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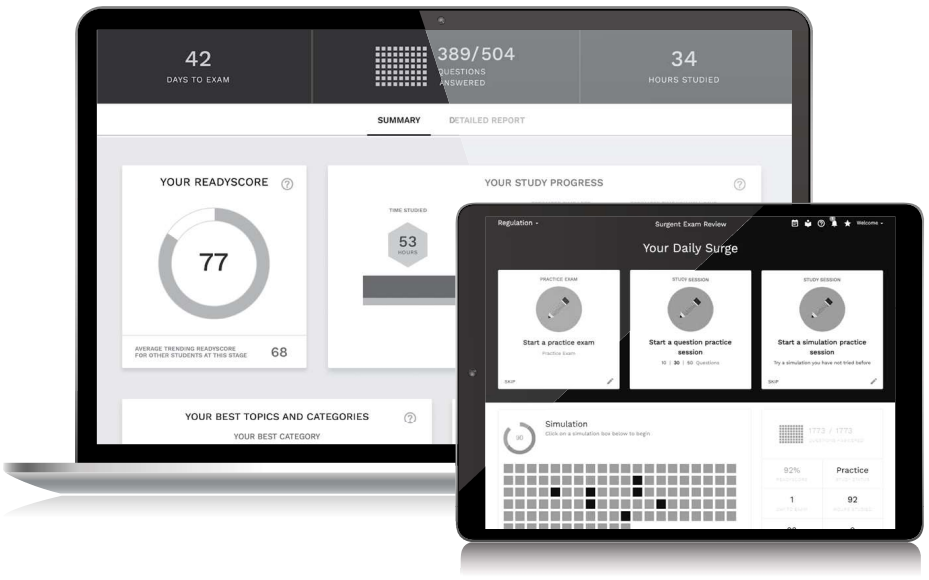


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# Estate Planning Documents


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# Estate Planning Documents

## *Learning objectives*

After studying this chapter, the reader will be able to:

- Identify various kinds of documents that directly or indirectly bear upon the amount, extent, and disposition of an individual's estate;
- Discuss procedures that should be followed to maintain the security and integrity of various estate planning documents; and
- Describe the process clients should follow in retaining, in an organized fashion, **only** necessary documents.

# *I. Documents*

## A. What documents affect estate planning

### *1. In general*

One of the more troubling problems that confronts the heirs of an estate is finding, collecting, and making sense out of all of the papers that connect the decedent's various assets, services, and the like. While some other tax strategies may be more exciting, it's nonetheless important that the decedent take steps during her lifetime to bring all these important documents together in a single work that identifies where they can be retrieved shortly after death.

Perhaps one of the most obvious of these documents is a life insurance policy. Without knowledge of the policy, heirs are unlikely to make a claim. An insurance company will not make any payments without a proof of death, even if the company suspects that policy premiums are not being paid due to the death of the insured.

a. In attempting to avoid the loss of important documents, one can go to the other extreme and save every document that one receives. Wading through documents to find the relevant ones can cause as much trouble for heirs as not being able to locate documents at all.

b. Professionals should encourage clients to keep a folder of documents and indicate where such documents are kept to family members and professionals hired by the client, such as accountants, lawyers, and brokers. Some documents should be retained by an attorney, others should be kept in a safe deposit box (make sure someone else also has access to the box), and still others may be placed in a home fireproof safe. Of course, this requires further indication of the identity of the attorney, where the safe deposit box is located, and the combination to any home safe. Organizing this effort to provide immediate access to all relevant documents of the client is a task that accountants in particular should be well suited to perform.

c. Clients should be advised that document collection and protection is an ongoing process that requires both structure and a **periodic monitoring** to be effective. While some documents may retain historic importance even after being superseded by later documents, the client or a hired professional should winnow out the wheat from the chaff to reduce the document load to a minimum.

d. All computer passwords should be available.

### *2. Specific documents*

a. The first and most obvious document that must be maintained and safeguarded is the original **will**. The attorney who prepared it typically retains a copy (to the extent permitted by state bar ethical requirements); the original should be kept in a safe deposit box, or somewhere else where it is highly unlikely to be damaged or lost. The will represents the client's wishes concerning the disposition of his or her assets and can also express the client's desire with respect to guardians of any underage children who survive him or her. Without a will, assets pass in accordance with state law presumptions, called **intestacy** laws, and guardians are appointed by a court without any input from the client. With a properly drafted will, the client's intent is generally followed.

b. In conjunction with the will, a client in many states can leave a **letter of instruction** to an executor that may, for example, identify the client's attorneys, accountants, and other financial advisors, as well as funeral instructions. Wills often contain a clause that directs the disposition of the client's tangible personal property to be given to such persons as are listed in a memorandum; in this letter, the client typically lists particular items that are to go to specific family members with the balance of undirected items passing in accordance with the remainder clause in the will (a clause which disposes of assets after all other assets are disposed of).

c. The will must be updated from time to time in response to specific circumstances. The will is revocable, and bequests made in an earlier will are not valid if the will is no longer valid. But because a will involves the government in the administration of the property, many clients find passing property through a will to be both cumbersome and expensive for the beneficiaries. Instead, clients may transfer all their assets into a fictional, yet legal, entity called a **revocable trust**, which, because it is a **private contract** between the client and the trustee, is not subject to many of the rules that apply to states and wills. By doing so, the client retains the ability to change the ultimate disposition of property in the trust as he or she would with a will but can have that disposition shielded from much court control. Both the will and the trust document must be kept secure in a place where they can be found when the time comes for administration.

***Note:***

One advantage of the revocable trust is that the client can retain control of the assets much in the same way the client does with owning those assets individually, but the trust arrangement can provide safeguards in the event the client becomes incapacitated. The trust could, for example, provide for a co-trustee or a successor trustee whose office begins with a finding of incapacity or incompetence of the client. A trust requires the client to specify his wishes in advance, in contrast to changing his mind from moment to moment as he does with his own assets; this puts premium on precise thinking and establishing trust to guard against the possibility of no longer being able to alter the terms of the trust to changing circumstances.

d. Another instrument that clients should have, in addition to or in lieu of a trust, is a **durable power of attorney**. The power of attorney gives another individual or institution the authority to act on behalf of the client. In general, such instructions are voided when the principal becomes incapacitated. In such circumstances, the family or relatives of the client might have to use the court procedure of the appointment of a guardian or conservatory, a process that will not only be time-consuming but will incur legal costs as well. The power of attorney, however, can generally be made durable, which is to say that its effectiveness survives incapacity. Financial transactions in the economy may

require timely action and substantial loss may be incurred if there is not enough time to appoint a surrogate to act with respect to client's property. Both the trust and the durable power of attorney can serve the goal of immediate action, but the durable power of attorney is generally more open-ended and provides greater discretion to the agent than does the trust. The location of a power of attorney must be known by family, advisors, and the designated agent. Part of the planning process involves selecting an individual or institution in whom great trust is reposed with respect to financial decision making. A durable power of attorney is particularly important if the signer is in a service business by herself, which needs to be sold quickly to maintain value if she is permanently incapacitated. Client or patient slippage is a terrible thing.

e. The **power of attorney** is not used solely for financial matters. Usually a separately drafted instrument for **healthcare** should be executed to handle the personal matters of the client. The identification of the agent is often different, as one may trust a person deeply to do the right thing regarding life, health, or quality-of-life issues, but not trust that same person to make sound financial decisions, and vice versa. The agent will be called upon to make health care decisions in the event of incapacity. Because of the mountain of federal law concerning health information privacy, this healthcare power of attorney requires significant legal compliance. Again, in the absence of such instrument, doctors, hospitals, and insurance companies may not speak with the agent and the family will need to go to court to have a guardian appointed with the legal authority to act on behalf of the client. Ultimate questions of the client's life are implicated, and construction of the power of attorney requires a three-way conversation among the drafter, the client, and the designated agent. The client must instruct the agent with respect to what should or should not be done in various contingencies and be assured that the agent will comply with those wishes. It may also be advisable that a client from time to time revise a letter of understanding for the agent's information as the client's views change. This is the so-called **living will**, which together with the power of attorney constitute an advance directive. AARP offers a state-by-state listing of advance directive forms on its website. Some companies have seen a market for issuing a wallet-sized card which identifies the existence of a living will much in the same way that a bracelet may identify aspects of an individual's health profile, so that a hospital can call to retrieve health care powers of attorney immediately when the client is brought in for care. In addition, privacy rules under HIPAA will require an agent to have a duly executed **Authorization to Release Protected Healthcare Information** form in order to discuss certain matters with physicians before making a decision on behalf of the principal. Bluntly, the living will is really for the benefit of the hospital and not your client. If she enters the hospital comatose and is dying, yards of tubes and machines will still appear without a living will. This will get expensive even though your client stated ORALLY that she wanted NO extraordinary means to save her life.

f. Clients may also hold various property interests that many in the family are not familiar with, including **cemetery plots**, partial interests in inherited out-of-state real estate, classic cars, and antiques that are stored away from the residence. Administering a client's estate will be easier if all of the assets are identified, and the professional must question the client carefully and thoroughly to uncover easily forgotten assets. An item like a partnership interest in undeveloped or non-income-producing property falls in this

category as the fact of its ownership will not appear on any informational document, such as a Schedule K-1, or in a written certificate of ownership in a general partnership.

g. A client may also be a shareholder in a closely held corporation **stock** from which neither compensation nor dividends are received. Any business or investment interest, other than one in a publicly traded company, may well have **operating agreements or other restrictions** on equity owners that inform the executor, trustee, or heirs of the nature of the asset and what can and cannot be done with respect to it.

h. Many of the client's assets can be determined by a review of the client's tax returns. Different clients retain tax returns for different periods of time and tax preparers retain their copies for differing periods of time. While the more or even most recent returns will provide more current information that identifies income-producing assets, it will not uncover all such assets and some interview and inventory of assets is advisable. One should know all **bank accounts**, **brokerage accounts**, and **deeds to real estate** owned by the client. The tax return is a good place to start discovering the source of interest income, dividend income and capital gains, real estate taxes, and mortgage interest, but it is **only one place** from which to gather such information.

i. While heirs and beneficiaries are naturally more interested in the assets of the decedent, one cannot overlook the client's debts and other obligations that must be satisfied because they often affect the amount that those heirs and beneficiaries will ultimately receive. A client should retain all **loan documents** to identify the creditor and the terms of the loan.

j. Not all assets pass through probate (and thus under the terms of the will) because they are not in a sense individually owned. The most common examples are **life insurance policies** and **retirement accounts**. As mentioned earlier, all life insurance policies should be identified and kept together. There should also be a list which can be used by a trustee or an agent under a power of attorney to identify the amounts of premiums, if any, and when they are due to prevent a **lapse** during a time when the insured is unable to make financial decisions. That list should also contain the name of each policy, its number, its issuing company, and information associated with that policy to facilitate the processing of any claim.

k. A greater and greater percentage of individual wealth is found in various pensions, annuities, 401(k) plans, and individual retirement accounts. In the case of an **IRA**, the custodian will have no reason to believe that the owner (or beneficiary, as the case may be) has died until age 73 when withdrawals are to begin (for those turning 73 in 2023). Not only should a list of the client's various accounts be maintained, but the **beneficiary designations** must be carefully examined periodically. On the death of the client, the assets in such arrangement pass not according to the terms of the client's will but under the terms of the beneficiary designation. Remember that most qualified plans will contain a default designation that will take effect in the event that the client fails to make an effective designation; this is often the estate of the client, and this designation is generally not desirable. The beneficiary designation form generally includes a primary beneficiary and a secondary beneficiary (who takes in the event the primary beneficiary does not or cannot), and some also include a tertiary or lower level beneficiary. Clients often have a faulty memory with respect to beneficiary designations, so it is important that they be physically examined.

l. Both in second marriages and in circumstances when there is a disparity in wealth, many couples will have executed a **pre-nuptial agreement** (in rarer cases, a post-nuptial), which spells out the property rights as a matter of private contract. This overrides the state statutes concerning the property disposition of couples on divorce or death as well as other circumstances.

m. Any currently effective **marriage license** should be retained to establish the identity of the spouse. In some cases, benefits flow to a surviving spouse, and the payor may require some proof of the legitimacy of the claim. Some companies provide death-benefit-only plans to which the client is never entitled because they're only triggered upon death, but the surviving spouse may be entitled to receive benefits.

n. Likewise, all **divorce decrees** or **privately drafted settlement agreements** must be identified to determine the client's rights and duties with respect to an ex-spouse or minor children. While alimony must cease after death, this is not true of child-support. Clients with retirement accounts must produce a copy of any qualified domestic relations order that establishes the rights of an ex-spouse to shares of them.

o. Many clients insure against the possibility of disability requiring managed care by the purchase of a **long-term care insurance policy** that provides comprehensive care.

p. To protect against damage to, and liability arising out of, the home and auto, a client will have a **home and auto liability insurance policy** (the practitioner should be particularly mindful of the provision in some home liability policies that the home must be occupied if the policy is to remain in effect). In addition, to cover those risks above and beyond risks in these underlying policies, clients often have an **umbrella policy**. The liability coverage can be excess, or it can be "drop down." Excess coverage provides additional liability protection but only comes into effect after the underlying insurance policies have paid out their maximum limits. It essentially adds an extra layer of coverage on top of the existing policies, extending the overall liability limit. On the other hand, with drop-down coverage, the umbrella policy kicks in and provides coverage when the liability limits of the underlying insurance policies are exhausted. In other words, if a claim exceeds the limits of the underlying auto or homeowners insurance, the umbrella policy drops down to cover the remaining amount, up to the umbrella policy's limit. Drop-down coverage can also provide coverage for certain risks that may be excluded or limited under the underlying policies. Read the home insurance policy. Some policies have a provision reducing or eliminating liability if a home is not occupied for a certain time.

q. A source of confusion and misinformation to survivors lies in the sheer number of documents, many of which are no longer effective. One must wade through all the above related papers to determine which are the most recent, so the client should throw out aged documents -- and, in many cases, destroy them to prevent identity theft. However, many clients do not discard documents for fear that they will be needed for some reason.

r. State law contains a provision generally called the "right of sepulcher," that is, the right to bury or cremate or dispose of the remains of a human being. Generally, the spouse is the first to have this right. The right of sepulcher is not an issue for married couples, but what of those who are partners? Check state law. You'll find that some states give this right to a person designated by the decedent, but the provisions of state law must be followed for the designation to be proper. This final disposition should always be in writing and signed.

***Planning point:***

A popular cable TV show illustrates in a backhanded way the virtues of maintaining order of files, records, and documents as an estate planning strategy. In *Hoarders*, viewers are, well, entertained by other people's misery, as they watch the disorder of compulsive hoarding behavior have negative consequences on a subject's relatives, neighbors, and the hoarder's own life.

Individuals suffering from compulsive hoarding may focus their obsession on documents, mail, and sentimental items while always begging off to dealing with the situation due to lack of time. Such individuals tend to be in denial about the problem, but when a pack rat/hoarder dies, this problem becomes the problem of the hoarder's loved ones as they attempt to marshal the debts and liabilities of the decedent to administer the estate. Estate planning thus is compromised because it lacked an organizing criterion. In one episode of *Hoarders*, a decedent left stacked papers, documents, and trash three feet deep, with barely enough space to accommodate the feet of a surviving family member. Somewhere in the house, somewhere in the piles scattered throughout, were stock certificates, bills, and other important documents.

Shouldn't part of estate planning involve making it not too difficult for survivors to find the necessary documentation to handle the estate, for tasks like probating a will and distributing assets? Leaving a mess for others to clean up has a cost. The executor or court-appointed personal representative has no choice but to sift through files and piles to find everything of relevance to administering the estate. In some cases, this may involve "only" time, but time that must be compensated in some way; in other cases, the clutter may result in structural damage, infestation, or other calamities that will cost a pretty penny (out of the estate) to remediate. In addition, disposal of hazardous and noxious materials may further run up the bill. It can take weeks to put a home into condition for use or sale, generally sapping additional time and energy from those already shouldering the burden of grief over the decedent's death.

## B. How to manage important documents

***Note:***

Personal and financial documents should be easily findable when a person or anyone else -- such as that person's spouse, attorney, agent, guardian, executor, or personal representative -- needs information. Given how scattered digital lives have become, it's important to have a good system for storing and managing important papers. That way, the individual, a relative, or a lawyer can quickly lay hands on a needed document.

Disorganization generally means the individual or his surrogate spends more time printing or pushing papers than is necessary. For example, the National Taxpayers Union estimates that the average U.S. taxpayer spends roughly 19 hours pulling together information for his tax return and filling out forms, while most office workers spend 30 minutes each week hunting for paperwork on a disorganized desk, according to a survey from office product manufacturer Brother International.

A bad system can cost money and reduce the estate that passes to heirs. Misplace that credit card bill (physical or virtual) until after its due date, and a late fee and a jacked-up interest rate are in the offing. Forget where the passport is, and it'll cost money for another -- plus additional money for rush processing and overnight delivery to get it in time for vacation.

Disorganization also increases the risk of **identity theft**, if a visitor happens across unsecured papers in the home or discarded ones in the curbside garbage.

### *1. What to discard*

Couldn't find an important paper that had been carefully put away someplace? Spending too much time trying to straighten out your household business affairs, especially at income tax time? How, in fact, do people decide what records are important to keep and what they can discard? How do they decide where

to store and keep such records and papers? Even though each family or household must work out its own system, some general guidelines can be helpful. As a starter, ask a few questions:

- How easy or difficult would it be for other members of the household to figure out the record system? (Or…is there even a system?)
- Who else knows where to turn for necessary information about the family household assets and obligations? Is there a listing of people who are important contacts, such as tax counselors, attorneys, bankers, brokers, insurance representatives, employers, creditors, and debtors?
- Are titles to property and possessions held in the best way for all concerned?
- A good record system will provide a bird's-eye view of what happens to property after death or the death of a member of the household. Other changes can alter plans for such property too -- for example, divorce or separation, children reaching legal age, a long illness, a lawsuit, a natural disaster, loss of a job, and retirement.
- What happens if the place where one lives is burglarized or if there's a fire and records are destroyed? What can be done when one loses track of important papers? Which papers can be replaced, and how does one go about that? Which ones cannot be replaced, and what can be done about those?

### *2. Items to keep in safe deposit boxes*

Every family household has some important records.

a. Each member of the household should have a birth certificate or an acceptable substitute. Since there are many occasions when information on a birth certificate will be needed, birth certificates must be kept in a safe place, preferably in a safe deposit box.
   - If there are lost or misplaced birth certificates, consider applying for replacements now, before there is a pressing need. Otherwise, one may have to wait for a replacement that is needed quickly.
   - State registration of births has been mandatory since 1920, and one can contact the State agency to get a copy. The Bureau of the Census also will search its files for proof of age.

b. By the same token, there will be a death certificate for every person someday. These will be needed occasionally and also are best kept in a safe deposit box.

***Note:***

If one needs to obtain these kinds of records, go to the Center of Disease Control and Prevention site for **vital records**. Such site will give you the address in each state to secure such records. Watch the site you go to, as above. There are **non-government** sites which would be very, very happy to get your OWN vital information while asking a question about the vital records of another.

c. Other important documents to be kept in a household's safe deposit box include marriage certificates, divorce or other legal papers regarding dissolution of marriage, adoption papers, citizenship records, service papers, passports, and any other document that is either government- or court-recorded.

d. The original copy of a will, in most cases, is kept in the safe of the attorney who prepared it. This is highly desirable, since it may stave off complications later. The client receives two carbon copies, one of which may be put into his or her own safe deposit box. However, there could be a legal delay in getting this copy at his or her death. The third copy, therefore, should be kept at home where it is readily accessible. There is ONLY an

original will. All others are copies. The original should be signed in blue ink, and every page should be initialed in blue so it is clear what is the single original and what are copies.

e. If there is a power of attorney, it may be wise to keep copies of these documents in a safe deposit box, ensuring they are accessible when needed.

f. Store valuable items that have sentimental or monetary worth, such as jewelry, rare coins, valuable collections, family heirlooms, and valuable artwork. Additionally, keep items that are difficult or impossible to replace, such as irreplaceable family photos, videos, or personal memorabilia.

g. Consider keeping electronic backups of important digital files, such as photos, videos, and important documents, on an encrypted hard drive or USB drive. This provides an additional layer of protection in case of computer failures, theft, or data loss.

h. Some of the important papers, such as investments, are of a business or financial nature.

(i) Certificates for securities are nonnegotiable (can't be sold or legally transferred) until they are signed by the owner. Nevertheless, such certificates can be lost or stolen, and the signature can be forged. In either case replacement involves both cost and delay. Such certificates, then, when not left with the broker, should be kept in the owner's safe deposit box.

(ii) Government bonds can be replaced without cost, but there will be a delay of several months, so it is best to keep these in the box also.

