a trust protector can be a powerful tool for building flexibility into an irrevocable trust and adding an extra layer of protection for your hard-earned wealth. If you decide to use this strategy, be sure to discuss it thoroughly with your tax and legal advisors: Trust protector provisions must be drafted with care to ensure that they comply with applicable state law and are consistent with your estate planning objectives. ▮

The self-canceling installment note: A calculated risk

There are many estate planning techniques that allow you to minimize or even eliminate gift and estate taxes when you transfer assets to your family. But, often, the most powerful techniques — notably, the grantor retained annuity trust (GRAT) — have a significant drawback: mortality risk. In other words, to achieve a GRAT's tax-saving benefits, you must outlive the trust's term. If you don't, the assets will be pulled back into your estate and potentially subject to estate tax.

What if your health is poor and you're not confident that you'll reach your actuarial life expectancy? Is there a way to reduce estate taxes without worrying about mortality risk? One possible solution is the self-canceling installment note (SCIN).

How SCINs work

To use a SCIN in estate planning, you sell your business or other assets to your children or other family members (or to a trust for their benefit) in exchange for an interest-bearing installment note. As long as the purchase price and interest rate are reasonable, there's no taxable gift involved. So you can take advantage of a SCIN without having to use up any of your lifetime gift tax exemption or annual gift tax exclusions.

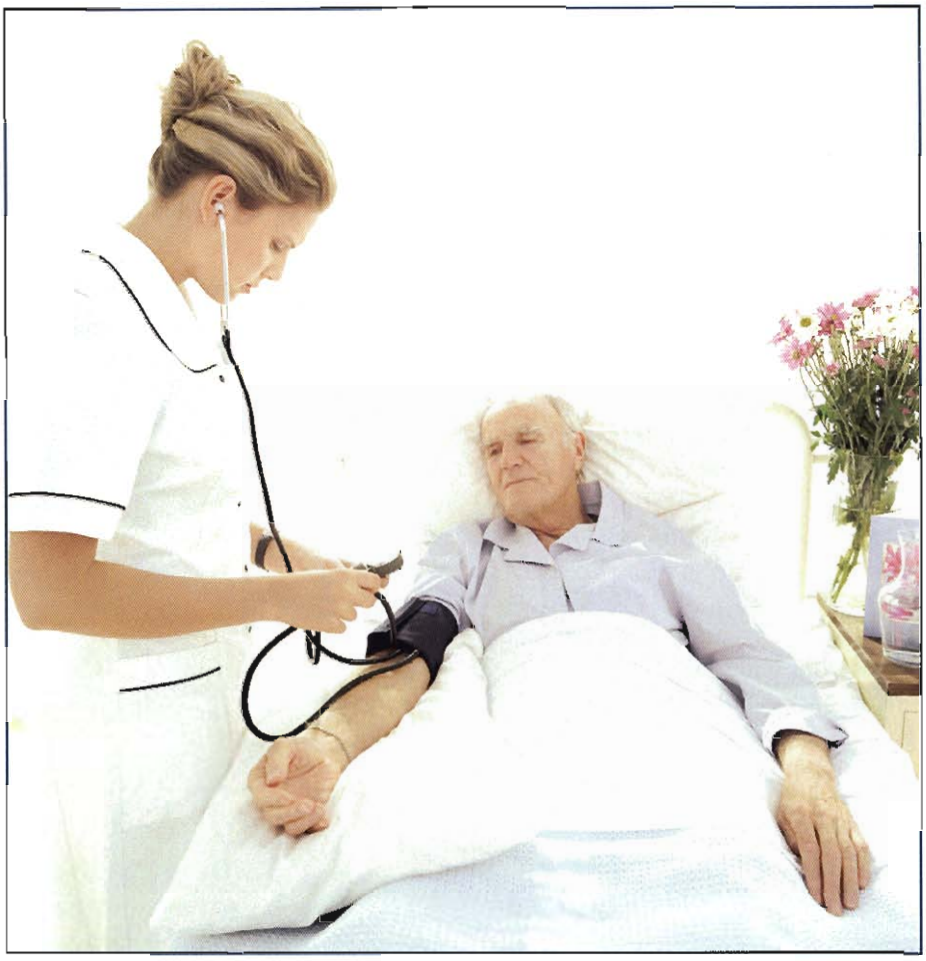
To use a SCIN in estate planning, you sell your business or other assets to your children or other family members in exchange for an interest-bearing installment note.