(iii) Among other investment-type documents that require safekeeping are papers that serve as proof of ownership, such as deeds for real estate, other mortgage papers, contracts, automobile titles (if this applies in the client's state), leases, notes, and such special papers as patents and copyrights. Additionally, keep copies of important financial records, including bank account information, investment statements, insurance policies, loan documents, and copies of legal agreements.

(iv) Store copies of insurance policies, including homeowner's insurance, auto insurance, and life insurance policies.

***Note:***

If a client doesn't have a safe deposit box, the client should get one. Often the smallest size is adequate, though larger sizes are available at slightly higher charges. If the client does have a safe deposit box, ask if it is large enough to hold everything that should be in it -- and small enough to keep out things that don't need to be there. The box should not be used as a catchall for souvenirs and unimportant papers.

***Question to ponder:***

Has anyone had an experience having to access an estate document on the weekend when the safe deposit box in the bank was closed?

### *3. What goes in and what stays out*

A guideline as to what goes in and what stays out of the safe deposit box might be: Put it in if it can't be replaced or would be costly or troublesome to replace. Also use the box as a backup for items that you wouldn't need to access or update frequently, such as an executed will, or copies of documents from the secure home lock-box.

a. Secure vital documents. Move anything irreplaceable to a lockable fire-proof and water-proof box. Include passports, birth and marriage certificates, Social Security cards, wills,

deeds, vehicle titles, current copies of insurance policies and photocopies of driver's license and insurance cards. You could also keep a written or video-recorded inventory of the contents of your home, in case of emergency. Use checklists from the Red Cross and Buttoned Up for more vital documents to collect should an emergency force you to evacuate.

- Many items can be replaced rather easily. Copies of insurance policies can be obtained from your insurance companies. Copies of cancelled checks are usually available at your bank.
- Back up online. Check online financial accounts to determine how long electronic copies of statements are kept -- usually, seven years. Other documents might be scanned and uploaded to a portable password-protected hard drive, or saved remotely to a backup service like IDrive or MozyHome.

b. Generally speaking, the following do not need to be kept in a safe deposit box: income tax returns, education records, employment records, bankbooks, guarantees, and burial instructions.

***Note:***

It is important to keep an inventory of the items stored in the safe deposit box and inform a trusted family member or executor of its existence and location in case of unforeseen circumstances.

### *4. Keeping tax records*

How long should tax records be kept? The Internal Revenue Service has three years to audit Federal income tax returns. However, this limit does not apply in unusual cases. If one failed to report more than 25 percent of one's gross income, the government has **six** years to collect the tax or to start legal proceedings. There are **no** time limitations if one filed a fraudulent return or failed to file a return at all.

- Reduce old tax returns. Hang on to returns and any supporting documents for seven years. As said, the IRS has three years to audit a taxpayer for good-faith errors, and six years if there's reason to believe income was underreported by more than 25 percent. After that, the taxpayer can only be audited for filing a fraudulent return or not filing one at all. IRS Publication 552 details all the different documents taxpayers may want to keep for tax purposes. Always have a client file a return even if no tax is owed. Such a filing triggers the start of the running of the statute of limitations.
- Separate tax materials. Keep another file box for anything needed for next year's tax return, as well as older returns separated by year. That way, everything will be in one place come tax-prep time.
- Prepare a backup. There should be copies of important documents in multiple places so that a set is always accessible.
- Many states are "piggy-back" states, which means such states follow the federal rules. Make sure to check the state of a client to determine whether such state follows the federal rules or has another set of rules.

***Note:***

However, you don't have to keep everything for tax purposes. You can lighten your record load by discarding certain checks and bills once they have served their purpose. For example, you can throw away weekly or monthly salary statements -- assuming you are paid in that way -- after checking them against the annual W-2 Form. But save cancelled checks that relate directly to an entry on the tax return and keep all medical bills for three years to back up the cancelled checks.

If one has misplaced an important healthcare-related document, the Centers for Disease Control and Prevention offer a database of ways to obtain new copies. The IRS generally keeps records for six years. You can obtain a copy of a tax return by writing to the IRS center to which the return was sent. Make sure to include your Social Security number and a notarized signature. You can also get your return online. See IRS site *Get Transcript.*

### *5. Making household inventory records*

Among your important papers, keep a household inventory. If there is a fire or burglary in the home, this record will help you remember what has to be replaced and how much each item is worth. An inventory also may show a need to increase your insurance because the possessions are worth more than you thought. The best way to go about compiling a household inventory is to start with a sheet of paper for each room in the residence.

- When making the inventory, start at one point in the room and go all the way around, listing everything. For each item, list what it is, how much it cost, when it was purchased, and what it would cost to replace it. Include the model number, serial number, brand name, dealer's name, any distinguishing features, and a general description. Include receipts, appraisals, or other supporting documentation whenever possible. This information will be helpful for insurance claims and determining replacement costs. Taking pictures of the rooms and the household possessions will make identification or replacement easier. Arrange expensive collections, silver, and jewelry separately and take close-up pictures. Record specific details that can help identify them accurately.
- Don't forget to check storage areas, and include any items stored in closets, basements, attics, and garages. Many valuable possessions, like tools, seasonal decorations, and sports equipment, are often stored in these areas.
- It may be helpful to group items by category (i.e., electronics, furniture, appliances, etc.) to make it easier to reference at a later point in time.
- When all the rooms, including the basement, garage, and attic, are finished, add up the total replacement cost. That figure will represent what the household is worth and is what insurance should cover.
- Update the inventory every six months or so by adding new purchases and adjusting replacement costs.
- You might also suggest that a client video the rooms and the contents of drawers and closets, significantly reducing the written inventory. Each year the client could review or retape the video and note any significant changes (new purchases, renovations).
- It is advised to keep digital copies of inventory records in multiple secure locations. Cloud storage services, external hard drives, or password-protected USB drives are great options. This ensures that records are accessible even if the physical documents are lost or damaged. Additionally, one could consider keeping a copy of his or her household inventory in a safe deposit box, with a trusted friend or family member, or in a secure location outside the home. This provides an additional layer of protection in case the primary records are lost or destroyed.

***Note:***

When updating household inventory records, it is beneficial to periodically review the homeowner's or renter's insurance policy to ensure it adequately covers the value of the belongings. Adjust the coverage as needed based on the information in the household inventory.

### *6. Organizing a home filing system*

A system for personal records is a necessity. No matter how modest the home facilities might be, there should be a special place to keep papers, ranging from an elaborate room or home office or just a corner of the kitchen, bedroom, or hall. Create a storage system. Now that the piles have been shortened, documents should be more easily found, and next year's keep/toss process simplified.

a. Records, regardless of the filing system used, should be reviewed at least once a year to discard items no longer needed. January is a good time for an overhaul since it's just before people begin to work on taxes.

b. The equipment you will need doesn't have to be elaborate, but there is no reason not to take advantage of existing technology and related systems. Think about a filing cabinet before thinking about a desk. If there isn't enough space for a small cabinet, you should buy accordion folders or a storage chest that fits under the bed, or get sturdy cardboard boxes of an appropriate size.

c. A home computer or portable typewriter and a pocket calculator can be handy, but they are not essential. **The key is to know where everything is**.

### *7. Two home files*

It is necessary to keep two home files, in addition to the safe deposit box at the bank. These two files are the active file and the dead storage file.

a. The active file will hold:

- Unpaid bills until paid;
- Paid bill receipts;
- Current bank statements;
- Current cancelled checks; and
- Income tax working papers.

***Note:***

After three years, move these items to your dead storage file.

b. There are other items which should always be kept in the active file, not automatically moved to the dead storage file. These include:

- Employment records, such as resumes, recommendation letters, and health benefit information;
- Credit card information, including the number of each card, by company name;
- Insurance policies;
- Copies of wills;
- Family health records;
- Appliance manuals and warranties;
- Education information, such as transcripts and diplomas;
- Social Security information on benefits and regulations; and
- An inventory of what's in your safe deposit box (you might store a key in the inventory folder).

***Planning point:***

A record book of the whereabouts of the important papers should be kept. A loose-leaf binder allows papers to be changed easily or pages to be copied.

The book should contain a list of all the savings and checking accounts. This way you won't become one of the missing depositors who have forgotten their accounts or who have died without telling relatives about them. Also, include the name and branch of the bank where the safe deposit box is kept.

The book also should have all of the family members' Social Security numbers and all of the insurance policy information. It's a good idea to keep a copy of household inventory here as well. Don't forget to record all household improvements.

Finally, make sure someone else knows and understands the family record-keeping system.

c. Sort accumulated paperwork. Make two piles: one of documents to shred and another to keep.

- Pare monthly papers. Keep monthly investment account statements and paychecks only until the annual W-2 and 1099 forms are received. Get rid of bills and credit card and banking statements that are more than a year old, too, unless needed for tax purposes.
- Keep current. Get rid of all but the most recent version or copy of insurance policies, annual Social Security statements, and legal documents. Throw out any expired warranties, instruction manuals for products no longer owned, and other similarly outdated documents. The Federal Citizen Information Center of the General Services Administration has more suggestions on papers that can be safely discarded.
- File active papers. Prepare a separate file for each type of current paperwork, as well as each financial account. Place newer documents in the front of each folder so that it's easy to find the newest copy and determine what can be thrown out as new papers arrive. Keep a separate box or file for paperwork to take action on, such as bills to pay.
- Check in with professionals. Ask the financial advisor, tax preparer, broker and attorney which, if any, paperwork they keep on file from their dealings. Also ask how long it will be kept.

***Planning point:***

Bad management doesn't just waste time -- it could lead to identity theft. So what not to do?

- Don't keep too much. Most people hang on to too many papers, which wastes space as well as time. When sorting items into "keep" or "toss" piles, justify the need for each document saved.
- Don't forget to shred. Identity thieves may comb trash for personal information. Use a cross-cut shredder that turns paperwork into confetti instead of strips that could be reassembled. Banks often sponsor free shredder days where customers can bring paperwork in for the industrial shredder.
- Don't forget **passwords**. Now that so much information is stored online, it's a good idea to include in your secure lock-box or safe deposit box the log-in details and passwords for your financial accounts.

### *8. DD-214*

If your client was in the military, the client would have been issued a DD [Department of Defense]-214 upon discharge. If the client does not have a copy, a copy can be secured from the Records Center in St. Louis, MO. Check website on how to secure. Once in hand, file in the Recorder of Deeds office for the county of residence of the client. The DD-214 is not a public record, but the family may need a copy someday. After the death of the client, a family member can secure a copy.

### *9. Preparing a net worth statement*

A net worth statement is generally an excellent means of keeping tabs on the possessions belonging to a client and the client's family. It provides a good overall picture and can be prepared in an hour or less. If the client maintains a statement annually, the client and professional can quickly see whether the client is getting ahead financially or falling behind and, in either case, how fast. An accurate net worth statement can serve as a point of departure for the year ahead. If financial progress is slower than expected, the client can decide whether to stay on course or to change directions for the coming year.

To make a net worth statement, all one does is list assets, list obligations, and subtract the debts from the assets. Hopefully the plus side of the ledger will get larger each year and the minus side smaller. But there may be good reasons why someone might fall behind sometimes. Perhaps one bought a new home, or other expenses have been heavier than usual.

SAMPLE MODEST NET WORTH STATEMENT FORM

NET WORTH STATEMENT as of _____

(update annually)

**Assets**

Cash on Hand $_____

Bank accounts (checking and savings) $_____

Credit Union account $_____

Savings & loan accounts $_____

Any other savings accounts $_____

House, market value $_____

Other real estate, value $_____

Household furnishings, value $_____

Automobile(s), blue book value $_____

Life insurance, cash value $_____

Stocks and bonds, today's value $_____

Cryptocurrency $_____

Profit-sharing or retirement plans $_____

U.S. Savings Bonds $_____

Money owed you $_____

Other assets or investments $_____

Personal property $_____

Total Assets $_____

**Obligations**

Mortgages, balance due $_____

Other loans (bank, credit union) $_____

Installment debts, balance due $_____

Credit cards, balance due $_____

Charge accounts, owed $_____

Other debts, total owed $_____

Insurance premiums due $_____

Taxes owed $_____

Other current bills $_____

Total Debts $_____

**Net Worth (assets minus debts)** $_____

***Note:***

This might be effective for a person of rather modest means, but a home inventory may be input to a more thorough net worth statement prepared by the client's accountant. Such a statement will provide a clearer and more accurate picture in more sophisticated contexts.

### *10. Summary of things to remember*

Use the checklist below, sorted by location, to remind you what to keep and what can be discarded.

a. **Safe deposit box**

- Birth certificates
- Citizenship papers
- Marriage certificates
- Adoption papers
- Divorce decrees
- Wills
- Death certificates
- Deeds
- Titles to automobiles
- Household inventory
- Veteran's papers
- Bonds and stock certificates
- Important contracts
- DD-214

b. **Active file**

- Tax receipts
- Unpaid bills
- Paid bill receipts
- Current bank statements
- Current cancelled checks
- Income tax working papers
- Employment records
- Health benefit information
- Credit card information
- Insurance policies
- Copies of wills
- Family health records
- Appliance manuals and warranties
- Receipts of items under warranty
- Education information
- Inventory of safe deposit box (and key)
- Loan statements
- Loan payment books
- Receipts of expensive items not yet paid
- Social Security card

c. **Dead storage**

- All active file papers over three years old

d. **Items to discard**

- Salary statements (after checking on W-2 Form)
- Cancelled checks for cash or nondeductible expenses
- Expired warranties
- Coupons after expiration date
- Other records no longer needed

# Will Provisions


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# Will Provisions

## *Learning objectives*

Upon reviewing this chapter, the reader will be able to:

- Identify various kinds of clauses found in a will and the purposes they serve;
- Discuss the need for guardians in many estate plans and how the client can provide input to the appointment; and
- **Describe the election against the will**, what it applies to, how much it encompasses, and what effect it has on the will provisions.

# *I. Will provisions that are needed*

***Note:***

According to FindLaw.com, roughly 70 percent of Americans don't have a will, which leaves them no say in what happens to their assets when they die. Furthermore, if one dies "intestate" without a legal will the living situation at death has no bearing on the division of your accidental estate. For example, you may be living with stepchildren who have no legal connection to you, and without a will, you'd leave behind a mess of legal uncertainty and dependents who may now inherit nothing.

More than just write and sign it; a will should also be validated and available. Even though the internet is full of advice and sample forms, it's wise to consult a lawyer to make sure you haven't missed anything. Remember that states have separate requirements. If a client misses one of those requirements, the will may be invalid.

## A. Necessary will provisions

### *1. In general*

A properly executed will or trust agreement aims to provide that an individual's property passes as he or she wants and that the surviving dependents are provided for. Quite often provision must be made to provide liquidity for the dependents who have previously relied on the earning power of the individual, and the management of the individual's property needs a new individual or organization to fill the breach.

While a will is very flexible in the particulars of its provisions, its general structure includes a lot of standard language or boilerplate that has developed over the years as a result of judicial testings. Experience has dictated many of these provisions as necessary elements to a will, which is not to say that their mere presence will necessarily solve all problems or avoid litigation, but their absence is often the source of many contentious, time-consuming and expensive resolutions. What follows are those standard provisions.

***Note:***

There are several points that should be considered with a will. First, is to understand its scope: it only applies to individually owned assets and then only those that do not provide a private, contractual disposition. For example, jointly owned property, individually owned life insurance, pay-on-death bonds, and Totten trust bank accounts will generally not be affected by anything in the will (but they may be by the tax apportionment clause) unless the estate is explicitly named as the beneficiary or becomes the beneficiary as a result of the default taker under state law or the contract when no beneficiary is named or as a result of being the secondary or tertiary beneficiary in cases when the primary or secondary beneficiary cannot take (usually either by predeceasing the testator or by disclaimer). Some partnership agreements may provide who succeeds to a partnership interest at the death of a partner, which could also govern the disposition rather than the will.

**Second, a valid will in one jurisdiction may not necessarily be valid in another jurisdiction**. While individuals may naturally think that they need only satisfy the law in the state in which they are domiciled, this is incorrect. The disposition of real estate, including that occurring by death, is generally governed by the law of the state in which it is located rather than the individual's state of domicile. Thus, a disposition of real estate in the will is recognized only if it is a valid will in the state where the property is located. The result of an invalid will in that state is that the state will treat the property as passing to the intestate heirs under the laws of that state rather than the individuals named in the will or even the intestate heirs under the laws of the state of testator's domicile.

### *2. Exordium clause*

Found at the beginning of a will, it serves to identify the testator (the person who claims the document as his will), distinguishing himself from others with the same or similar name by address and location, and to replace any prior writings claimed as a will or codicil (an amendment to a portion of a will). Invariably the exordium will revoke all previously written wills and codicils and usually states your address information or general location. It is often necessary to include a list of AKAs ("also known as") not only to further distinguish the individual from other individuals but also to match the name to an individual: some persons may have been known even to their families by a nickname, such as Frank or Butch or DeeDee, when their legal name was Francis, Seymour, or Delilah. The legal name may be important in locating any birth certificates or other documents indexed under that name.

***Note:***

While not necessary, in some cases it may be helpful to further identify family members to nail down the identity of the testator and to match up, generally, beneficiaries named later in the will.

I, Michael Anthony, also known as Butch Anthony, of the Town of _____, County of _____, and State of _____, being of sound and disposing mind and memory, do hereby make, publish and declare this to be my Last Will and Testament, hereby revoking all Wills and Codicils previously made by me. I declare that I am married as of the date of this Will and that my wife's name is Susan B. Anthony. I further declare that I have two (2) children, namely: Carter X. Anthony of _____, _____, and Jennifer H. Anthony of _____, _____.

### *3. Debts and taxes*

The will directs the personal representative of the estate to pay all of the decedent's lawful debts – and sometimes "just debts," which would include paying off some obligations that are not legally enforceable by reason of the running of the statute of limitations – because the claim of the beneficiaries of the estate is lower than the priority to creditors, taxing authorities, the costs of burial, cremation, or other disposition of the decedent, taxes, funeral expenses, and the costs incurred in administering the estate (including compensation for services of the personal representative, attorneys, and accountants). It is important to

note that the TCJA suspended miscellaneous itemized deductions for individuals, estates, and non-grantor trusts for any tax year beginning after December 31, 2017, and before January 1, 2026. Final regulations released on September 21, 2020, clarified that the following deductions of decedents' estates and non-grantor trusts are allowable in figuring adjusted gross income and are not miscellaneous itemized deductions:

- Deductions for costs paid or incurred in connection with the administration of the estate or trust which would not have been incurred if the property were not held in such estate or non-grantor trust;
- The deduction concerning the personal exemption of an estate or non-grantor trust;
- The distribution deductions for trusts distributing current income; and
- The distribution deductions for trusts accumulating income.

Distributions made before such payments expose the distributee to the risk that a creditor may look to such property even after its distribution to satisfy its claim. The clause in one sense reminds the personal representative that first things first means to pay or otherwise secure assurance that they be paid.

Many practitioners will remove the word "debts" altogether, fearing that any mention in the will could be misconstrued to mean all debts rather than only the debts required by state law. The personal representative is still "on the hook" with respect to such debts.

The primary purpose of the estate is to **protect creditors** before the property passes to the decedent's heirs. If the property were to go directly to the heirs before the creditors had a chance to collect, the heirs would likely consume, transfer, or squander the assets before the creditor had a chance to collect the creditor's claim from the assets. As a result, every state has estate laws that require the property to be supervised or managed by someone for a certain period of time before the property is transferred to the heirs. Any creditor of the decedent has the authority to compel administration of the estate in order to receive payment of the creditor's claim from the decedent's property.

***Note:***

Everyone eighteen and older needs wills to ensure that their death will not create any more problems than necessary and should include **funeral and burial instructions**, but these are rarely included in a will and may be left in a separate memorandum to be applied in concert with the Will. Such instructions provide guidance to survivors on the details of the final arrangements. Those who will be making these decisions will be trying to do what you would have wanted. This document allows you to tell them what you want and even binds those involved to carry out those wishes.

Copies should be provided to all family members who sign it and to the attorney (who will put the document with other important documents in his/her fireproof safe).

It is designed to be enforceable as the Last Will and Testament. When the Will becomes outdated, it does not become unenforceable, just ineffective. After-death Instructions are still valid and will guide the survivors, although it is likely that some of the information will need updating to match the current situation.

Oral instructions are more confusing (and subject to differing recollections) than those written. Reliance on what was told to family members may be remembered in such different ways that it promotes the first of what promise to be a series of family fights. And this can arise very innocently, as when an individual tells some, but not all of the persons he told in the first place of changes in the instructions, pitting those who were not informed but think they were against those who were informed in each instance.

One may create a handwritten document that amends the Will by revoking any After-Death Instructions created before the date of the handwritten document. Signing and dating the

document and attaching it to the Will revokes the prior instructions. Because the funeral arrangements are needed immediately, at least a copy should be kept in the fireproof safe at home and with the attorney's copy of the will so that it may be accessed quickly, more quickly than the Will itself.

Alternatively, all copies may be physically destroyed. New instructions must be established at the same time as the revocation or destruction to maintain this level of assurance.

A client can reduce the stress level associated with having to make a lot of decisions quickly following one's death by in effect making them before the fact.

One person should serve as point for finalizing the arrangements, and it is usually better to designate someone other than the spouse; another, strong family member or friend so as to reduce the impact on those who are less likely of coping with the situation and the grief at the same time.

One should leave a list of the people to be invited to the memorial and/or wake.

***Example:*** I direct that all of my legally enforceable debts, funeral expenses and estate administration expenses be paid as soon after my death as may be practicable, except that any debt or expense secured by a mortgage, pledge or similar encumbrance on property owned by me at my death need not be paid by my estate, but such property may pass subject to such mortgage, pledge or similar encumbrance.

### *4. Bequests, legacies, and devises*

The area of most concern to most clients is the disposition of the client's property upon death. Failure to execute a legally enforceable will or living trust will cause the property to pass according to **state intestacy** laws, which sometimes will agree with an individual's desires and sometimes will not. For example, most married individuals with children would want their individually owned assets to pass to their surviving spouse. Some state intestacy laws, however, provide the surviving children (even if minors) with a share of these assets. Such a disposition could deprive the surviving spouse of property needed to provide for his or her own support or could necessitate the use of a guardianship for minor children. Single individuals without close relatives may have their property given to a distant cousin with whom the individual had no relationship rather than to the friends and colleagues with whom he or she shared his or her life. (Howard Hughes, who died without a valid will, made some very distant relatives very rich and very grateful.)

a. Until recently, the estate and gift tax law imposed potential tax exposures that had the effect of limiting the choice of the beneficiaries. The unlimited marital deduction was almost required when other dispositions of property might otherwise generate a federal tax liability. In an environment in which the applicable exclusions are high relative to the size of all but the largest of estates, this is no longer an overriding consideration – although state death tax systems may, though generally to a lesser extent than the kinds of numbers involved with federal transfer tax, provide tax saving opportunities that may channel dispositions in similar ways. As America became less divorce averse, the presence of second marriages and second families prompted the use of complex disposition schemes designed largely to remove the ultimate power of disposition from a second spouse. The tax cost of certain alternate dispositions may now be relatively small so that they no longer significantly affect the making of such gifts.
    (i) The identification of a beneficiary presupposes that the beneficiary survives the testator; gifts cannot be made to a dead person.

b. With perhaps greater freedom to choose immediate beneficiaries of the individual's assets, the individual must consider with respect to each beneficiary:
    (i) The amount of the gift;

(ii) The kind of gift (cash, personal property, real property); and

(iii) The time line of the enjoyment of the property.

c. With respect to the amount of the gift, one has to choose a fixed amount or a variable amount depending on a formula. Examples of the first are “My 2020 BMW”; the latter, “one-third of my residuary estate” (depending on the actual size of the residuary estate at the future moment in time when the testator dies). One of the tax advantages of a fixed gift is that under the Internal Revenue Code, there is no income (and consequently no income tax liability) when the beneficiary receives the gift. By contrast, when any other distribution is made, the recipient will generally be taxed in accordance with the complex rules of Subchapter J that passes out all or a portion of the estate’s (or trust’s) taxable income to the beneficiaries. However, a variable gift may have the effect of correcting a gift to conform to the economic growth or deterioration of the estate from the date the will was drawn to the date of death.

***Note:***

Many existing wills still bear the formula approach in determining the amount of the marital share as a function of the size of the maximum applicable exclusion amount and the size of the testator’s taxable estate, neither of which may be known at the time the will was drawn. Given the roller coaster ride in the tax law and the wild ebbs and flows in the economy, this provision eliminated the need of constant revision of the instrument to take into account either of these changes.

d. With respect to the kind of gift, some “lingo” follows. A gift of cash is often referred to as a legacy; a gift of other personal property is often referred to as a bequest; and a gift of real property is often referred to as a devise. Happily, in some states, much of the “lingo” is gone. “Bequest” will do. An identification of specific items of property, such as family jewelry and heirlooms, may be appropriate for some beneficiaries (who might not need the cash for their living expenses), while cash may be more important for others who have immediate needs that can no longer be supplemented by the testator. (If there are two diamond rings, make sure that one is distinguished from another.) Likewise, real estate may be important to one beneficiary in particular (such as use in a family business, or as a personal residence) where it might be part of a fixed gift, or may be saleable soon after death and be just a part of the pot for the various beneficiaries.

(i) Under the laws of some states, real estate passes at death (prior to the recording of a deed) to the beneficiaries of the gift.

(ii) As noted earlier, real estate presents more legal problems. Even if the will is valid in the state where the property is located, if the provision of the will fails to meet the requirements of a conveyance of real estate in that state, the gift likewise fails. Apart from other structures discussed elsewhere to avoid this problem, one must seek legal advice not only from the attorney in the state of domicile drafting the will but also from a lawyer in the state where the real estate is located.

(iii) The estate will have to establish ancillary administration in the other states. Ancillary administration is required when a decedent owns real or tangible personal property in a state that is not his or her domicile. Generally, one will wish to avoid ancillary administration because of the costs and delay associated with commencing and conducting another probate proceeding. In today’s society, individuals often maintain residences in several states. This can become more complex – and more expensive – when the individual owns realty in more than

two states. It is important to evaluate the costs and tax consequences associated with the property located in the old domicile state so that estate planning opportunities can be explored to avoid or minimize these costs.

(iv) When assets are located outside the domicile, the personal representative will want to take prompt steps to qualify as ancillary representative or administrator. A personal representative who is ineligible to qualify in the other jurisdiction will have to find another party qualified to act.

(v) The executor may find that the decedent owned real estate in another state. The executor has no power to control real estate located in another state solely by reason of letters testamentary (or administration) issued in the state of decedent's domicile. As a result, the executor will need to probate the will in the state where the real property is located in order to have ownership of the property pass to the executor and then to the decedent's heirs.

f. If, after paying all debts and expenses, there are insufficient assets to pay all of the legacies, then the legacy may be **abated**. Certain classes of legacies have priority over others. For example, a specific legacy takes over a general legacy, and both are prior to a residuary legacy. The testator's intention with respect to the priority of abatement may dictate the kind of gift given to each beneficiary.

***Example:*** Susan dies with a will leaving her 2020 BMW to Ken, $10,000 to Bill, and the residuary to Jon. If her assets are the car and $50,000 and she has no liabilities, Ken will get the car, Bill will get $10,000, and Jon will receive the remaining $40,000. If, however, Susan has $25,000 in liabilities, Ken will still get the car, Bill the $10,000, but Jon will only receive $15,000. If Susan's liabilities are $40,000, then Jon will not receive anything; if it is greater than $40,000, Bill may receive less or even nothing. Lastly, if the liabilities are too great, the car may be sold and Ken may receive less than the fair market value of the car, or possibly nothing.

g. If the testator left a 2020 BMW to the testator's niece, Jessica, and the decedent did not own the BMW at the time of death, what would happen? Jessica's interest in the BMW has been adeemed and she cannot take any interest in place of that interest under the will. Ademption is a matter of state law, and the courts often fashion strange remedies to avoid ademption. In one case, a court interpreted a provision similar to the above as intent by the testator to transfer whatever car the testator owned at death. Thus, at least in that case, Jessica would take whatever car the testator owned at death, but the results are likely to vary from state to state. The executor should consult with counsel before declaring that a particular beneficiary's interest has been **adeemed**. The will could provide an alternative gift to the same beneficiary in the event the primary gift is adeemed.

h. Many states hold that if a testator makes a specific bequest of money to a beneficiary-child and within some statutory or judicially established period of time before death the testator makes a transfer without full and adequate consideration to the beneficiary-child, then that beneficiary-child's interest under the will has been partially or completely satisfied. **Satisfaction** is an equitable remedy designed to promote harmony among the beneficiaries.

***Example:*** Suppose that Mom wrote a will stating, "I give my son, Bill, the sum of $10,000." Six months prior to Mom's death, Mom gave Bill $10,000. Many, if not most,

states would rule that Bill cannot take an additional $10,000 under the will because his interest was satisfied by the gift from Mom during life.

***Note:***

Uniform Probate Code §2-609(a)(1990) would treat a gift during lifetime as satisfaction of an interest under the will only if: (i) the will provides for deduction of the gift; (ii) the testator declared in a contemporaneous writing that the gift was in satisfaction of the bequest; or (iii) the beneficiary acknowledged that the gift was in satisfaction of the bequest.

i. What if the beneficiary who was supposed to receive the interest dies before the testator? The gift to that beneficiary would lapse.

***Example:*** Suppose that Mom wrote a will in 1996 stating, "I give my son, Bill, the sum of $10,000." Bill dies in 2020 and Mom in 2023. Bill's gift under the will is said to lapse. If Mom's will stated, "I give my son, Bill, $5,000 if he survives me, and if he does not, then to his children," Bill's children would receive the $5,000.

***Note:***

In cases when the will does not specify a taker of the gift in the event the named beneficiary cannot, some states have an **anti-lapse** law, which provides that interests passing to certain family members who predeceased the testator do not lapse; the interest passes to the specified members of the beneficiary's family. The provisions typically stop at certain degrees of consanguinity, i.e., closeness of blood relationship. For example, a bequest to a predeceased first cousin may pass to that cousin's heirs, while bequests to a predeceased second cousin or friend will lapse. Thus, in the above example, Bill's children would inherit in either case.[1] But this might not be the result that a testator wants, and it requires him or her to keep track of the provisions of the statutes rather than the status of a beneficiary as alive or dead.

j. Gifts can be immediately enjoyed by having the property pass directly to the beneficiaries or in trust where the enjoyment will be delayed or spread over time, or both.

(i) Some of the beneficiaries may be of advanced age or have significant health problems that could lead to incapacity. Some of the beneficiaries may be legally incapacitated, such as minors, from receiving property. In these circumstances, a trust arrangement may serve the purpose of providing a person of capacity to receive the gift and control its use. The alternative is a guardianship (which still may be required for other reasons). Guardianships should generally be avoided; they are costly, administratively burdensome, and characterized by a lack of administrative flexibility.

(ii) Some of the beneficiaries may be reckless or spendthrift and, while not legally incapacitated, are not capable of owning the gift in a responsible way. Some, while not established spendthrifts, may give the testator pause with respect to their general financial acumen to the extent that he or she believes it too important to leave the decision to have professional money management to the beneficiary when the trust gift will assure that result. Again, a trust arrangement that separates the legal control and ownership from the equitable enjoyment of the property may indicate a gift structured in trust. A guardianship is unavailable for the merely financially foolish.

[1] See Uniform Probate Code §2-603(b)(1)(1990).

### *5. Disposition of tangible personal property*

Make a separate provision in your will for your personal items, such as clothing or dishes that you want to leave to someone specifically. Normally these types of items are taken by a surviving spouse or children. However, to make sure that these items are not taxable as income, they should be given to your immediate family in your will.

***Note:***

Lying in the shadowy world between what is legally binding and morally urgent is the memorandum or instructions that are referred to in the instrument, here the Will. Some states recognize these (even if they are not executed with the same legal formality of a Will) as part of the Will by reason of the reference. The memorandum or instruction only works when it is read with another document; it is useless all by itself.

It serves as a guide for trustees, personal representatives, agents, conservators and/or guardians. They read the statement to give them direction in carrying out the decedent's wishes. It allows those feelings to influence beneficiaries when the decedent is unable to express them.

The executor of the estate uses it in deciding what distributions to make, leaving it to the decedent to express changed views of sentimental attachment.

It should be kept with other legal documents, including the Will, in a safe deposit box.

An individual should update the memorandum when he or she is reviewing estate planning to keep the document consistent with current feelings.

Although the memorandum may not be legally binding, the fiduciary who will be using it as a guide (and hopefully the beneficiaries of the estate) will feel a moral obligation to honor these requests.

Like all legal documents, all changes should be written with copies sent to the attorney who has custody of the Will, trusts, or general power of attorney. For example, in a gift-giving program, such instructions may during the lifetime of the individual who has become incapacitated provide guidance as to which or what kinds of property should be given to which objects of the individual's bounty. Because it is not binding on the agent, the agent will not give away assets unless the situation warrants it. It also provides evidence of the intent to make gifts.

***Example:*** A. I give and bequeath all of the tangible personal property that I may own at the time of my death, which is not otherwise specifically bequeathed under this Will, including my personal effects, jewelry, household furniture and furnishings, garden and lawn furnishings and equipment, books, silver, china, glass, rugs, art objects, hobby equipment and collections, wearing apparel, automobiles, and other personal articles, to my wife, Susan B. Anthony, if she survives me. If my wife does not survive me, then I give and bequeath all of the aforesaid property to my children who survive me, in substantially equal shares, to be divided in such manner as they shall agree or, if they shall fail to agree upon a division within six (6) months after the date of my death, as my Executrix shall determine. B. I may leave a memorandum of my wishes regarding the ultimate disposition of some or all of my tangible personal property, and I would hope that my wishes as to the ultimate disposition of such property would be respected. However, such memorandum shall not affect the absolute nature of the bequests made under this Article.

This provision treats such tangible personal property as a specific bequest, and, as such, does not result in taxable income to the recipient under Code §663.

***Question to ponder:***

Dividing personal property is often the most difficult aspect of administering an estate. Have any practitioners seen the $5,000 attorney bill over a $100 item?

### *6. Residential real estate*

Although generally residences are owned jointly and pass by operation of law to the surviving joint tenant or tenant by the entireties, there are cases in which, perhaps for asset-protection purposes, they are in the name of the decedent alone. Rather than have the property split up as part of the residue among several owners, most want the surviving tenant (generally the spouse) to retain possession of the home, so it is a prime candidate to be a specific bequest.

***Example:*** I give and devise to my wife, Susan B. Anthony, if she survives me, absolutely and free of trust, all of my right, title and interest in and to all residential real estate used by my wife or by me as a permanent or seasonal home at the time of my death, together with all property or liability insurance policies relating to such residential real estate. If my wife does not survive me, such residential real estate shall be distributed as part of my residuary estate as hereinafter provided in this Will.

### *7. Residuary clause*

Anything not specifically listed anywhere else in the will is covered in this clause. It serves as a **"catch-all"** in case anything is missed due to any purchases or sales made after execution of the will. Sometimes it will be in trust created by the will, sometimes it will "pour over" to a living trust created during the decedent's lifetime, or sometimes it will pass outright in shares determined by the clause to the named beneficiaries.

***Example:*** A. All the rest, residue and remainder of the property that I may own at the time of my death, whether real, personal or mixed, of whatever kind and nature and wherever situated, including all property that I may acquire or become entitled to after the execution of this Will, or other gifts made by this Will that fail for any reason, but excluding any property over or concerning which I may have any power of appointment (all hereinafter referred to as my "residuary estate"), I give, devise and bequeath to my wife, Susan B. Anthony, outright and free of trust, if she survives me.

B. If my wife survives me, but disclaims all or any part of the property constituting my residuary estate, then I give, devise and bequeath such disclaimed property to the Trustee (including any successor or successors thereto) of the Michael Anthony Living Trust, which trust was created under a Declaration of Trust signed by me, both as Grantor and as Trustee, on _____, _____, but before the execution of this Will, to be held, administered and distributed in accordance with the terms and provisions thereof. The right to disclaim shall include the personal representative of my wife, if she is not then legally or physically capable of attending to her own affairs, or the personal representative of her estate. Such disclaimer shall be made in writing within the time period required to treat such disclaimer as a "qualified disclaimer" under Section 2518 of the Internal Revenue Code of 1986, as amended.

C. If my wife does not survive me, then I give, devise and bequeath my residuary estate to the Trustee (including any successor or successors thereto) of the Michael Anthony Living Trust, which trust was created under a Declaration of Trust signed by me, both as Grantor and as Trustee, on _____, _____, but before the execution of this Will, to be held, administered and distributed in accordance with the terms and provisions thereof.

### *8. Simultaneous death*

Sometimes it may not be clear that a beneficiary named in the will has survived the testator. States have a uniform Simultaneous Death Act, which generally takes one of two forms: In the absence of a directive in the will, in cases where the order of deaths cannot be determined, OR where the deaths occur within 120 hours of each other, a testator will be presumed to have survived the beneficiary. Thus, the gift will in such cases fail and be governed by an anti-lapse provision or intestacy unless the will provides otherwise. In the case of spouses in a common accident, for example, without a direction in the will, each will be presumed to have survived the other. In many cases, the will does provide otherwise, such as in the event the order of deaths cannot be determined, by a presumption aimed at overriding the state statute. Such a provision would, for example, permit property to pass to the spouse for purposes of the marital deduction, which may remain important for state death tax purposes or in the event that future federal tax law brings individuals back into the environment where federal estate taxes become an overarching consideration. Such provisions need not be symmetric, and one spouse may want to retain the state presumption while the other should provide a different intention.

a. The Simultaneous Death Act can apply to nonprobate (such as jointly owned) property as well. When two joint owners die simultaneously, an analysis of the death tax inclusion in each estate must take place. In states that have adopted the Uniform Simultaneous Death Act, half the value of the property is treated as received from the other owner and is included in each decedent's estate. If the decedents are spouses, the half of the property included in each spouse's estate will not be eligible for the marital deduction, because in each estate that half of the property will be treated as being received from the other spouse, rather than passing to the other spouse.

b. If the decedents are spouses and the property is a "qualified joint interest," the half of the property other than the half included in each estate as above will be included in each estate to the extent required by Section 2040(b). As a result, an additional one-quarter of the entire property (one-half of the half of the property other than the half included above) will be included in each of the spouses' estates. This one-quarter in each estate, however, will be treated as survivorship property that passes to the surviving spouse. Therefore, this one-quarter in each estate will qualify for the marital deduction and will not increase the tax in either estate.

***Example:*** A. If my wife, Susan B. Anthony, and I die simultaneously or under such circumstances that make it difficult to determine who survived whom, it shall be deemed for all purposes of this Will that my wife survived me.
B. If any beneficiary under this Will, other than my wife, fails to survive me by thirty (30) days, it shall be deemed for all purposes of this Will that such beneficiary did not survive me.

### *9. Appointment of guardians*

As noted elsewhere, a Guardian is to be appointed for the person or for the estate. The Guardian of the person has a duty to assert the rights and best interest of the incapacitated person. The Guardian of the estate of the minor appointed by the court generally has the right to and may take possession of, maintain, and administer each real and personal asset the minor has been given until the minor attains majority. Appointment of a guardian is critical. The court does not have to follow any directive because the court is charged with protecting a minor, but it will give great weight to a directive as below.

***Example:*** A. If my wife, Susan B. Anthony, does not survive me, I nominate and appoint my brother, Marc Anthony, and his wife, Jennifer L. Anthony, both of _____, _____, as joint guardians of the person and

 

property of each of my minor children. If either my brother, Marc Anthony, or his wife, Jennifer L. Anthony, predeceases me or fails to serve as guardian for any reason, then the other individual so named shall serve as the sole guardian of the person and property of each of my minor children. If both my brother, Marc Anthony, and his wife, Jennifer L. Anthony, predecease me or fail to serve as guardians for any reason, then I nominate and appoint my wife's brother, August Busch, and his wife, Livia Busch, both of _____, _____, as joint guardians of the person and property of each of my minor children. I direct that no bond or other security shall be required for the faithful performance of their duties or, if bond is required, that sureties thereon be waived.

B. I authorize and empower the guardian of each minor child of mine to retain in kind any tangible personal property that is distributed to such child pursuant to any provision of this Will until such child attains majority age, provided that such child may be permitted to use the same in the meantime if such guardian deems it advisable to do so. I also direct that such guardian shall not be required to sell the same for the purpose of investing the proceeds thereof and shall not be under any liability or obligation for any loss, damage to, or depreciation in value of any such tangible personal property that is retained in kind.
C. I request and direct that the guardian of the person of any minor child of mine shall see to it that such child is accessible to and has reasonable visitation with members of my immediate family and my wife's immediate family, if so requested by any such child or by the members of either of our families.