Generally, you can avoid gift taxes on an installment sale by pricing the assets at fair market value and charging interest at the applicable federal rate. As discussed below,

however, a SCIN must include a premium.

The "self-canceling" feature means that if you die during the note's term — which must be no longer than your actuarial life expectancy at the time of the transaction — your buyer is relieved of any future payment obligations. A SCIN offers a variety of valuable tax benefits:

- If you die before the note matures, the outstanding principal is excluded from your estate, allowing you to transfer a significant amount of wealth to your children or other family members tax free.
- The buyers may be able to deduct the interest they pay on the note.
- You can defer capital gains on the sale by spreading the gain over the note term. If you die before the note matures, however, the remaining capital gain will be taxed to your estate even though no more payments will be received.



In addition to these benefits, any appreciation in the assets' value after the sale is also excluded from your estate.

The catch

Like most things in life, you can't get something for nothing. To compensate you for the risk that the note will be canceled and the full purchase price won't be paid, the buyers must pay a premium — in the form of either a higher purchase price or a higher interest rate. There's no magic number for this premium, but a good rule of thumb is 25% to 30%. If the premium is too low, however, the IRS may treat the transaction as a partial gift and assess gift taxes.

Either type of premium will work, but they may involve different tax considerations. If you add a premium to the purchase price, for example, a greater portion of each installment will be taxed to you at the more favorable capital gains rate, and the buyers' basis will be larger. On the other hand, an interest-rate premium increases the buyers' income tax deductions.

The premium catch also comes with risk. In fact, SCINs present the opposite of mortality risk: The tax benefits are lost if you live *longer* than expected. If you survive the note's term, the buyers will have paid a premium for the assets, and your estate may end up *larger* rather than smaller than before.

Taking the risk

By using a SCIN, you're taking a risk that you won't survive the installment note's term. Bear in mind that you can't take advantage of this strategy if you're terminally ill, because the IRS will view the transaction as a sham. But if your health is poor or your family has a history of shorter-than-average life expectancies, a SCIN may be a bet worth taking. ▮

Avoid intrafamily disputes with a family mission statement

When you plan your estate, you may have several goals in mind, such as providing for your family's financial security, establishing a family tradition of charitable giving or transitioning a family business to the next generation. One outcome that most certainly isn't part of that vision is having family members sue each other over your money.

In most cases, you can avert intrafamily disputes by clearly communicating your plans to your loved ones and giving them some input into the final decisions. An effective and increasingly popular tool for accomplishing this is the family mission statement.

Mission control

The idea behind a family mission statement is for the family to agree on a basic set of guiding values and principles — on anything and everything, from philanthropy to education to religion to the future of the family business — and to memorialize them in a written document.

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There are no special rules that govern the format or length of a mission statement — it can be a single sentence or a 20-page monograph. The important point is to make sure that everyone is on the same page and that there are no surprises when it comes time to implement your plan.

A family mission statement is particularly valuable if you own a family business, plan to give a sizable portion of your estate to charity, have children from a previous marriage, or have established one or more "incentive trusts" designed to shape the behavior of your heirs.

When a family business is involved, for example, you may struggle to balance your desire to treat all of your children equally with your interest in preserving the business and rewarding those children who are committed to working in it. If most of your wealth is tied up in the business, it may be difficult to provide for children who don't work in the company without giving them an equity interest. But this may

be objectionable to the children whose hard work contributed to the business' success.

One potential solution is to divide the equity equally among your children but to provide those working in the business with management control by issuing voting stock to them and nonvoting stock to the others. Whatever strategy you come up with, the key to success is to discuss it in advance with those who have a stake in the outcome.

If one of your goals is to leave a philanthropic legacy, it's even more important for your family to participate in the discussion. Warren Buffett is famously leaving the bulk of his multibillion dollar estate to charity, and his children are fine with that. But imagine if they didn't learn of his intentions until the reading of his will.

By discussing these potentially divisive issues in advance and outlining your plan in a family mission statement, you can avoid unpleasant surprises and disputes.

Making a statement

No matter how hard you work to ensure that your estate plan treats all of your family members fairly, hurt feelings and disputes can result if your heirs don't understand your motives. A family mission statement isn't the only way to communicate the values and principles underlying your plan, but the process of putting the statement together can be an effective way to articulate those values and principles and to give family members an opportunity to be heard. ▮

Estate planning pitfall

You've left all of your assets to your spouse

At first glance, leaving all of your wealth to your spouse may seem like a simple, effective estate planning strategy. After all, the unlimited marital deduction exempts all transfers between spouses from gift and estate taxes (provided the recipient spouse is a U.S. citizen). Plus, it ensures that your spouse is provided for. But leaving everything to your spouse is a potentially costly mistake that can cause you to waste your federal estate tax exemption and dramatically reduce your children's inheritances.