Whenever, pursuant to the provisions of this Will, a distributive share of my estate, or a distributive share of the principal of any trust created hereunder, if any, is payable to a beneficiary under the age of twenty-one (21) years (other than a child of mine for whom a separate trust is established under this Will), then title thereto shall pass to such beneficiary but the actual distribution shall be deferred until such beneficiary reaches the age of twenty-one (21) years. In the meantime, such share shall be held by the Trustee hereinafter designated, with all the powers granted herein, who shall pay to or apply for the benefit of such beneficiary so much of the net income and principal thereof as the Trustee, in its sole discretion, shall determine for the health, education, support and maintenance of such beneficiary. When such beneficiary reaches the age of twenty-one (21) years, the Trustee shall deliver to him or her the then remaining principal of such share, together with any accumulations of income thereof. The Trustee may make payment of any income or principal to the guardian of such beneficiary, to a custodian of such beneficiary under the Uniform Gifts to Minors Act of the State of _____, or to any other person with whom such beneficiary shall then reside, or directly to such beneficiary, or may apply the same for his or her benefit, and the receipt from the guardian, custodian or other recipient, or evidence of the application of the income or principal for the benefit of such beneficiary, shall be a full and complete discharge and acquittance to the Trustee to the extent of such payment.

### *10. Appointment of an executor*

**Executor Appointment** -- Nominate the person you wish to be the executor of your estate. Make sure your executor knows she will be your executor. Secure her consent. This nomination is either accepted or rejected by the courts depending on whether anyone objects to your choice. Choose a back-up executor in case your first choice is not able to serve. Be sure it's someone you trust to distribute your property according to your wishes.

a. An executor automatically has certain powers regarding carrying out your will. However, you define fewer or more extensive powers. This is more important for larger estates. Your attorney can help you decide what's appropriate for your situation. Additionally,

there are some powers which need to be specifically mentioned in the will in order to be wielded by the executor. These include the authority to continue your business or sell your real estate if necessary. You'll also need to establish the powers of a trustee if your will creates a trust. Carefully choosing executors and trustees, and granting them a wide range of powers, helps to ensure that they can deal with whatever issues come up in handling your affairs.

b. In most states, executors, administrators, trustees, and guardians must post bond when appointed that acts as a promise to reimburse the estate for any losses created as a result of negligence or wrongdoing. A bond "without sureties" is backed by that person's own assets. A bond "with sureties" has outside guarantees such as that from insurance. Generally, in the will the individual can **waive** the requirement for a bond to be posted.

***Example:*** A. I nominate and appoint my wife, Susan B. Anthony, of _____, _____, as Executrix under this Will and with faith in her, direct that no bond or other security be required for the faithful performance of her duties or, if bond is required, that sureties thereon be waived.
B. If my wife, Susan B. Anthony, predeceases me or fails to qualify as Executrix or, having qualified, should die, resign or become incapacitated, then I nominate and appoint my brother, Marc Anthony, of _____, _____, as Executor, and give him the same powers and authority as my original Executrix was given.
C. If my Executrix under this Will shall be unable or unwilling to act in any other jurisdiction where the administration of my estate is necessary, I authorize and direct my Executrix to appoint another individual or corporation to serve in such other jurisdiction. In addition, I authorize my Executrix to pay all or any part of the debts, expenses and taxes incurred in the administration of my ancillary estate directly from the assets of my domiciliary estate.
D. My Executrix under this Will, including any successor or successors thereto, shall have the power, in her sole discretion, (i) to make such elections under the tax laws as she may deem advisable, including an election to create qualified terminable interest property for estate tax purposes and/or generation-skipping tax purposes, and (ii) to allocate the unused portion, if any, of my generation-skipping tax exemption under Section 2631 of the Internal Revenue Code of 1986, as amended, to any property with respect to which I am the transferor for generation-skipping tax purposes (whether such property passes under my Will or otherwise), in such manner as she may deem advisable, without regard to the relative interests of the beneficiaries; provided, however, that my Executrix shall not make adjustments between principal and income or in the interest of the beneficiaries to compensate for the effects of such elections and allocation. Any decision made by my Executrix with respect to the exercise of any tax election or the allocation of my generation-skipping tax exemption shall be binding and conclusive on all persons.

### *11. Tax apportionment*

This clause generally directs the inheritance and estate taxes to be paid from the remainder of the estate after property and money are distributed to named beneficiaries in specific bequests. The executor may be directed to pay taxes from the assets making up the remainder not being distributed to the specific beneficiaries chosen. This is the most overlooked clause in most wills. Without an apportionment under the will, taxes will be apportioned in accordance with the state law (which generally is sourced to the identity and amounts of the gifts). One might want to change this residuary apportionment when there are large, specific gifts to people that result in comparatively low amounts for unnamed beneficiaries, who will be left with the tax burden, leaving them with little or nothing in the estate.

***Example:*** I direct that all estate, inheritance, legacy, transfer, succession and other death taxes or duties (together with interest and penalties thereon, if any) that are levied or assessed upon or with respect to any property included as part of my gross estate, whether such property passes under the provisions of this Will or otherwise, shall be paid out of my residuary estate as an administrative expense, without any proration or apportionment that might otherwise be required by law.

## B. Guardianship and conservatorship

### *1. Introduction*

Every adult is assumed to be capable of making his or her own decisions unless a court determines otherwise. If a mental disability causes an adult to become incapable of making responsible decisions, the court will appoint a substitute decision maker, often called a "guardian," but in some states called a "conservator" or other term. Guardianship is a legal relationship between a competent adult or entity (the "guardian") and a person who because of incapacity is no longer able to take care of his or her own affairs (the "ward").

The guardian is authorized to make legal, financial, and **health care** decisions for the ward. Some of these decisions must be approved by the court (in some states, while in others no court approval is required for any action). In many states, a person appointed only to handle finances is called a "conservator."

The scope of the guardianship can be circumscribed when incapacitated individuals can make responsible decisions in some areas of their lives but not others through the offices of guardian decision-making power over only those areas in which the incapacitated person is unable to make responsible decisions (a "limited guardianship"). In other words, the guardian may exercise only those rights that have been removed from the ward and delegated to the guardian.

### *2. Incapacity*

The standard under which a person is deemed to require a guardian differs from state to state. In some states the standards are different, depending on whether a complete guardianship or a conservatorship over finances only is being sought. Generally, a person is judged to be in need of guardianship when he or she shows a lack of capacity to make responsible decisions. A person cannot be declared incompetent simply because he or she makes irresponsible or foolish decisions, but only if the person is shown to lack the capacity to make sound decisions. For example, a person may not be declared incompetent simply because he or she spends money in ways that seem odd to someone else. Also, a developmental disability or mental illness is not, by itself, enough to declare a person incompetent.

### *3. Process*

In most states, the only requirement for bringing an action of guardianship is the interest in the proposed ward's well-being. Such actions are generally initiated by a petition in the proposed ward's county of residence. The proposed ward may have to be present in some states, while in others he or she need only be given due notice. The court will judge whether or not the proposed ward is incapacitated and, if so, to what extent that individual requires assistance. If the court determines that the proposed ward is indeed incapacitated, the court then decides if the person seeking the role of guardian will be a responsible guardian.

***Note:***

A guardian need not be related to the ward -- although most often the guardian is a spouse or other family member -- and could be a friend, a neighbor, or a professional guardian. **A competent individual may nominate a proposed guardian through a durable power of attorney in case he or she ever needs a guardian**.

The guardian need not be a person at all -- it can be a non-profit agency or a public or private corporation (but would a non-profit or a public or private corporation be all that concerned about the welfare of the ward)? If a person is found to be incapacitated and a suitable guardian cannot be found, courts in many states can appoint a public guardian, a publicly financed agency that serves this purpose. In naming someone to serve as a guardian, courts give first consideration to those who play a significant role in the ward's life -- people who are both aware of and sensitive to the ward's needs and preferences. If two individuals wish to share guardianship duties, courts can name co-guardians.

### *4. Reporting requirements*

Courts often give guardians broad authority to manage the ward's affairs. In addition to lacking the power to decide how money is spent or managed, where to live and what medical care he or she should receive, wards also may not have the right to vote, marry or divorce, or carry a driver's license. Guardians are expected to act in the best interests of the ward, but given the guardian's often broad authority, there is the potential for abuse. For this reason, courts hold guardians accountable for their actions to ensure that they don't take advantage of or neglect the ward.

The guardian of the property inventories the ward's property, invests the ward's funds so that they can be used for the ward's support, **and files regular, detailed reports with the court**. A guardian of the property also must obtain court approval for certain financial transactions. Guardians must file an annual account of how they have handled the ward's finances. In some states, guardians must also give an annual report on the ward's status. Guardians must offer proof that they made adequate residential arrangements for the ward, that they provided sufficient health care and treatment services, and that they made available educational and training programs, as needed. Guardians who cannot prove that they have adequately cared for the ward may be removed and replaced by another guardian.

### *5. Alternatives*

Because guardianship involves a profound loss of freedom and dignity, state laws require that guardianship be imposed only when less restrictive alternatives have been tried and proven to be ineffective. Less restrictive alternatives that should be considered before pursuing guardianship include:

a. A power of attorney is the grant of legal rights and powers by a person (the principal) to another (the agent or attorney-in-fact). The attorney-in-fact, in effect, stands in the shoes of the principal and acts for him or her on financial, business or other matters. In most cases, even when the power of attorney is immediately effective, the principal does not intend for it to be used unless and until he or she becomes incapacitated.

b. A Representative or Protective Payee is a person appointed to manage Social Security, Veterans' Administration, Railroad Retirement, welfare or other state or federal benefits or entitlement program payments on behalf of an individual.

c. In some states a person needing assistance with finances may petition the probate court to appoint a specific person (the conservator) to manage his or her financial affairs. The court must determine that the conservatee is unable to manage his or her own financial

affairs, but nevertheless has the capacity to make the decision to have a conservator appointed to handle his or her affairs.

d. A revocable or "living" trust can be set up to hold an older person's assets, with a relative, friend, or financial institution serving as trustee. Alternatively, the older person can be a co-trustee of the trust with another individual who will take over the duties of trustee should the older person become incapacitated. A trust is subject in general to less supervision than a guardianship.

## C. Elective share

### *1. In general*

The surviving spouse may elect to take against the estate of the decedent instead of receiving a bequest under the will. Even if a valid will makes no provision for a spouse, the laws of all states provide that the spouse may elect to take a **statutory** share of the decedent's estate. This right is personal to the spouse and must be made by the spouse during the spouse's lifetime. In addition, an attorney-in-fact may elect on behalf of the spouse, but such an election usually must be made with court approval. The creditors of a spouse may not force the spouse to make an election against the will.

But remember that the executor is representing the estate and not the surviving spouse. There is the question of a conflict of interest. The surviving spouse may have to hire outside counsel.

### *2. Augmented estate*

A spouse who files a timely election is entitled to receive a percentage of the "augmented estate." The augmented estate includes all property passing by will or intestacy plus the following:

a. Property conveyed by the decedent during marriage, without adequate consideration, to the extent that the decedent retained the use of the property or the income therefrom;

b. Property transferred by the decedent during the decedent's lifetime, without adequate consideration, to the extent that the decedent retained a power to revoke the transfer or to consume, invade or dispose of the principal for the decedent's benefit. Some states provide that revocable transfers, such as revocable living trusts, are not part of the augmented estate. A living trust, therefore, is one method of avoiding the elective share in these states;

c. Spousal joint property;

d. Survivorship rights in an annuity contract purchased by the decedent during the marriage if the decedent was receiving annuity payments therefrom at the time of decedent's death;

e. Property conveyed by the decedent during the marriage within one year of death; and

f. In some states, the surviving spouse must also include the surviving spouse's personal assets including the surviving spouse's comparable nonprobate transfers to others. These inclusions discourage elections by surviving spouses in marriages of short duration and where the surviving spouse has substantial personal assets.

### *3. Applicable percentage*

In states following the 1983 Uniform Probate Code, the election percentage is usually 33-1/3 percent of the augmented estate and may be 50 percent if the decedent has no other descendants. However, states following the 1990 Uniform Probate Code have adopted an accrual-based system. The accrual system employs a rising percentage scale based upon the length of the marriage. The elective-share

percentage rises from a low of three percent of the augmented estate after the first year of marriage to a high of 50 percent of the augmented estate after 15 years of marriage. At the end of 15 years, each spouse has earned a 50-percent elective-share interest at death in each of the other's entire estate. In addition, regardless of the length of the marriage, the 1990 Uniform Probate Code includes a supplemental or minimum monetary amount of $50,000 for a surviving spouse.

### *4. Effect of making the election*

The elective-share amount is an amount of money and not a specific interest in any one asset. If the surviving spouse elects against the will, the spouse will be deemed to have disclaimed or renounced any other interest under the will. The spouse, however, may still receive the spouse's interest in joint property, but such interest is charged to the elective-share amount.

# Trust Basics


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# Trust Basics

## *Learning objectives*

Upon reviewing this chapter, the reader will be able to:

- Describe the various kinds of trusts;
- Discuss the appropriateness of trusts in fulfilling estate-planning, financial-planning, and tax-planning goals;
- Discuss the tax issues and consequences of revocable and irrevocable trusts;
- Advise when the use of a revocable *inter vivos* trust may be appropriate;
- Advise when the use of an irrevocable trust may be appropriate;
- Discuss the special issues with minors' trusts and some of the alternatives under the Uniform Transfer to Minors Act; and
- Identify the issues surrounding a disabled child before and after reaching the age of majority.

# *I. Trust basics*

## A. Definitions

### *1. Important terms*

A trust is a legal instrument where property, real and/or personal, is held by one party (trustee) for the benefit of another party (beneficiary). The code contains no definition of a trust, but the newly issued classification regulations provide a similar definition.

a. The **trustor** (**grantor or settlor**) is the person who transfers or puts the property into the trust.

b. The **trustee** then manages the property for the benefit of the beneficiaries and distributes income and/or principal in accordance with the terms of the trust instrument.

c. **Beneficiaries** of the trust fall into three categories:

- **Income beneficiaries** -- Entitled to receive all or a portion of the trust income for a period of time or lifetime;
- **Principal beneficiaries** -- Entitled to receive all or a portion of the trust principal in accordance with the terms of the trust; and
- **Remainder beneficiaries** -- Entitled to receive all or a portion of the principal and/or accumulated undistributed income at termination of the trust.

### *2. Kinds of trusts*

a. A trust may be:

- **Inter vivos** -- A trust made while the grantor is alive; or
- **Testamentary** -- A trust that comes into existence at the testator's (grantor's) death. It is generally part of the will.

b. A trust created during lifetime may be:

- **Revocable (living trust)** -- This trust may be changed by a competent grantor at any point during the grantor's lifetime; or
- **Irrevocable** -- This trust may **not** be changed by the grantor. It can be established either by will (testamentary trust) or by the grantor during the grantor's lifetime (inter vivos trust).

c. An inter vivos trust may be revocable or irrevocable. A revocable inter vivos trust is often called a **living trust**.

d. A testamentary trust is **always** irrevocable.

### B. Types of trusts

Some types of trusts are:

- Grantor-retained annuity trust (GRAT);
- Grantor-retained unitrust (GRUT);
- Grantor-retained income trust (GRIT);
- Grantor-retained interest in tangible property;
- Grantor-retained interest in personal residence trust;
- Charitable lead trust;
- Charitable remainder trust;
- Irrevocable life insurance trust;
- Irrevocable trust;
- Revocable or living trust;
- Income trust under §2503(b);
- Minor trust under §2503(c);
- Income sprinkle trust;
- Spendthrift trust;
- Qualified terminable interest property trust (QTIP);
- Pour-over trust;
- Bypass or credit-shelter trust or A-B trusts;
- Unfunded or standby trust; and
- Dynasty trust.

## *II. Purpose of trust*

### A. Control of assets

Trusts are used primarily to control assets for the benefit of the beneficiaries. Trusts can be effective for tax minimization.

(i) Trusts are useful to make full use of the applicable credit amount and yet still have funds available for the surviving spouse if needed.

(ii) Testamentary trusts are useful for tax minimization. Effective types are:

- A-B trusts;
- QTIP trusts; and
- Bypass trusts.

(iii) **A trust is a legal entity under state law that is different from its grantor**.

### B. Traditional purposes of trusts

#### *1. Avoidance of probate*

Upon the settlor's death, the assets can be distributed directly to the beneficiaries without the appointment of a personal representative.

In some states, probate requires a formal court procedure that can add to the costs to the estate as well as delay distributions to the beneficiaries. **Therefore, a trust may be preferable**.

#### *2. Privacy*

Trust documents need not be publicly recorded.

#### *3. Management of assets and protection*

The trust continues with either the same or successor trustee without interruption.

#### *4. Management of assets during lifetime of settlor*

Provides management of assets if the settlor becomes incapacitated and the settlor can evaluate the trustee's abilities during the settlor's lifetime and can provide for management of assets for a settlor who does not have the ability or time to do so.

### C. The purpose of trust must be specific

Trusts must have a specific purpose when made to be effective. Courts have upheld "specific purpose" to include the following:

- Health;
- Support;
- Maintenance; and
- Education.

Courts have held that general purposes such as "to provide for my general welfare and well-being" are insufficient and vague. It is important that a trust direct the trustee as to what are and what are not appropriate actions for the trustee.

## *III. Revocable inter vivos trust*

### A. Terms and purposes

#### *1. Defined*

A revocable inter vivos trust is a trust the settlor created during life, in which the settlor retains the right to revoke the trust, either alone or in conjunction with another, or in which a power to terminate the trust is granted to someone other than the settlor. Upon revocation or termination of the trust, the corpus ordinarily reverts to the settlor, unless the settlor directs some other disposition.

a. A revocable trust, also known as a living trust, is one that can be changed, altered, modified, or even revoked in part or in full at the competent, living grantor's discretion. The grantor is treated as the owner of the trust to the extent of such powers.[1]

b. The trust may be either "funded" or "unfunded." A grantor transfers assets into a funded revocable trust during lifetime. An unfunded revocable trust is not typically funded until the grantor's death.

c. In the unfunded revocable trust, the will may **"pour over"** assets into the trust for ultimate disposition and/or management. However, "pour over" assets must first go through probate.

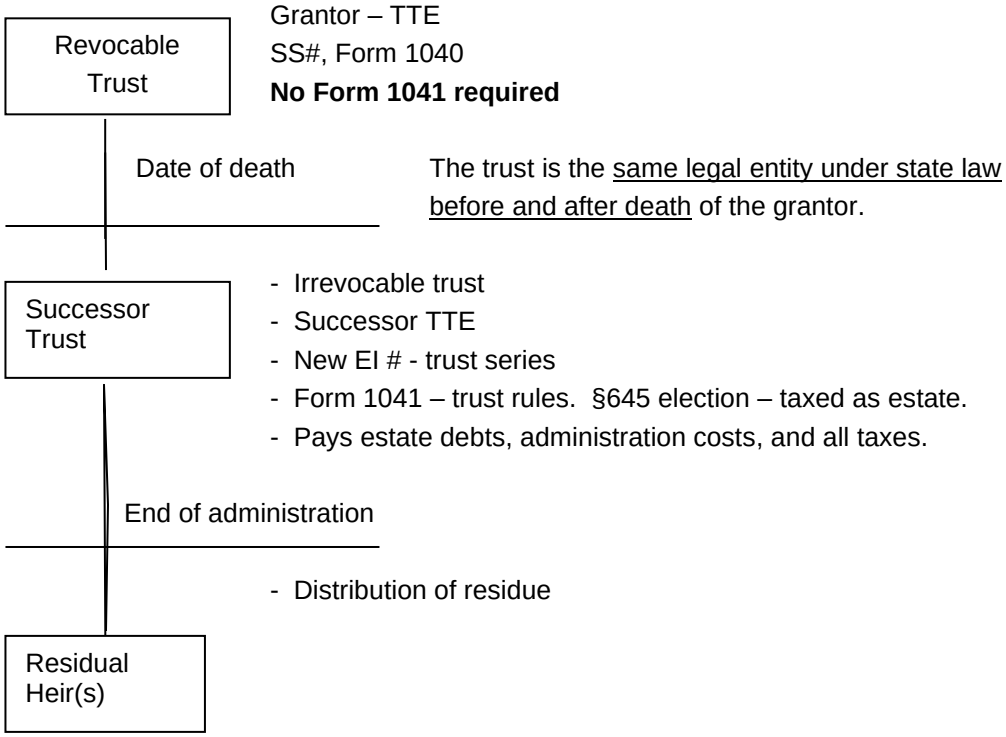
[1] I.R.C. §676.

### *2. Creation by using bank accounts -- Totten trusts*

In some jurisdictions, a deposit in a savings account held in the depositor's name as trustee for someone else is considered to be held in a revocable trust. Trusts of this type are commonly referred to as "Totten" trusts.[2] In general, the entire account automatically becomes the property of the beneficiary at the depositor's death, with the beneficiary taking title as a remainderman succeeding to the trust's property at the life tenant's demise.

### *3. Estate and gift tax*

A revocable transfer is considered incomplete for income-tax, estate-tax, and gift-tax purposes, so the transferor is treated as the owner of the income, is not treated as having made a taxable gift, and is treated as having property that is transferred at death for estate-tax purposes. A grantor owns any trust or trust portion as to which the grantor (or the grantor's spouse) or any other nonadverse person, or some combination of these persons, retains the power to revest the title to the trust assets in the grantor.[3]




[2] *In re Totten*, 179 N.Y. 112, 71 N.E. 748 (1904) (a deposit by a person of his or her own money in the person's name as trustee for another establishes a tentative trust, revocable at will, until the depositor dies or completes the gift in his or her lifetime by some unequivocal act or declaration).

[3] I.R.C. §676.

***Practice point:***

**Revocable living trusts** -- All assets held in a revocable living trust are subject to federal estate[4] and state death taxation at the grantor's death. A commonly held misconception is that assets held in a living trust are **not** subject to death taxes. **This belief is absolutely false**.

Under the Taxpayer Relief Act of 1997, gifts made from the trust within **three** years of the death of the grantor are not includable in the grantor's estate under the three-year rule.[5]

A properly drafted living trust instrument is a complex document that must be prepared by an experienced, knowledgeable attorney who will customize the trust to satisfy the grantor's unique wishes and needs. There are very sophisticated issues involving tax planning and asset ownership that must be considered. Even a "minor" error in drafting the trust and related documents could result in tens or hundreds of thousands of dollars of unnecessary expenses or losses.

## B. Uses

Generally, the uses for a revocable inter vivos trust fall into the following categories:

- Management of the settlor's property;
- Protecting the settlor's assets from the claims of various persons;
- Selecting the situs of administration of various trust assets; and
- Improving estate liquidity.

### *1. Current management for the property*

A settlor may wish to use a revocable trust as a means of relieving the settlor of custodial and investment management duties with respect to the trust property. The use of a funded revocable inter vivos trust may appeal to those who are: (i) inexperienced in investment management; (ii) too busy to devote time to, or incapable of, managing their own affairs; (iii) looking to consolidate management of fractional interests owned with others; or (iv) owners of assets requiring special management. Individuals who recently inherited great wealth or in whose favor a custodianship or trust just terminated are particularly likely candidates for revocable trusts, as could be individuals whose jobs frequently take them out of the country.

### *2. Future management of property*

A revocable inter vivos trust, whether funded or unfunded, may serve as a vehicle for providing competent, and sometimes professional, management for the property at a future date when the settlor is unavailable, incapable, or unwilling to manage the assets personally, as a standby in the event the settlor becomes incompetent. In contrast to a power of appointment, the retitling resolves the authority of the legal titleholder to act in connection with the property. In addition, the settlor may limit the extent of such management or segregate certain assets from the application of a power of attorney (as long as the power holder is not given the power to revoke the trust in the grantor's stead). The management of the standby trust should change from the settlor to the other trustee (or trustees) upon the earliest to occur of the settlor's death, incapacity, or unexpected absence or mysterious disappearance for a period greater than a specified number of days (or weeks).

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4 I.R.C. §§2035 and 2038.

5 This enacted the rule in *McNeely Estate v. United States*, 16 F.3d 303 (8th Cir. 1994); and *Kisling Estate v. Commissioner*, 32 F.3d 1222 (8th Cir. 1994).

***Planning point:***

A revocable life insurance trust is aimed at the management of the insurance proceeds for the beneficiaries. It may also provide a dispositive scheme not apparent in a will, if the will pours over into the trust, thereby providing some privacy to those concerned about the public learning what dispositions were made. In cases in which the estate is held as joint-tenants-with-right-of-survivorship, an insurance policy payable to a revocable trust can fully fund the credit-shelter trust.

### *3. Will substitute*

Another situation in which a revocable trust may be an appropriate will substitute is when the client wishes to avoid probate. The property held by a decedent in a revocable trust is not part of the probate estate, and is not, therefore, subject to the administrative procedures affecting probate property. There was a time when banks and other institutions who held assets were not comfortable with grantor trusts. Those days are long past.

### *4. Means of making gifts*

An effective method to make gifts from a revocable trust is to combine the use of the trust with a durable power of attorney authorizing the named attorney-in-fact (usually the same person as the trustee) to make gifts on the settlor's behalf.

### *5. Claims of creditors*

Although the grantor of a revocable trust is generally afforded little protection against the claims of the grantor's creditors, it may be used to provide children income without having the trust corpus or anticipated income be subject to the creditors of the children. The grantor may retain the right to revoke the trust at any time the heat on the children is turned up.

### *6. Advantages of revocable trusts prior to the death of the grantor*

a. The grantor can control, coordinate, and distribute all property interests while alive and competent.

b. Assets titled to the trust prior to death do not pass through probate. (Probate-fee savings may be significant, depending on the asset mix and probate fees of the county and state where the grantor/decedent resided.) However, this does not assure a reduction of legal expenses by any significant amount. Moreover, contrary to popular belief, a revocable trust does not save estate/inheritance taxes. However, the trust does avoid ancillary probate on real estate owned outside the state of domicile.

c. The at-death assets of the trust and their distribution may be private rather than public. However, many states permit the inheritance tax returns to be accessible to the public, and thus, the information is often available on these returns rather than from the probate filings, so privacy cannot be assured.

d. All opportunities of estate-tax planning available through a will are equally available through the use of a revocable living trust. This includes using each spouse's applicable credit amount to shield up to $12,920,000 from federal estate tax in each estate for 2023, a maximum applicable credit amount of $5,113,800.

e. In states with lengthy probate procedures, the trust may save time in transferring assets to beneficiaries. It is especially beneficial for large, complex estates or those with relatively few liquid assets all or most of which are "management intensive."

f. It often serves as a management and control device in the event the grantor becomes incapacitated or for the benefit of a survivor needing financial management assistance; it avoids guardianship costs (and frustrations).

g. Furthermore, it can serve as a receptacle for future transfers of property where the grantor is concerned about future senility, incompetence, or disabling illness, and wishes to provide for protection and management of property similar to that achieved by using a durable power of attorney.

h. There are no adverse lifetime income-tax consequences. All income is taxed to the grantor just as if the trust was not created. (Trust income appears on the 1040 as do deductions and credits.) The trust must maintain a calendar year.

i. The trust is easy to create, maintain, amend, change, fund, or cancel.

j. A revocable trust can serve as a device to segregate community property so as to maintain the separate status of each.

k. In addition, it can serve as a mechanism for trust management of eventual life insurance proceeds and/or qualified plan death benefits where use of a testamentary trust is either ineffective under local law or otherwise inconvenient.

l. Moreover, the revocable trust is legal in every state and can easily be moved if the owner moves. (Living trusts are subject to state law and should be legally reviewed when changing domicile.)

m. It is more difficult to challenge (and usually less successfully attacked) by disgruntled beneficiaries than is a will.

n. The grantor may choose the situs of trust administration and which state laws will govern the validity, interpretation, and administration of the trust.

o. If a living trust has multiple beneficiaries with substantially separate and independent shares, the shares are separate trusts[6] and are treated as such for purposes of determining distributable net income.[7] Probate estates are now subject to the separate-share rules. This may actually be advantageous in some situations.

### *7. Tax disadvantages after death of grantor*

There are a number of tax disadvantages associated with a revocable living trust that may arise after the grantor's death.

- **Calendar versus fiscal year** -- Trusts must use a calendar year for reporting purposes after the grantor's death.[8] In contrast, an estate may use a fiscal year and thus defer income.
- **$25,000 rental real estate loss deduction** -- A trust cannot use this exception to the passive-loss-deduction-limitation rules. An estate can use this exception for years ending less than two years after decedent's death.[9]
- **Reforestation costs** -- The amortization deduction and credit are allowed to an estate but not to a trust.
- **Exemption limitation** -- A complex trust (which can accumulate income and distribute principal) is limited to a $100 personal exemption. A simple trust (which must distribute all income currently) is allowed only a $300 exemption.[10] An estate receives a $600 exemption.

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6 I.R.C. §663(c).
7 Treas. Regs. §1.663(c)-3(f).
8 I.R.C. §645.
9 I.R.C. §469(i)(4).
10 I.R.C. §642(b).

- **Estimated payments** -- Trusts must make estimated payments starting at death of grantor unless the trust was the decedent's grantor trust at death and residue of grantor's estate is willed to the trust[11] or trust is responsible for paying debts, taxes, and expenses of administration. Estates do not pay estimated taxes for those taxable years that end before the second anniversary of the decedent's death.
- **Small-business stock**[12] -- Such stock owned by a grantor trust cannot qualify the grantor for ordinary loss treatment.
- **Stock holding period** -- Non-QSST or non-ESBT trusts can hold S stock for only two years after the death of the grantor, while an estate can be an S shareholder for as long as there are good reasons to keep the estate open.[13]
- **Charitable deduction for amounts set permanently aside** -- The set-aside deduction is not allowed for simple trusts; however, it can be used by an estate or complex trust.[14]

***Planning point:***

Most, if not all, of these disadvantages can be eliminated or reduced by a special election that permits a revocable trust to be treated as part of the grantor's estate for income-tax purposes. The details of this election are discussed in reference to merging the revocable trust into the estate and making the §645 election, discussed below.

# *IV. Irrevocable trusts*

## A. In general

### *1. Nature of the trust*

An irrevocable trust, in contrast to a revocable trust, is one in which the grantor does not have the power to change the enjoyment of any interest in the trust by altering or amending its terms, or by revocation or termination. In other words, it runs contrary to the psychology of most Americans who endured the Depression (or parental stories of the Depression) not to give up control of property. In this sense, it resembles an outright transfer, but the grantor can impose conditions on its enjoyment that are often more attractive to this mindset than an outright disposition. The trust permits the grantor(s) essentially to control the property from the grave.

***Note:***

A feature that should be considered when creating an irrevocable trust is the use of a special power holder called the **trust protector**. This is an individual who is not a beneficiary of the trust and who, absent bad faith, owes no fiduciary duty to the trust beneficiaries. Typically, this is a trusted advisor of the grantor, such as a partner at the grantor's law firm or accounting firm. The trust protector has the discretionary power to terminate the trust. He could also be given the power to appoint the trust assets to the trust beneficiaries in such proportions and manner as the trust protector determines in his or her sole discretion.

### *2. Income tax*

An irrevocable trust can generally be used to shift property value and income (other than grantor trusts) to younger-generation beneficiaries. Income can be shifted through the use of an irrevocable trust, for

11 I.R.C. §6654.
12 I.R.C. §1244.
13 I.R.C. §1361(c)(2)(A)(ii).
14 I.R.C. §642(c).

example, to create a fund for a child, provide current income for an adult child, or provide current income for an aged parent (with the principal thereafter distributable to a younger-generation member). Such shifting of income is not possible when the trust is revocable, but is also not possible in certain irrevocable transfers in which the grantor has retained certain rights and powers.

### *3. Gift tax*

Unlike a revocable transfer, a transfer to an irrevocable trust is generally treated as a **completed gift** for gift-tax purposes. A completed transfer occurs when the grantor has ceased sufficient dominion and control so as to be unable to further control the disposition of the transferred property.

A donor is considered as having a power if it is exercisable by the donor in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income.[15]

a. A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in the donor. A gift is also incomplete if, and to the extent that, a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard.[16]

b. A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. Thus, the creation of a trust (the income of which is to be paid annually to the donee for a period of years), the corpus being distributable to the donee at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, constitutes a completed gift.[17]

c. The relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event that completes the gift and causes the tax to apply. For example, if A transfers property in trust for the benefit of B and C but reserves the power as trustee to change the proportionate interests of B and C, and if A thereafter has another person appointed trustee in place of A, such later relinquishment of the power by A to the new trustee completes the gift of the transferred property, whether or not the new trustee has a substantial adverse interest.[18]

d. If a donor transfers property to the donor as trustee (or to the donor and some other person, not possessing a substantial adverse interest, as trustees), and retains no beneficial interest in the trust property and no power over it except fiduciary powers, the exercise or non-exercise of which is limited by a fixed or ascertainable standard, to change the beneficiaries of the transferred property, the donor has made a completed gift and the entire value of the transferred property is subject to the gift tax.[19] Yet many grantors fail to recognize the need to file Form 709, *United States Gift (and Generation-skipping Transfer) Tax Return*, when the irrevocable trust is funded by such a completed gift**. Without filing the return, the grantor does not start the statute of limitations in**

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15 Treas. Regs. §25.2511-2(e).
16 Treas. Regs. §25.2511-2(c).
17 Treas. Regs. §25.2511-2(d).
18 Treas. Regs. §25.2511-2(f).
19 Treas. Regs. §25.2511-2(g).

**respect of these gifts because there is no adequate disclosure to the Service under the regulations**.

***Note:***

The gift tax is applicable only to a transfer of a beneficial interest in property. It is not applicable to a transfer of bare legal title to a trustee. A transfer by a trustee of trust property in which the trustee has no beneficial interest does not constitute a gift by the trustee (but such a transfer may constitute a gift by the grantor of the trust, if until the transfer the grantor had the power to change the beneficiaries by amending or revoking the trust).[20]

If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or non-exercise of which is limited by a **reasonably fixed or ascertainable standard** set forth in the trust instrument. A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary, for the beneficiary's reasonable support and comfort, to enable the beneficiary to maintain the beneficiary's accustomed standard of living, or to meet an emergency, would be such a standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not such a standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or non-exercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists.[21]

***Note:***

A transfer need not be denominated as revocable in order to be treated as such for transfer-tax purposes. Thus, if the transfer into trust is a fraudulent conveyance, or otherwise is available to the creditors of the grantor, the "irrevocable" transfer in trust may be treated as revocable because the grantor can in essence enjoy some or all of the trust by forcing the creditors to look to the trust assets for satisfaction of their claims. Such transfers are not complete for gift- or estate-tax purposes.[22] The transfer of property to an irrevocable trust, under the terms of which the trustee had the discretionary power (entirely voluntary under the trust instrument and applicable state law) to distribute income and principal to the grantor, constitutes a completed taxable gift of the entire value of the property transferred since under local law the grantor's creditors could not attach this property.[23]

The use of an irrevocable trust thus may have the advantage of protecting the beneficiaries from the claims of creditors (until an actual distribution from the trust). Typically, a spendthrift provision precludes the interest from attachment, which is not possible with respect to the grantor as a beneficiary. This is discussed in more detail in the material on asset protection in a later chapter. In most states, the creditors can require a trustee to perform mandatory as opposed to discretionary actions, so, strictly from this perspective, greater protection is accorded if distributions of principal and income are wholly within the discretion of the trustee, because required distributions of annual income or distributions of principal subject to ascertainable standards are subject to creditor action. This does not mean that the creditors can force the trustees to make distributions to the creditors to the extent of the claims against the beneficiary, only that the creditors may force the trustee to make the distributions to the beneficiary. The trustee cannot stand pat and sweat out the beneficiary's creditors by not making distributions.

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20 Treas. Regs. §25.2511-1(g)(1).
21 Treas. Regs. §25.2511-1(g)(2).
22 Rev. Rul. 76-103, 1976-1 C.B. 293.
23 Rev. Rul. 77-378, 1977-2 C.B. 347.

***Note:***

The Service is free to redetermine the amount of a gift made after December 31, 1996, which is not adequately disclosed on a gift tax return or in a statement attached to the return that is filed in respect of the calendar period in which the transfer occurs, even though the statute of limitations for the assessment of the gift tax on such transfer may have otherwise expired.[24]

**For these purposes, a transfer is considered adequately disclosed on the return only if it is reported in a manner adequate to apprise the Service of the nature of the gift and the basis for the value so reported.** Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed if the return (or a statement attached to the return) provides the following information:[25]

- A description of the transferred property and any consideration received by the transferor.
- The identity of, and relationship between, the transferor and each transferee.
- If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument.
- Generally, a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. In the case of the transfer of an interest in an entity (for example, a corporation or partnership) that is not actively traded, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity. In addition, if the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, a statement must be provided regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return. If 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity.[26] If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required must be provided for each entity if the information is relevant and material in determining the value of the interest; and
- A statement describing any position taken that is contrary to any proposed, temporary, or final Treasury regulations -- or Revenue Rulings published at the time of the transfer.

***Note:***

The change in the gift tax exclusion amount from $1,000,000 to $12,920,000 (2023) (as adjusted) has enhanced the transfers into trust by eliminating the gift tax charge for most transfers. This has been further encouraged by making the new limitation permanent so that there is no potential claw-back as an adjusted taxable gift to the estate tax.

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24 Treas. Regs. §301.6501(c)-1(f)(1).

25 Treas. Regs. §301.6501(c)-1(f)(2).

26 The Service suggests that examples of businesses when the valuation of the entity would properly be determined by the net value of the assets held by the entity include entities holding securities or real estate, since in those cases the value of an interest in the entity would be determined based on a pro rata portion of the value of 100 percent of the entity.

### *4. Estate tax*

If the grantor does not retain certain rights and powers, the transfer to a trust may not be included in the grantor's gross estate. However, certain irrevocable transfers are nonetheless incomplete for estate-tax purposes where the grantor retains certain rights and powers. If the irrevocable transfer is complete for estate-tax purposes, the property transferred to the trust, together with the post-transfer appreciation on that transferred property, should not be subsequently included in the transferor's gross estate at death.

***Practice point:***

The federal estate tax begins with a collection of property called the **gross estate** and derives a taxable estate by subtracting certain allowable deductions. A tentative tax on all taxable transfers (by gift or by testamentary disposition) is computed on the sum of the adjusted taxable gifts made by the decedent and the decedent's taxable estate. From this tax, credit must be given to the tax already paid on those gifts as well as the applicable credit available for all transfers, as well as certain other credits permitted by the Internal Revenue Code.

**ESTATE-TAX SYSTEM (in a nutshell)**
Gross estate at fair market value on applicable date
- Allowable Deductions
Taxable Estate
+ Adjusted Taxable Gifts made after 1976[27]
Tentative Tax Base
Tentative Tax
- Gift Taxes paid after 1976
- Applicable credit amount
- Other Credits
ESTATE TAX DUE

**Adjusted taxable gifts** are the sum of all taxable gifts made by the decedent after 1976, less any taxable gifts which are being reported at death as included in the gross estate under any of the incomplete transfer code sections (IRC §2035, 2036, 2037 or 2038). The same item is never reported twice for transfer tax purposes, once as a taxable gift during life and again as an estate asset at death, but the value of the taxable gifts is integrated into the calculation of the estate tax.

The trust mechanism can enable protection for the trust beneficiaries from themselves. Because an intermediary trustee holds the funds, the trust beneficiary does not have immediate access to the entire funds. The continued integrity of the income from those funds is assured through the use of a trust, including the unavailability of those funds to creditors of the beneficiaries (until an actual distribution of those funds by the trust). A **spendthrift clause** included in the trust agreement, as authorized by applicable state law, will provide additional assurance concerning the continued integrity of those trust funds, since the beneficiary could not accelerate access to those benefits through a sale of the beneficiary's trust interest. A spendthrift clause precludes the beneficiary from having any claim to the property or its income prior to its actual distribution; this is usually used for a beneficiary who may be subject to designing persons or whose profligate tendencies would dissipate the trust so that there would be little or nothing available when the beneficiary might truly need it. Essentially, the creditors of the beneficiary cannot look to the trust to satisfy their claims and so they are less likely to extend credit to the beneficiary in the first instance.

[27] Adjusted taxable gifts are defined in the Code as the total amount of the taxable gifts (within the meaning of §2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent. I.R.C. §2001(b). Taxable gifts are the total amount of gifts made during the calendar year, reduced by any applicable exclusions and deductions (marital and charitable). I.R.C. §2503(a).

***Example language:*** "A beneficiary may not alienate or in any other manner assign or transfer his or her interest in any trust hereunder, and no one (including a spouse or former spouse) may attach or otherwise reach any interest of any beneficiary hereunder to satisfy a claim against that beneficiary, whether the claim is legal or equitable in origin."

***Planning point:***

The distinction between the rights of a creditor of a beneficiary to reach trust assets is based on whether the trust is a discretionary trust or a support trust.

For a "discretionary trust," the trustee has absolute discretion over distributions. The beneficiaries have no property right in the trust because they cannot enforce a standard for distributions. The cases have generally provided 100 percent protection against the beneficiary's creditors for a discretionary trust, even if the trust does not have a spendthrift clause.

A "support trust" has a standard for distributions -- often health, education, maintenance, or support ("HEMS" power). Creditors of beneficiaries of support trusts can step into their shoes to request a court to order a distribution of assets (pursuant to the standard) to pay their debts if the trust does not have a spendthrift clause, but if the trust has a spendthrift clause, the trust is protected against most creditors.

***Note:***

The National Service Center in Cincinnati has a toll-free number, open Monday through Friday from 6 a.m. to 10 p.m. EST, dedicated to answering case-related questions on Forms 706 and Forms 709. The number is (866) 699-4083. Inquiries about closing letters and the status of an amended return are among the typical calls that more than 60 tax assistants service. You might also call (800) 829-1040.