A better approach is to contribute some or all of your assets to a bypass trust that provides income to your spouse for life, but preserves the principal for your children. For example, John is married to Anita, and he has an estate worth $7 million. John dies in 2009, when the exemption amount is $3.5 million and the top estate tax rate is 45%. John's will calls for all of his assets to go to Anita. The marital deduction shields his estate from estate tax, but his exemption goes unused.

If Anita dies later in 2009, her exemption will protect $3.5 million in assets from estate taxes, but the remaining $3.5 million will be taxable, reducing the amount available for their children by nearly $1.6 million.

John could have avoided this result by leaving $3.5 million to Anita outright and placing the other $3.5 million in a bypass trust. The trust provides Anita with income and on her death leaves the principal to their children.

The assets Anita receives outright are protected against estate taxes first by the marital deduction and later by Anita's $3.5 million exemption. The funds in the bypass trust are shielded from tax by John's exemption and are never included in Anita's estate. Thus, John and Anita's children will receive the entire $7 million, estate tax free.

Estate planning counsel you can trust

When you are looking for ways to preserve and protect your wealth, or develop a succession plan for your business, you want cutting edge legal advice that achieves your objectives. In other words, you want the specialized services of the preeminent trusts and estates group at Hinkle Elkouri Law Firm L.L.C.

Since 1987, we have helped individuals and businesses throughout the Midwest with estate planning, business succession planning, tax planning and other wealth management issues. Because our various practice areas compliment each other, the firm's 40+ attorneys have built a reputation for discovering creative solutions to difficult situations, while providing exemplary service with the highest degree of confidentiality.

Our trusts and estates group is ready to serve you in these and other ways:

- Creating and funding revocable and irrevocable trusts
- Preparing wills, powers of attorney and health care directives
- Designing asset protection plans
- Determining the value of business entities
- Designing charitable giving plans
- Planning with life insurance
- Structuring business entities to optimize control and transfer of wealth
- Preparing buy-sell agreements and business succession plans
- Representing clients in probate, tax and trust administration matters
- Preparing pre-marital and post-marital agreements
- Assisting with elder law and medicaid issues

Dan C. Peare chairs Hinkle Elkouri's Trusts and Estates practice. He has extensive experience in high-net worth estate planning, asset protection planning and planning with family businesses. He also assists with business valuations and planning with life insurance. Dan speaks and writes frequently on estate planning and family business planning topics. He received his law degree from the University of Kansas School of Law, and holds a finance and MBA degrees from Wichita State University.

Hugh W. Gill has teamed with Dan Peare for over thirteen years to form one of the best planning groups in Kansas. In addition to estate planning, Hugh manages sub-specialties in probate and trust administration, guardianships and conservatorships, disability planning, marital planning and post-mortem tax planning. Hugh holds finance, MBA and JD degrees from the University of Kansas.

Donna F. Bohn has over eighteen years of legal experience. She handles a variety of transactional matters for the firm's family business clients. Donna also concentrates in medicaid and elder law planning, business entity formation, structuring buy-sell agreements and split dollar life insurance planning. Donna has an accounting degree from Kansas State University and law degree from Washburn University.

Kari D. Coultis is an attorney, Certified Public Accountant and Certified Business Valuation Analyst. She focuses on estate planning and business valuations. Kari supervises drafting assignments with practice group legal assistants and attorneys to ensure errorless document preparation. She also assists with charitable planning and estate and gift tax planning. Kari holds a BS in Accounting and Business Administration, a Master of Accounting and Information Systems, and a JD degree from the University of Kansas.

Ryan D. Farley joined the Trusts and Estates practice group in 2008 after clerking for the Kansas Court of Appeals as a research attorney. Ryan provides depth to the Trusts and Estates practice group with his strong drafting, editing, research and writing skills. Areas of responsibility include estate planning, business planning and estate administration. Ryan has a BA in History from Emporia State University and a law degree from Washburn University.

We welcome the opportunity to discuss your needs and put our extensive knowledge and experience to work for you. Please call us at 316-267-2000 and let us know how we can be of service.

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