The Service Center indicates that it can provide information about whether an individual has filed a federal gift tax return (Form 709). They need the name of the taxpayer, his or her Social Security Number, and the specific year for which inquiry is being made. For a general request (encompassing several years) as to whether Forms 709 have ever been filed by an individual, the Service Center will initiate a search request and respond by either letter or return phone call "within a few days."

***Planning point:***

The income-tax and estate-tax rules are **not** the same, so care must be taken not to assume that because the transfer is complete for income-tax purposes, it is complete for estate-tax purposes. Conversely, the mere fact the transfer is incomplete for income-tax purposes does not necessarily mean that the transfer is incomplete for estate-tax purposes. This fact lies at the heart of so-called "intentionally defective grantor trusts" as part of an estate plan. Since a revocable transfer is incomplete both for income-tax and estate- and gift-tax purposes, the planning strategy revolves around certain administrative powers under §675 that cause the trust to be disregarded for income-tax purposes, yet not be disregarded for estate-tax purposes. For example, if the grantor has the power to substitute property of like value for trust corpus in a nonfiduciary capacity, the trust is disregarded for income-tax purposes, yet none of the trust is included in the grantor's gross estate.

According to one well-known authority, the following powers present significant estate-tax risk whether or not held as trustee or otherwise by the grantor:[28]

- The power to defer the enjoyment by the beneficiary of the trust property or its income;
- The power to accelerate enjoyment by the trust beneficiary by either termination of the trust or invasion of corpus;
- The power to add or substitute beneficiaries to the trust;
- The power to sprinkle or spray to trust beneficiaries the income or principal of the trust, uncontrolled by an external standard;
- Broad powers of administration, such as broad powers held with respect to: (i) investments; (ii) allocation of receipts and disbursements; (iii) dealing with trust assets; and (iv) voting rights in corporate stock; and
- A retained right to designate the grantor's self as a replacement trustee[29] (a power by the grantor to remove a **corporate trustee** and to appoint another corporate trustee does not trigger inclusion in the gross estate).[30]

***Note:***

Trusts should always be used to receive and manage the shares of funds received by a minor, no matter how small those shares may be.

If the trust shares are to a minor, a disabled individual, or an individual with no financial ability, and large enough in amount, a corporate fiduciary may be necessary. Since the estate may grow in size after the will is executed, it is usually wise to empower the individual trustee to select a corporate trustee to serve with or in place of the individual trustee.

In most cases, a grantor or decedent will wish to give the trustee a liberal authority to invade trust principal for the support, maintenance, health, and education of the trust beneficiary if the trust income is not adequate to provide for those needs.

- To insure the current trust income will be adequate and the trust principal will keep pace with inflation, the testator should provide the trustee with liberal investment powers. The testator may wish to empower the trustee to apply income for the benefit of the minor trust beneficiary and accumulate and invest and reinvest income not needed by the minor beneficiary.

## B. Minors' trusts

### *1. Separate trusts for children*

Use of separate trusts for the benefit of the testator's children where each trust will be large enough to induce a corporate fiduciary to accept the letters of trusteeship typically is $100,000 to $300,000 per trust, depending on the geographic location and the particular bank nominated.

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28 Tax Management Portfolio No. 800-1st (Bureau of National Affairs), Streng, *Estate Planning*.

29 Rev. Rul. 73-21, 1973-1 C.B. 405.

30 *Wall Estate v. Commissioner*, 101 T.C. 300 (1993), repudiating Rev. Rul. 79-353, 1979-2 C.B. 325, withdrawn Rev. Rul. 95-58, 1995-2 C.B. 191. See also Rev. Rul. 77-182, 1977-1 C.B. 273.

***Note:***

The trust can be structured as a §2503(b) trust, which permits the grantor to take advantage of the annual $17,000 exclusion (2023) ($34,000 in the case of a gift split with the grantor's spouse) if the minor receives a present interest. An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property. An exclusion is allowable with respect to a gift of such an interest (but not in excess of the value of the interest). If a donee has received a present interest in property, the possibility that such interest may be diminished by the transfer of a greater interest in the same property to the donee through the exercise of a power is disregarded in computing the value of the present interest, to the extent that no part of such interest will at any time pass to any other person.[31]

***Planning point:***

The advantages of this arrangement in comparison to other structures is the fact that the trust can continue in whatever manner the grantor wants, except for having to give the minor a present interest. Distributions of income may be inadvisable to the extent they place the funds at risks beyond those of trust investment. Generally speaking, these funds are placed in a Uniform Gift to Minors Act trust account, which precludes access until the minor reaches 18. One hidden trap: if the parent on the account is the grantor, the Service may argue that the grantor has retained a right over income that is an includable right in the grantor's estate.

### *2. Section 2503(c)*

Transfers to trust for the benefit of children often suffer from the fact that the grantor does not want to give the minor a present interest in the form of an income interest. The $17,000/$34,000 annual exclusion generally does not apply to a transfer of a future interest. The §2503(b) trust requires an annual distribution of income. The §2503(c) trust requires that income **and principal** be distributed when the minor reaches age 21, but does not require the trustee to distribute income currently.

a. To obtain the exclusion by a gift to a minor under §2503(c), the trust must provide that:
   - The income and principal are expended by or on behalf of the beneficiary;[32] and
   - To the extent not so expended, income and principal will pass to the beneficiary at age 21;[33] or
   - If the beneficiary dies prior to age 21, income and principal will go to the beneficiary's estate or appointees under a general power of appointment, even if local law prevents the minor from exercising a general power of appointment.[34]

b. The full amount of the transfer to the trust (up to $17,000 for the donor or $34,000 for the donor and the donor's spouse) will qualify for the annual exclusion.

***Note:***

The trustee may be given the discretion to determine the amounts, if any, of the income or property to be expended for the benefit of the minor and the purpose for which the expenditure is to be made, provided there are no substantial restrictions under the terms of the trust instrument on the exercise of such discretion.[35]

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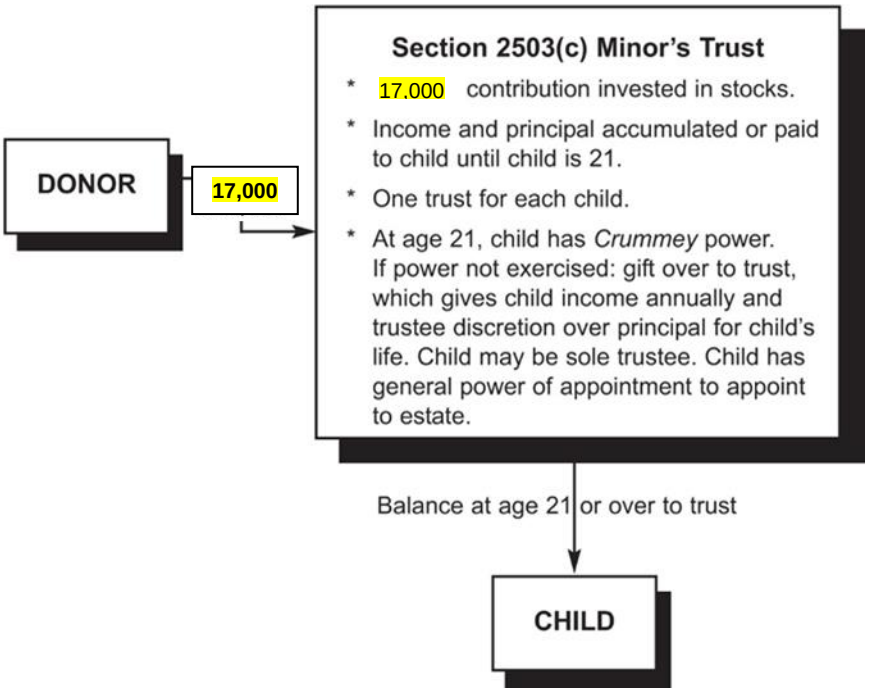
31 Treas. Regs. §25.2503-3(b).
32 Treas. Regs. §25.2503-4(a)(1).
33 Treas. Regs. §25.2503-4(a)(2).
34 Treas. Regs. §25.2503-4(a)(3).
35 Treas. Regs. §25.2503-4(b)(1).

## Section 2503(c) Minor's Trust




c. If the minor dies before age 21, the trust corpus will pass either to the beneficiary's estate or to appointees under a general power of appointment.

(i) If the trust corpus goes to the beneficiary's estate, then the property is subject to probate. Unfortunately, the beneficiary will likely be a minor and without a will. As a result, the probate will be subject to intestate succession.

(ii) The better approach is the general power of appointment. The donor would include a provision in the trust that gives the beneficiary the power to appoint the property by will to whomever the beneficiary chooses. If the beneficiary fails to appoint the property, it will pass to individuals named by the donor in the trust (referred to as takers in default). Since it is unlikely that the beneficiary will have a will, the property will pass to the takers in default.

***Note:***

Either a power of appointment exercisable by the donee by will or a power of appointment exercisable by the donee during the donee's lifetime will satisfy the conditions. However, if the transfer is to qualify for the exclusion, there must be no restrictions of substance by the terms of the instrument of transfer on the exercise of the power by the donee. If the minor is given a power of appointment exercisable during lifetime or is given a power of appointment exercisable by will, the fact that, under the local law, a minor is under a disability to exercise an inter vivos power or to execute a will does not cause the transfer to fail to satisfy the conditions of §2503(c).[36]

***Note:***

The governing instrument may contain a disposition of the property or income not expended during the donee's minority to persons other than the donee's estate in the event of the default of appointment by the donee.[37]

[36] Treas. Regs. §25.2503-4(b).
[37] Treas. Regs. §25.2503-4(b)(3).

***Example language:*** If CHILD dies before attaining the age of twenty-one (21) years, the Trustee shall distribute the entire trust assets to the person or persons to whom CHILD appoints the trust assets by a specific reference to this general power of appointment in his last will and testament. CHILD may appoint the trust assets to any person or persons, including himself or his estate, outright or in trust, and in whatever shares he or she deems appropriate. If CHILD dies without validly exercising this general power of appointment, the Trustee will distribute the trust assets to CHILD's surviving issue, per stirpes. If CHILD dies without validly exercising this general power of appointment and without being survived by issue, the Trustee will distribute the trust funds in equal shares to the Grantor's other surviving children and the surviving issue of any of the Grantor's children who have predeceased CHILD, per stirpes.

d. A substantial amount of flexibility can be built into the §2503(c) trust. Income that has been accumulated, as well as any principal in the trust, can be paid to the donee when the donee reaches age 21. However, the donor may want the trust to continue to age 25 or older. The donor can provide continued management of the trust assets and at the same time avoid forfeiting the annual exclusion by giving the donee, at age 21, a right for a limited period to require immediate distribution by giving written notice to the trustee. The treatment of the gift for the benefit of the minor as a present interest is not eliminated by giving the minor the right to extend the term of the trust after reaching age 21.[38] If the trust is extended beyond age 21, a substantial sum can be accumulated on behalf of the beneficiary. Prior to the beneficiary reaching age 21, the trust is taxed as a complex trust; thereafter the trust is not taxed at all, but the beneficiary is treated as the grantor of a grantor trust for as long as the trust continues.

***Planning point:***

A gift to a minor that does not satisfy these requirements may still qualify as a present interest under the general rules. Thus, for example, a transfer of property in trust with income required to be paid annually to a minor beneficiary and corpus to be distributed to the minor upon attaining age 25 is a gift of a present interest with respect to the right to income, but is a gift of a future interest with respect to the right to corpus.[39]

[38] Treas. Regs. §25.2503-4(b)(2).
[39] Treas. Regs. §25.2503-4(c).

# *V. Trusts for children*

## A. Minor child

### *1. In general*

The appointment of guardians for minor children is one of the most important aspects of a parent's estate plan. If called to serve, the ideal guardian will oversee the upbringing of the child by providing a safe and loving home, serving as an adult role model, delivering supervision, encouragement and discipline as needed, attending to the child's social and intellectual development, helping the child through the trials of adolescence and beyond, assisting the child with educational and career decisions, and generally supporting the child on his or her path to becoming an independent adult.

### *2. Who becomes guardian on death of parents*

State statutes generally fall into one of two categories.

a. Some states require court appointment and approval of the guardian, regardless of the appointment in the Will.[40] The court will **give due regard** to the request contained in a person's Will, but will consider other factors, such as the relationship of the appointed person to the minor by blood or marriage, the workload, capabilities and potential conflicts of interest of the proposed guardian, whether the appointed person and the parents share the same religious preferences and whether an adult sibling is able to serve.

b. The second category of states provides that the person or persons appointed in the parent's Will control.[41] Some of these state laws include an escape valve that permits the court to reject the appointed guardian if it is not in the minor's best interests. In other states, the appointed guardians automatically receive "letters of guardianship" when the Will is probated.

***Note:***

While most individuals will wish their estate to pass to their children, they must also make provision for who will handle the funds that are conveyed to minor children who lack the legal standing to deal with such property. Because one should plan for the contingency that parents will die while their children are still minors, it is important to select a Guardian for the children. It should be noted that ultimately the appointment of a Guardian may be made by a court; while it is not automatic that the person or persons or institution named by an individual will be respected, in almost all cases a court will consider those wishes very seriously.

c. Regardless of whether the guardian is court-appointed or parent-appointed, several states include the minor child in the decision-making process. In many court-appointed states, the court first considers the preference of a minor age 14[42] or older in appointing the guardian, and the guardian named in the Will is of secondary importance. In many of the parent-appointed states, a minor age 14 or older may object to the guardian named in

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40 Arkansas, California, Delaware, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Kentucky, Missouri, New Hampshire, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Vermont, Wisconsin, Wyoming.

41 Alabama, Alaska, Arizona, Colorado, Connecticut, District of Columbia, Georgia, Idaho, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, New York, North Dakota, Utah, Virginia, Washington, West Virginia.

42 Age 14 in Colorado, Connecticut, and Texas.

the Will within a certain period of time. Such an objection instigates a court proceeding to appoint the guardian – typically the guardian nominated by the minor child.

d. Special problems arise in the context of a divorced couple.
   (i) Since most states specifically provide that the Will of the last parent to die controls, there is uncertainty of his or her child's upbringing in the event of the parent's premature death.
   (ii) If the custodial parent dies first, the custody and guardianship passes to the other surviving parent.

***Question to ponder:***

| At what age would you think a child should have input as to his or her guardian? |
|---|

### *3. Guardian of person v. guardian of property*

**Most state statutes provide for a guardian of the person and of the property for minor children, each bearing different duties and authorities and each may be filled by different persons.** If a client plans to place the child's share of the estate in trust, the guardian of the property will have little to no responsibility. The trustee of the child's trust will serve as manager of the bulk of the child's assets, whereas the guardian of the property generally will manage smaller amounts coming to the child outside of trust, such as gifts from relatives or earnings from the child's personal work efforts. The guardianship provision should clarify whether the person designated as guardian will serve as guardian of both the person and the property or whether the person appointed as trustee of the child's trust will serve as guardian of the property.

### *4. Considerations when choosing a guardian*

Choosing a person or family to care for one's children is difficult, even more so if spouses disagree as to who is best suited to serve as guardian. The parents should begin with the longest possible list of potential guardians, identify the best choices, and then rank those persons in order of preference to establish the appointed guardian and successor guardians. While candidates include the child's siblings, cousins, aunts, uncles, grandparents and child care providers, and the parent's business partners, friends and neighbors, the core criterion should be whether the parents would trust a person to parent their child.

- The younger the child, the more crucial the choice of guardian is, because the child's natural parents may not yet have had the opportunity to instill their morals and values. It is important to look for a guardian who shares similar values, beliefs, and parenting style, and to consider the guardian's ability to provide a loving and nurturing environment that aligns with the parents' wishes for the upbringing of their child. As the child grows older, the decision usually becomes easier. For children who have already established roots in their community, the guardian should either be located in the same town as the clients or should be willing to move there. Take into account the potential guardian's location and proximity to the child's current home, school, and support network. Consider how the potential guardian's location might impact the child's relationships and stability. However, if the child is unhappy in his or her current environment, he or she may welcome the chance to start over in a new community.
- The guardian should have the ability to meet the physical demands of child care and should have sufficient "free" time to raise children. The ideal candidate is someone who is in good health, energetic, and close in age to the clients. Nevertheless, many clients' first instinct is to name one of the child's grandparents as guardian. The clients must consider whether their parents are too old to raise children a second time. Particularly if

the child is very young, the health and age of the potential guardian is an important factor.

***Note:***

One advantage to naming the minor's grandparent or grandparents often is availability. A couple the same age as the natural parents may be career-driven and may not have the time or patience to deal with a grieving child, even if they mean well. If the grandparents are retired or semi-retired and comparatively young and healthy, and the grandchild is at least close to adolescence, the grandparents may be able to provide the child with more time and emotional support.

- Consider the existing relationship between the child and the potential guardian. It can be beneficial for the child to have a close bond with the guardian to ensure a smoother transition.
- For some parents, religion is a matter of supreme importance, and for others, it is a much less important factor. For many parents, the child-rearing philosophy of the potential guardian is more important than religion. Ideally, the nominated guardian will share the clients' values and principles regarding raising children, discipline, work ethic, education, and financial values.
- If the client believes their child would benefit from more than one adult role model, it may be preferable to select a guardian who is in a committed relationship or married. Typically, however, if the client wishes to name a person who is married to serve as guardian, it is best to list only one spouse of the couple as guardian. Otherwise, if the appointed couple is divorced when the client dies, a legal battle for custody of the client's child may ensue.
- When the client's siblings are deemed acceptable, but the spouses of the siblings are less trustworthy, even though the sibling may be the only actual guardian serving at a time, that guardian's spouse will undoubtedly have a significant role to play, if not a legally recognized one.
- When the potential guardian already has children, the client must consider whether the potential guardian has the emotional and financial ability to add to his or her own children. The arrival of one or more new children in a household will be a hugely unsettling event, both for the guardians themselves and any minor children of their own. Does the guardian have a consistent lifestyle, a secure financial situation, and the ability to provide a stable home environment? Does the guardian have a strong support network of their own (friends, family, community) that could provide additional stability and resources for the child?
- A question for the parents who have quite a number of children (say, three or more) is whether the children should be split up and sent to separate homes. Practical difficulties may effectively require that result.
- Most importantly, the potential guardian should be consulted to determine his or her willingness to serve. The person asked may want some time to think it over, as guardianship is an enormous responsibility. If the potential guardian is willing to serve, the client should be encouraged to have a frank discussion with the prospective guardian to make certain that he or she respects and agrees with the client's views on parenting. Ensure they have the necessary skills to advocate for the child’s well-being and make informed choices.

### *5. Compensation*

Assuming the clients are financially stable and/or well insured, potential guardians should not be eliminated from the list for financial reasons unless they lack basic money-management skills. Guardians are not legally obligated to support their wards out of their own pockets. Although public benefits may be available, part of the client's estate planning should be to ensure both the child's and the guardian's material well-being. If there are not sufficient resources to provide a stream of income that will support both the child and, if necessary, the appointed guardian, additional life insurance purchased by a life insurance trust may well be necessary.

a. Typically, the client's Will and/or life insurance trust will provide that the funds to be used for the benefit of the client's child or children be placed in a separate trust until the child (or the youngest of all the children) reaches a certain age. The terms of such trust should provide that, at a minimum, distributions of the trust net income and principal may be made for a child's health, education, maintenance and support, but may also allow distributions for travel, camp and other extracurricular activities while the child is a minor.

b. The client should also consider whether the guardian will need financial support. In many cases, significant economic issues will arise for the guardians at the time they are called upon to assume their duties, including housing, childcare, and general household expenses. The client should consider permitting the Trustee of the child's trust to make distributions of net income and principal to: (i) add living space to the guardian's residence or purchase a larger residence to accommodate the guardian's enlarged family; (ii) purchase additional furniture or furnishings for the larger residence; or (iii) employ child-care providers, housekeepers, or other support to enable the guardian to balance a career and the responsibilities of serving as guardian.

c. If the client has agreed to provide for the guardian and/or the guardian's family out of the child's trust funds, the client should consider the interplay between the guardian and the trustee. The client's primary purpose in creating a trust for his or her child is to provide for the child's support and education. If there is any question that the guardian might misappropriate trust funds for his or her benefit, squander the child's trust funds on frivolous purchases, make poor investment choices or neglect the management of the trust funds, then the guardian and trustee should be different persons.

d. At a minimum, the guardianship provision in a client's Will should appoint a guardian, successor guardian and, if appropriate, waive the guardian's responsibility to post bond. The counselor and client should discuss whether any additional provisions might be included, such as permissible distributions to the guardian and/or the guardian's own children, provisions for the guardian's residence, distributions to the child's family members for visitation, and any written wishes regarding the child's upbringing, such as religion and education.

   (i) The clients may not want the guardian to be obligated to take on significant financial burdens as a result of his or her undertaking to serve. The clients may authorize the trustees of the child's trust to pay any expenses of the guardian that he or she would not otherwise incur but for the fact that the person is serving as the guardian. For example, the trustee may be authorized to pay for housekeepers or any other personnel necessary for the maintenance of the guardian's residence or for the purpose of providing assistance to the guardian in connection with his or her duties. In addition, if the guardian has children of her or his own, the client may authorize the trustees to pay for all or a part of the costs incurred by both the client's children and the children of the guardian for

vacations, lessons and other "extra-curricular" activities, so that the client's children and the children of the guardian are raised, to the extent possible, in the same manner and with the same benefits.

(ii) The client may provide detailed guidance to the appointed guardian about the client's children and the sort of experiences and family environment the client would like for them. Any values about which the client feels very strongly should be made explicit in written instructions to the guardian. Such instructions may be included in the Will or in a separate writing.

## B. Disabled child

### *1. In general*

There is no cookie-cutter solution to the estate plan for a family with a disabled child. It depends, among other things, on the client's family situation, assets, liabilities, and objectives:[43]

- The amount of assets that the parents wish to devote to the care or support of the disabled child is complicated in many instances by the presence of other children in the family;
- The nature and severity of the child's disabilities;
- The age and state of development of the child;
- The child's potential for partial self–support;
- The availability of government benefits;
- The cost and availability of private or public facilities or community–based living arrangements;
- The adequacy of assets and life insurance to meet objectives;
- The general attitude of the parents and other family members toward the disabled child.

a. Planning for a mildly disabled child who may not be eligible for government disability benefits yet may have very limited capacity for self-support differs significantly from planning for a severely disabled child who may be able to count on some level of government assistance and not need a great deal of additional financial assistance from the parents to provide a decent standard of living.

b. The following specific information concerning the disabled child should be memorialized in writing for the benefit of those who may have to act as surrogate for the parent later:

- The nature and degree of any mental or physical disability, and the age of onset (if other than birth);
- Accompanying physical or mental disabilities;
- Personality and behavioral traits;
- Capabilities and limitations (e.g., reading level, ability to walk, talk, dress, drive, take public transportation);
- Special medical needs (and principal providers of medical services);
- Educational level and future education plans;
- Vocational objectives, work and earnings history;
- Present housing arrangements and future plans;
- Assets of the disabled person, including how the assets are held;

[43] Effland, Trust and Estate Planning President's Committee on Mental Retardation, *The Mentally Retarded Citizen and the Law* (1976).

- Accounts, if any, held in trust for the disabled child, or by a custodian under the Uniform Transfers to Minors Act or the Uniform Gifts to Minors Act, or pursuant to a personal injury settlement;
- Medical insurance coverage and Medicare and Medicaid status;
- Amounts and sources of income, including Social Security disability benefits, SSI, and survivor's annuities;
- Other financial provisions that have been made for the disabled child by parents, grandparents, or others; and
- The personal legal status of the child (e.g., whether legal guardianship of the child's person or estate has been established or whether the child is a ward of the state).

***2. Special arrangements***

The selection of fiduciaries — personal representatives, guardians and trustees — is very difficult when a disabled child is involved. Unlike the circumstance of providing for a minor child if the parents die prematurely who will someday become independent and self-supporting, lifetime planning and care for a disabled child who may never become fully independent are substantial with respect to both care givers and fiduciaries (guardians, conservators, trustees).

a. As noted elsewhere, parents are the natural guardians of a minor, at least for purposes of personal decision–making, without the need for court appointment under the laws of most states. But once a child reaches the age of majority (18 or 21), there is a legal presumption of competence that can only be overcome by a judicial decree. It may come as a shock to many parents that they lose their legal authority to act for the child in many areas once the child reaches majority. The alternative is to have a legal guardian appointed at that time.

(i) A guardianship basically strips the individual of all power to make decisions for himself or herself, including the ability to contract, marry, vote, and sign checks. Once declared incompetent by a court, an individual requires another court proceeding to declare competency to regain any lost rights.

***Note:***

Guardianship involves a fair amount of complexity, inconvenience, and expense. Parents may be reluctant to institute formal proceedings, realizing that the appointment of a guardian usually entails expensive and cumbersome safeguards, including the **posting of a bond**, the filing of **annual accounts** (including accounting for benefits paid to the guardian as representative payee under federal programs), and court supervision and approval. Guardianship may involve an infringement of the disabled individual's rights, freedom, and privacy.

(ii) Nevertheless, the appointment of a guardian is sometimes necessary because a disabled individual has incapacities: For example, if the individual inherits or acquires property that requires management that he or she cannot provide (whether by reason of minority or disability), a guardian must be appointed to manage the property unless state law allows for the establishment of a trust for the property. If an individual's own consent for needed medical care is legally ineffective, a guardian may provide a decision-maker. If an individual has uncontrollable, self-destructive urges to spend money, a guardian may place these in check. Those who wander off have a civil right to do so without

interference unless there is a guardian who can legally prevent such person from doing so.

b. Parents should prepare a written statement (often called a letter of intent) that tells guardians and trustees everything the parents would want a person to know to carry out the parents' intent in the particular context of a disabled (or minor) child, detailing the disabled person's personal history (with records), abilities and disabilities, condition and medical needs, educational and vocational goals, expectations regarding housing, health care procedures and service providers, and friends and individuals who can contribute in various ways to the quality of the disabled person's life. It should further relate the disabled person's wishes and desires to the extent the parents are aware of them.

***Note:***

The Uniform Probate Act or Uniform Guardianship and Protective Proceedings Act (UGPPA) allow a parent to make a testamentary appointment of a guardian for an incapacitated person and do not require any subsequent judicial proceeding in most cases, aside from the filing of an acceptance of the appointment with the appropriate court. Other state statutes give priority to the parents' nominee.

### *3. Transferring property*

If a parent does not have an effective will, his or her probate estate will pass under the applicable state laws of intestate succession. These laws almost certainly will not be in accordance with the wishes of the parents of a disabled child. In many jurisdictions a portion of the property would pass outright to a surviving spouse and a portion would pass outright to the children, and the surviving spouse's entire estate would pass **outright** to the children.

- Most states do not require a parent to provide any post mortem support for a child. If the family's assets are all left to other children, the disposition cannot affect the disabled child's eligibility for benefits or give rise to state cost-of-care claims. The theory is that a nondisabled adult child will expend a fair portion of the assets for the disabled child. However, this "informal trust" creates only a moral obligation and not a legally binding obligation, and it runs the risk not only that the sibling does not use the funds as the parents intended, but also that death, disability, divorce, debt, or other circumstances in the life of the sibling may prevent the willing sibling from honoring his or her moral obligation.
- The parents can also decide to give a substantial amount of property to a disabled child outright by will. If the disabled child is fairly independent, substantially self-supporting, and capable of managing the inheritance, there may be no reason not to treat the disabled child like any other child. In some cases, if the estate is small, an outright gift may be the only economically feasible way to deal with the property. In many cases, however, impact on government benefits and cost-of-care liability will make an outright gift of even a small amount unrealistic and unwise.

### *4. Trusts*

Trusts are generally flexible enough to provide for the special needs of the disabled child and the general needs of the rest of the family, including a surviving spouse, in the face of changing conditions and future contingencies. A trustee will have the custodial and investment function of managing trust assets and the distributive function of paying out the income and principal. Many advise a corporate trustee in these circumstances who both provides experienced and knowledgeable investment management along with needed bookkeeping and tax return services; and the continuity, experience, and prudence in the

management of assets, all of which are necessary for any trust, but those for incapacitated individuals are meant to last their entire lifetime.

a. Under normal circumstances a gift-giving program can be an excellent way to reduce the estate of the parents while at the same time passing property, especially appreciating property, to children. However, when the family includes a disabled child, gifts may be wholly inappropriate for the disabled family member because a gift may result in the child's disqualification for government benefits and subject the property to cost-of-care liability or to Medicaid lien or estate recovery laws. Furthermore, if the child lacks capacity to make gifts or a will, it may be difficult, if not impossible, to further transfer the property, except by intestate succession, once it is gifted to the child.

b. A discretionary special needs trust is the appropriate vehicle for assets intended to benefit a disabled child after the parents' deaths. A discretionary trust differs from a support trust in one essential point, namely that because the trustee in a support trust is under a duty to provide support, and medical care is an item of support, which makes the trust to the extent of such support a countable resource in eligibility for government-based programs and the trust assets generally liable for the cost of care. A discretionary trust in which the trustee is under no duty to make payments to or for the benefit of the disabled beneficiary is subject to neither of these disadvantages.

   (i) The size of such trust depends on the extent of the disabled child's likely needs. Sometimes equal division of the parents' estate among all children, with the disabled child's share left in trust, will be the appropriate choice. Sometimes, because government benefits are likely to meet the disabled child's basic needs and he will have little use for substantial additional amounts, a smaller share may be appropriate. In other cases, particularly in the case of vulnerable mildly disabled persons whose entitlement to government benefits may be uncertain yet who have little or no ability to support themselves, a larger, properly protected, share may be warranted.

   (ii) Another possibility is whether a share should be set aside in separate discretionary trust for the disabled son or daughter, or whether a sprinkle trust -- in which the timing and amounts of distributions and the identity of the distributee among a class of beneficiaries (all the children) -- determined by the trustee to continue during the disabled child's lifetime; such trusts could, divide into separate shares at certain specified times so that each non-disabled child receives a share outright eventually while the share of the disabled child continues in trust. If the future needs of the disabled child are hard to estimate, however, it may be preferable to defer division of such a trust into shares during the disabled child's lifetime. The trustee could be authorized to distribute excess funds to other children in the trustee's discretion.

c. There is often a need for life insurance when it is probable that the disabled child will never become independent or self-sufficient. The proceeds can create an estate to provide financial protection for a disabled child after his or her parents have died. Because the need for the insurance proceeds may not decrease as the disabled child becomes an adult, as it does with nondisabled children, the amount of insurance required may be significantly more than for another non-disabled child.

### *5. Final considerations on guardianships (minor or disabled)*

Most individuals don't want to think about their death, let alone their death leaving their children without apparent guidance; but this, coupled with unrealistic expectations, can only result in delay or failure to determine what will be best for the children.

- Parents should realize that while they would like to have an individual who is a clone of themselves, who shares all the same values, this may be criteria that cannot be easily satisfied. There are undoubtedly reasons to dismiss any person from holding this important and sensitive position, but just as the client may not be a perfect parent himself, neither should he expect some other individual to be so. A parent will not find someone who would parent the child in the same way that the parent himself or herself would. The best one can do is to consider candidates that are reasonable and choose accordingly. Because the designation of a Guardian is itself revocable, an individual can change his or her mind as matters develop and discard those who no longer meet a minimum standard and elevate those who either are better or who become better in the eyes of the individual.
- It is easy to rationalize putting off a decision with respect to a Guardian in the hopes that some member of the family will naturally step forward and offer to do so. That may be all right as far as it goes, but as noted earlier this could place the child in the middle of a guardianship dispute rivaling that of a custody dispute between or among well-meaning relatives, a process that may sow discord within the greater family unit.
- As noted elsewhere in these materials, clients can express their wishes with respect to certain specific items by way of a letter of understanding or memorandum. Of course, ultimately a court will decide the guardianship, but if the letter memorandum is not available, the wishes expressed in it cannot be brought before the court. It is generally advisable that the appointment of guardians should be made in the will.
- The choice of a Guardian is not strictly made by the parents, but is also made by the would-be guardian who must assess the situation in light of the responsibility entailed in dealing with children or with the children's assets. Parents should know that raising a child involves considerable commitment, and guardians should be aware of responsibility involved in doing so; love by itself is not enough. One should also consider how this arrangement will work. For example, will the Guardian be moving into the client's home or will the Guardian be expected to make room to take the children into his or her home? Considerations for a Guardian must also address financial support the Guardian will be entitled to with respect to the children. This applies not only to a Guardian of the persons of the children but also to a Guardian of the property of children.

## C. Alternative gift to minor

### *1. UTMA accounts and other transfers to minors*

The Uniform Transfers to Minors Act (“UTMA”) is a convenient and useful arrangement for accumulating wealth on behalf of a minor. But since such property must be transferred to the minor at age 18 or 21, many donors feel that this is too young for the beneficiary to receive the custodial property outright upon the termination of the custodianship, especially if the property has appreciated substantially in value.

***Note:***

The UTMA is the successor to the Uniform Gifts to Minors Act (“UGMA”). Most states have replaced the UGMA with the UTMA, because (in general) the UTMA enables the custodian to

hold property until the minor reaches age 21 (or older, in some states), covers a broader range of property, and permits the custodian to apply the property more liberally for the minor's benefit than does the UGMA.

a. As a general matter, minors cannot contract for any substantial transfer of property and cannot accept a receipt for the transfer of property. There are three common ways that a donor may make a transfer to a minor which qualifies for the gift tax annual exclusion. First, the donor may transfer the property to a court-appointed **guardian**. The guardian must account to the court for most expenditures of assets on behalf of the minor and must distribute the property to the minor when the minor reaches the age of majority. Second, the donor may transfer the property to a **trust** that meets the requirements of §2503(c). Third, the donor may transfer property to a **custodian** pursuant to the provisions of the UTMA. Of these alternatives, guardianship is the most expensive and time-consuming, and UTMA is the easiest and least expensive to implement and administer, as a general rule.

b. Custodian is not the legal title holder of the property; the minor is. A UTMA account for the benefit of a minor is created by giving custodial property to an adult individual, or to a bank, trust company or other entity authorized to act as a trustee, as custodian, by designating that individual or entity as custodian in the appropriate beneficiary designation (as in the case of an insurance policy), or by executing an instrument describing the property and having the custodian sign a written acknowledgment of receipt. The “custodian” is a person so identified by the transferor of the property. Once the transfer is complete, legal title to the property vests in the minor beneficiary. The custodian has broad discretion to apply the custodial property for the benefit of the beneficiary, without regard to any other person's duty to support the beneficiary. In addition, the minor (if he or she has attained **age 14**) or an interested person may petition the court to order the custodian to pay to the minor or expend for the minor's benefit so much of the custodial property as the court considers advisable.

c. A custodian has the same **powers** over custodial property as an unmarried adult owner has over his or her own property, even though the beneficiary—not the custodian—is the legal owner of the property. The custodian's authority is intended to include the power “to borrow, whether at interest or interest free, the power to invest in common trust funds, and the power to enter contracts that extend beyond the termination of the custodianship.”

d. Generally, the custodian must transfer the custodial property to the beneficiary when the beneficiary reaches age 21 (or to the beneficiary's estate upon the beneficiary's earlier death), but some states allow the donor to specify a later age; some permit the donor to designate either age 18 or age 21 as the age of payout. If a choice is available, it is generally recommended that the donor choose age 21 (or older, if permitted) as the payout date, because the minor may be able to manage the property more prudently at that age than he or she would at age 18.

e. Such transfers are treated for transfer tax purposes like a transfer to a §2503(c) trust; therefore, the exclusion may depend on whether the property must be distributed to the minor by age 21. Even though legal title to custodial property vests in the minor upon transfer, the property nonetheless will be includable in the gross estate of the donor under §2038(a)(1), if the donor is also the custodian and dies while serving in that capacity, because the custodian has the power to terminate the custodial arrangement at any time and, therefore, may withhold enjoyment of the income from the property.

***Note:***

The donor should probably not serve as the custodian of the property because there is the potential inclusion in the estate. The donor's spouse probably may serve as custodian, even if he or she "splits" the gift to the UTMA account with the donor spouse for gift tax purposes. Under the reciprocal trust doctrine, however, spouses should not create identical UTMA accounts for minor children and name each other as custodians, causing the custodian spouse to be treated as the transferor for federal estate tax purposes of the UTMA account over which that spouse is custodian and thereby triggering gross estate inclusion.

f. With respect to UTMA accounts created or maintained pursuant to a divorce settlement, may a custodian who is a parent of the beneficiary apply the property to discharge his or her obligation to support the beneficiary? Courts have held, as a matter of state UTMA law, that a parent-custodian may not apply the property to discharge his or her support obligation, at least while the parent has sufficient funds of his or her own to support the minor. If a parent does not have sufficient funds to discharge his or her support obligation, the UTMA funds probably may be used to support the minor, at least if permitted by a court.

***Note:***

The mere power to use the custodial property to discharge the custodian's support obligation causes the custodial property to be includable in the parent-custodian's gross estate as a retained interest. Courts have held in several cases that custodial assets may be used to satisfy claims of the custodians' creditors. Some courts have held that the mere fact that the custodial assets were commingled with the custodian's personal assets and/or used to pay the custodian's debts means that no custodianship was created in the first place, because the donor did not have the requisite donative intent in creating the UTMA account. Other courts have held that the funds are not subject to the claims of the custodian's creditors in any event.

g. A custodian may transfer custodial property to another entity, such as a trust or a limited partnership that would provide a mechanism to restrict a beneficiary's access to custodial funds after the beneficiary reaches the age of majority only if such transfer was a legal investment and a prudent investment.

(i) Because a custodian has the same powers over the custodial property as an adult owner would have over his or her own property, including the power to transfer his or her own property to an LP; a custodian legally may transfer custodial property to a limited partnership under certain circumstances. For such a transfer to satisfy the custodian's fiduciary duty to act prudently, the beneficiary probably should have the right to liquidate his or her LP interest, either on demand or for a certain period of time after reaching the age of majority, and for a minimum price, either fixed or determined by reference to a formula.

(ii) Investing custodial property in a limited partnership might be considered a breach of fiduciary duty for these reasons; (a) the transfer is likely to reduce the value of the assets; (b) the limited partnership interest is more difficult to liquidate than the marketable securities because it is not publicly traded; and (c) a limited partner may have no rights to distributions from the entity and, if the limited partner has a minority interest in the entity, will be unable to force a liquidation of the partnership.

(iii) **Contributing custodial assets to a partnership also may be a breach of the custodian's duties to turn over the property to the beneficiary upon his or**

**her reaching the age of majority and to keep the custodial property separate, because the beneficiary may not be able to take the property out of the partnership immediately upon reaching the age of majority and because the custodial property will have been commingled with other partnership assets. This (iii) applies not only to partnership interests but to any interest where quickly reversing a bad decision is important.**

(iv) It is clear that a limited partnership interest could constitute custodial property in a UTMA transaction, so it is generally better to create the limited partnership first, then transfer interests to the custodian rather than have a transfer to the custodian followed by a transfer to a limited partnership.

h. May the custodian transfer custodial assets to a trust for the benefit of the beneficiary before the beneficiary reaches the age of majority? Some states expressly permit this, but other states do not. The major advantage of transferring custodial property to a §2503(c) trust is that the trust may continue after the minor reaches age 21 if the minor does not withdraw the property after a certain minimum period of time.

i. A transfer of custodial assets to a §529 plan should be considered. Because the assets of a §529 plan must be used for the beneficiary's qualified educational expenses (including K-12 under the TCJA), the transfer of the custodial assets would appear to be a permissible use of custodial assets since the custodial assets are paid to the minor or expended for the minor's benefit. However, the custodian probably could not later change the beneficiary of that plan to a sibling or cousin of the beneficiary, because it likely would violate the custodian's duty to expend custodial assets only for the beneficiary. In states where college education is deemed an obligation of support of a parent, and the custodian by the transfer discharges in whole or in part that obligation, this would violate the duty of the custodian not to do so.

Under the SECURE Act, signed into law in 2019, §529 plans allow for the withdrawal of $10,000 (lifetime maximum) to pay student loan principal and related interest for the beneficiary or the beneficiary’s siblings. The SECURE Act also expands coverage of qualified expenses to include apprenticeships and trade schools. The SECURE Act provisions apply to distributions made after December 31, 2018. Additionally, the SECURE Act 2.0, signed into law in 2022, permits beneficiaries of 529 college savings accounts to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA. Such rollovers are subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. The rollover cannot exceed the total amount contributed to the account more than five years before the rollover. Roth income limit restrictions are not applicable to the 529 plan Roth conversion. As a result of this new provision, individuals will have the option to avoid the penalty on a non-qualified withdrawal of leftover 529 plan funds. This new SECURE 2.0 provision applies to distributions after December 31, 2023

***Note:***

There are two major disadvantages to using UTMA for transfers to minors:

- UTMA assets are likely to be included in the donor's estate if he or she serves as custodian; and
- There are very few options for restricting the beneficiary's access to the UTMA assets upon his or her reaching the age of majority. In states where permitted under the applicable UTMA statute, the custodian should consider transferring the custodial property to a §2503(c) trust, which will permit the beneficiary to withdraw the trust property for a short period of time upon reaching the age of majority, but thereafter the property (to the extent not withdrawn) will remain in trust for the beneficiary's benefit.

### *2. Section 2503(c) trusts*

Under §2503(c), a gift to a minor in trust constitutes a present interest in property and, therefore, qualifies for the annual exclusion if the property transferred to the trust (and the income from the property): (i) may be expended by or for the benefit of the donee (i.e., the minor) prior to his or her attaining age 21; (ii) will pass to the donee upon his or her attaining age 21; and (iii) if the minor dies before reaching age 21, will be payable to the donee's estate or as the donee may appoint by a general power of appointment.

a. Income from property held in a §2503(c) trust may be taxed to the trust, because the trustee—not the minor beneficiary—holds legal title to the trust property. Thus, a transfer to a trust may provide the advantage of using the trust's income tax bracket, which may result in a lower tax rate (although some or all of the trust's income may be taxed at the parent's bracket). In addition, the trustee may distribute all or a portion of the trust's income that constitutes “distributable net income” (which generally includes all the trust's income other than capital gain) to the minor, and to that degree, shift taxable income from the trust to the minor.

b. An alternate beneficiary may be designated if the minor dies before reaching the age of majority, which is not possible with a UTMA account. Therefore, if the beneficiary dies before age 18 years or without executing a will, the UTMA assets will pass by intestacy and could end up in the hands of someone else whom the transferor did not intend to benefit.

## D. Family loans

### *1. Planning opportunity*

Loan interest rates are historically low, but that doesn’t mean that in the current environment it will be easy for an adult child to get a loan for residence or business. The child may benefit from a loan from the parents. The low interest-rate environment makes it easy to lend money to family members on very favorable terms with full IRS approval. This might be “win-win” as the return can easily outpace the interest accruing on a certificate of deposit.

***Note:***

Before making a family loan, several other issues must be considered, including whether the borrower is a spendthrift unlikely to pay you back. What is the overall family dynamic? Will the individual help out other family members in a similar fashion, and if not will that create bad blood?

### *2. Deemed rate*

If a **below-market-interest-rate loan** is made, the lender is deemed to have made the loan at a higher interest rate than that fixed by the loan agreement, and the borrower (employee) is deemed to have paid

this interest rate to the lender; the source of the "payment" depends on the particular circumstances. However, in the case of a **compensation-related loan**, it is treated as compensation.

a. The interest rate of a term loan is considered **below market** if the amount loaned exceeds the **present value** of all payments received under the loan.[44] Generally, the present value is determined by using a discount rate equal to the applicable federal rate compounded semiannually, that is, the AFR in effect the day the loan was made.[45]

b. A demand loan is considered as carrying a below-market interest rate if its interest rate is below the applicable federal short-term interest rate (i.e., three years or less) that is in effect during the period for which the interest rate is being determined.[46]

c. Amounts are treated as transferred on a daily basis. Thus, the AFR for any day is the relevant rate for the month in which such day falls. This is in contrast to term loans in which the AFR is always the rate in effect for the day in which the loan was made.

***Note:***

In contrast to a term loan, a demand loan has no specific repayment date or schedule. The lender can demand full repayment at any time. As noted above, the interest rate must be recomputed as the AFR changes from one month to the next. If interest rates move up (as they probably will), higher rates are required. But a term loan taken at the present time locks in the favorable rates for the entire term of the loan.

***Planning point:***

Ordinarily, this means that the potential "deemed" interest income can be avoided by providing an adequate amount of interest. Deemed interest income is phantom income as the lender does not actually receive the additional interest that would be attributed to the lender.

### *3. Doing it right*

A family loan for a mortgage done right should include:

- A promissory or mortgage note that bears a minimum interest rate equal or greater than AFR and spells out its term and payment dates, meaning it must be decided whether payments are to be monthly, quarterly, or annually.
- A mortgage or deed of trust properly recorded with correct governmental authority, which makes the mortgage secured and gives the lender the legal right to foreclose.

The income-tax implications for a properly documented and recorded mortgage are:

- The lender records mortgage interest as income on Schedule B of their return.
- The borrower can deduct mortgage interest expense as an itemized deduction.

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44 These are the same as used in original-issue-discount rules under I.R.C. §1274.
45 I.R.C. §7872(e)(1)(B).
46 I.R.C. §7872(f)(2)(B).

***Note:***

Even if the loan is not structured to fail the below-market loan category, the impact of a below-market loan is mitigated in the case of any gift loan directly between individuals. First, the required inclusions do not apply to any day on which the aggregate outstanding amount of loans between such individuals does not exceed $10,000. This exception does not apply in the case of any gift loan directly attributable to the purchase or carrying of income-producing assets, so it is probably better suited to the child's purchase of a home rather than to a business transaction.

Second, in the case of a gift loan directly between individuals not in excess of $100,000, the amount treated as retransferred by the borrower (child) to the lender (parent) as of the close of any year shall not exceed the borrower's net investment income for such year. For these purposes, if the net investment income does not exceed $1,000, it is deemed to be zero.

# Lifetime Planning Documents


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# Lifetime Planning Documents

## *Learning objective*

Upon reviewing this chapter, the reader will be able to:

- Describe how the financial and health-care issues of the incompetent individual may be served by durable powers of attorney, living wills, revocable living trusts, and the titling of property in joint tenancy.

# *I. Decision-making during incapacity*

### A. Background

Many older people worry about losing control over their lives if illness or senility overtakes them. Management of their assets and decisions about their health care may be taken out of their hands without regard to their personal preferences. The families of the aged are often more concerned about such disability than their elderly parents. The family realizes that difficult decisions may be thrust upon them that must be made quickly, efficiently, and, if possible, inexpensively. Yet, the legal authority to act decisively may not exist. Often, the practitioner may have to persuade a reluctant elderly client to face the possibility of incapacity and the need for planning.

As a greater percentage of the population ages and sophisticated medical procedures prolong life, more and more accountants will have clients who may suffer a period of physical or mental incapacity. Early planning is necessary to establish the proper procedures and modalities before incapacity strikes so that an agent can gain control of the individual's personal, medical and financial management, and asset-conservation goals.

Resource maximization is not only one of the concerns of those who increasingly fear becoming incompetent themselves or having disabled children or other family members for whom they must provide planning. It is also an area where accountants are in a strong position to provide related services. Many federal and state benefits programs available to disabled individuals are premised on the financial need of those they seek to serve. In particular, resource maximization for both the client who may become incompetent and the family that includes a disabled child requires professional advice from financial mentors that can both preserve assets and qualify for programs that may finance care.

Without some advanced planning, it is not easy to shift control of these assets from the owner to some agent who will manage, conserve, and protect the assets. Often no mechanism has been established for the orderly transfer of control.

***Note:***

Do not overlook the psychological resistance of those clients to broach the subject of their own incapacity. In many respects, death is an easier subject with its finality, while disability conjures up haunting images of helplessness. And yet, before the client's mental powers decline to the point where neither the character of an action nor its consequences are understandable, the client should establish a safeguard for this possibility.

Three legal devices for managing property are generally available if incapacity occurs:

- The durable power of attorney;
- The revocable living trust; and
- Joint tenancy.

## B. Durable power of attorney

A **power of attorney** is a written instrument by which one person, as principal, appoints another as the person's agent (**attorney-in-fact**) and confers the authority to act in place of the principal for the purposes stated in the instrument. The person executing a power of attorney must have the requisite capacity to understand the nature and significance of the person's act at the time the power of attorney is executed. An ordinary power of attorney is useless as a technique for dealing with disability because the common law requires ongoing capacity of the principal for the agent's actions to be valid. This shortcoming has been remedied in all states by allowing a **durable** power of attorney, which survives the incapacity of the principal. The power of attorney permits the principal to exercise full control over the principal's affairs until incapacity occurs. A power of attorney that will take effect only upon the incapacity of the principal, called a "springing power," is generally available.

Additionally, the principal is free to select the agent, rather than to be forced to rely on the judgment of a court to make the selection in a guardianship proceeding. Using a power also avoids the costs associated with court proceedings (e.g., guardianship proceedings).

- Because the agent is entitled to exercise all of the powers conferred by the power of attorney, the agent may cause concern to the client who wants to manage the client's own affairs until disability or incapacity occurs.
- This worry can be allayed by appointment of a trusted agent who understands that the power is not to be exercised until the incapacity of the principal has been established. Another safety valve is the principal's power to revoke the consent at any time. If, however, the client does not wish to delegate power immediately, the springing power is an alternative, assuming the jurisdiction permits it.

### *1. Requirements*

a. The power of attorney must be in **writing**.

b. In order to be durable, the instrument must contain the words: "This power of attorney shall not be affected by the subsequent disability or incapacity of the principal or lapse of time," or "This power of attorney shall become effective upon the disability or incapacity of the principal," or similar words showing that the principal intends that the authority conferred may be exercised after the principal's disability or incapacity. The reference to "lapse of time" is intended to allow the agent's authority to continue indefinitely unless the instrument states a time of termination.

c. The principal must have legal capacity to make the appointment at the time the power is created.

d. Some states may require witnesses to the execution of a durable power of attorney or notarization.

### *2. Springing power*

A **springing power** of attorney becomes effective only after a determination has been made that the principal is incapacitated. The instrument creating the springing power should incorporate both a mechanism for making this determination of incapacity and a definition of incapacity. For example, the

instrument might name two parties (other than the agent), one of whom is the principal's physician, who are responsible for making this judgment. The instrument might define incapacity to mean that the principal lacks sufficient understanding or capacity to make or communicate decisions about the principal's property and business affairs. In addition, the power should provide a method of documenting the principal's incapacity (e.g., by a written opinion of the physician), to satisfy individuals doing business with the agent.

### *3. Powers*

A durable power might appropriately give the agent the powers usually exercised by a trustee, guardian, or conservator. If the principal wishes to confer powers that may be exercised only with a court order, this should be expressly stated in the instrument creating the power of attorney. These are powers that do not directly advance the principal's interests, such as the power to make gifts, to create trusts, to change insurance beneficiaries, and to disclaim a property interest.

a. A jurisdiction's views about the power of an agent to change an incompetent principal's domicile should be examined carefully because of its implications for the principal's Medicaid eligibility.

b. Although an agent's self-dealing ordinarily is a breach of trust, a wife/agent's transfer of her husband/principal's property to herself was approved where the husband clearly intended such action but was unable to do so himself. Practitioners might advise spouses to create a durable power of attorney for one another, so that if one spouse were to be institutionalized and apply for Medicaid, the other spouse, as agent, could transfer the home to the spouse's name exclusively and thereby avoid a Medicaid lien.

### *4. Court-appointed fiduciary*

a. An interested person may petition successfully for such an appointment, because of the dissatisfaction with the agent selected by the principal, or simply a desire to obtain personal control over the management of the principal's assets. In some states, the principal may avoid this by nominating in the durable power of attorney the same person whom the principal wants to serve as guardian or conservator. In those states, the court is required to appoint the principal's most recent nominee, unless there is good cause not to do so or the nominee is otherwise disqualified.

b. In some instances, appointment of a fiduciary by a court automatically revokes a durable power. In other states, if a person other than the agent is appointed guardian of the estate or conservator by a court, the agent is accountable to both the fiduciary and the principal.[1] The fiduciary may have the same power to amend or even revoke the power of attorney that the principal would have if not incapacitated, although some states demand specific court authorization for such action by a fiduciary.

### *5. Termination*

A power of attorney terminates when it is revoked by the principal, the principal dies, or it expires according to its own terms. Generally, a durable power is not terminated with the death of the principal as long as the agent acts in good faith and without actual knowledge of the principal's death. The agent's authority to act without actual knowledge of the principal's death may be superseded by statutes requiring the recording of real estate instruments.

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[1] UDPAA §3(a).

### *6. Durable power of attorney (for financial matters)*

Everyone 18 or older who has the power to legally act for themselves needs to appoint someone to act for them so they are able to plan for disability or disappearance. This agreement permits an individual to appoint a person, the agent, to conduct the financial affairs if he or she is unable to do so. This power to act may become effective immediately and will survive (or even be triggered by) disability or disappearance. It can be used effectively while a person is incapacitated, traveling, or missing, e.g., to allow a sale to take place even though the principal is not available. Most durable powers of attorney are effective on execution and are still rarely springing powers, but not always.

a. As with other important legal documents, this agreement should be kept in a secure place. It is effective and usable when signed, so if the agent has possession of the document, he has the power to do almost anything with respect to the principal's financial matters. In many cases, it should only be taken out and provided to the agent when it is necessary.

b. It is **less expensive** than a guardianship and is generally not subject to costly court proceedings in the event of incapacity. When incapacity occurs, absent putting an arrangement in place in advance, no one can manage those finances without having a court deciding who should serve as guardian or conservator, a process that will involve attorneys, court-appointed doctors, investigators, appraisers and then require the person so appointed to put up an expensive bond based on the estate's value.

c. A power of attorney does not preclude the principal from acting, even to his own detriment, so a **conservatorship** proceeding may be required in some circumstances even though there is a power of attorney.

### *7. HIPAA authorizations*

The HIPAA Privacy rule requires the execution of an Authorization for Release for health care records pursuant to HIPAA and other laws. That rule sets national standards to protect individuals' medical records and other personal health information. It (includes):

- Boundaries on the use and release of health records.
- Appropriate safeguards that health care providers and others must achieve to protect the privacy of health information.
- Holds violators accountable, with civil and criminal penalties that can be imposed if they violate patients' privacy rights.
- Generally limits release of information to the minimum reasonably needed for the purpose of the disclosure.
- Empowers individuals to control certain uses and disclosures of their health information.

a. Anyone eighteen years of age or older who wants to ensure that their surrogate or health care agent is able to receive his or her Protected Health Information ("PHI") should have this Authorization.

b. The HIPAA Authorization is required if:
   - The health care provider's internal policy does not expressly allow use or disclosure of the PHI. Because of the civil penalties, health care providers will tend to err on the side of withholding PHI.
   - The use or disclosure is of certain mental health records.

c. A valid HIPAA Authorization requires:
   - A specific and meaningful description of the PHI to be used or disclosed;

- The name of the person, class of persons, or organization that will be making the disclosure of PHI;
- The specific name or other identification of the person, class of persons, or organization to whom disclosure is made;
- A description of the purpose of the use or disclosure of PHI;
- An expiration date or an expiration event of the authorization that relates to the purpose of the use or disclosure;
- A statement that the patient has a right to revoke the authorization;
- The patient's or patient representative's signature and the date of signature;
- If the authorization is executed by a patient representative, a description of that person's authority to act for the individual; and
- A statement that the health care provider cannot condition treatment on whether the patient signs the authorization.

d. Staff at a health care provider might condition treatment on obtaining authorization in the following circumstances:
   - The patient is participating in research, and the authorization is sought in connection with that research; or
   - The patient has requested the health care provider staff to do an examination or provide other treatment, in order to disclose that information to a third party.

e. The original should be retained with important documents, but copies should be provided to the health care providers for their patient records.

***Note:***

The Privacy Rule requires that an Authorization contain either an **expiration date** or an **expiration event** that relates to the individual or the purpose of the use or disclosure. An Authorization remains valid until its expiration date or event, unless effectively revoked in writing by the individual before that date or event. The fact that the expiration date on an Authorization may exceed a time period established by State law does not invalidate the Authorization under the Privacy Rule, but a more restrictive State law would control how long the Authorization is effective. It should be reviewed periodically to ensure that the expiration date has not expired.

A physician does not need the patient's written authorization to send a copy of the patient's medical records to a specialist or other health care provider who may treat the patient. HIPAA permits a health care provider to disclose protected health information about an individual, without the individual's authorization, to another health care provider for that provider's treatment of the individual.

### *8. Durable medical power of attorney*

Everyone 18 or over needs a Medical/Health Care Durable Power of Attorney, because disability is more likely than death. That POA enables the principal to appoint a person as agent to make health care decisions on his or her behalf when the principal is unable to make them himself. This power only becomes effective when incapacitated, so the principal remains in complete control until then. It is valid until it is revoked, but it should be renewed every five years to update the document to keep the information current, such as when the phone numbers of the agents change. Copies should be given to the principal’s doctors and hospitals. The Durable General Power of Attorney becomes effective immediately and deals with property management issues. The Medical Power of Attorney is not effective until needed and deals with health care issues.

a. The agent chosen must know the principal’s wishes and be capable of honoring them. The only way to ensure this is by discussing those wishes with the agents ahead of time.

***Note:***

By contrast, if the individual becomes incapacitated and doesn't have a medical POA, the court will have to appoint a guardian, which is expensive and time-consuming, to make those decisions. Treatment may be administered that runs contrary to the principal's religious beliefs or access may be denied to the type of treatment the principal wanted. Having a Durable Medical POA in place ensures there is a designated person authorized to make healthcare decisions promptly and efficiently, minimizing delays in critical situations.

b. Just because the principal has a Living Will does not mean there is no need for a Medical Power of Attorney for Health Care. The Living Will deals with terminal medical issues, while the Medical Power of Attorney deals with all other medical related issues. In addition, they are designed to work together to ensure that there is a document that a person in power will honor.

***Caution:***

Contrary to popular belief, a spouse **cannot** make these decisions without a power of attorney; only the principal can consent to or reject medical treatment, make contracts to pay, or sign waivers. These can only be done by the principal or his agent without going to court.

c. There should be at least two named agents; in that way the availability of any agent is more likely to be immediate than trying to locate the first named agent.

***Note:***

Individuals should not only tell their family about it but also carry a Wallet Information Card, in the event of an emergency, so whoever finds the individual or provides the individual with medical treatment will know that that individual has an agent, where the power is, and who to call.

d. If an individual becomes unable to make rational decisions, but is unable to realize that fact, the agent may petition the court to be appointed guardian for the purpose of having the legal authority to protect the principal and prevent those irrational decisions from being legally binding.

### *9. Durable mental health care power of attorney*

Durable Mental Health Care Power of Attorney gives instructions and preferences regarding mental health treatment. The advance instruction may include consent to or refusal of mental health treatment. "Mental health treatment" means the process of providing for the physical, emotional, psychological, and social needs of the principal for the principal's mental illness. Mental health treatment includes, but is not limited to, electroconvulsive treatment, treatment of mental illness with neuroleptic or other psychotropic medications, and admission to and retention in a facility for care or treatment of mental illness. Individuals should make the family and primary care doctors aware of their Durable Mental Health Care Power of Attorney and provide copies.

a. The decision about when a person is incapable of making mental health decisions for themselves can only be made by a licensed physician, psychiatrist, or psychologist who will evaluate whether the person can give informed consent.

b. The principal must sign the MHPA in the presence of at least two qualified witnesses who believe the principal to be of sound mind at the time of the signing. The signatures of the principal and the witnesses must be acknowledged before a notary public. A qualified witness is someone who personally knows the principal, and who is not:

- The attending physician or mental health treatment provider or an employee of the physician or mental health treatment provider;
- The owner, operator, or employee of an owner or operator of a health care facility in which the principal is a resident; or
- A person related to the principal or the principal's spouse.

c. An advance instruction becomes effective when it is signed, witnessed, and notarized. It remains in effect unless revoked by the principal.
   - The MHPA remains revocable for as long as the principal is able to give informed consent to mental health treatment. Such revocation is effective when the principal notifies his or her doctor that it is revoked. The principal may not choose whether the MHPA is revocable or irrevocable if he or she is unable to give informed consent to mental health treatment.
   - The doctor may rely upon an advance instruction in the absence of actual knowledge of its revocation or invalidity.

***Note:***

The principal's doctor must continue to obtain the principal's informed consent to all mental health treatment decisions when the principal is capable of providing informed consent or refusal. Instructions given by the principal while he or she is capable supersede the instructions written in the principal's advance instruction. The doctor must make the advance instruction part of the patient's medical record. The doctor must comply with it to the fullest extent possible, unless compliance is not consistent with:

- Generally accepted community practice standards of treatment to benefit the principal;
- Availability of the mental health treatments requested;
- Applicable law;
- Appropriate treatment in case of an emergency endangering life or health; or
- When the principal is involuntarily committed to a 24-hour facility and undergoing treatment as provided by law.

d. The health care agent may make decisions about mental health treatment on behalf of the principal only when the principal is incapable. The principal is incapable when the doctor or eligible psychologist determines that the principal currently lacks sufficient understanding or the capacity to make and communicate mental health treatment decisions.

e. A health care agent's decisions about mental health treatment must be consistent with any statements expressed in the principal's MHPA. If the principal does not have an advance instruction, the health care agent must make mental health decisions consistent with what the agent, in good faith, believes to be the wishes of the principal.

### *10. Living will*

**Everyone needs one because we live in a world of million-dollar miracle medical machines that are able to extend and maintain a life that some people would consider as not worth living**. A Living Will ensures that quality of life is not sacrificed in order to maximize quantity of life. It enables individuals to maintain control over their medical care and ensures their wishes are respected even if they are incapacitated or unable to communicate. The individual should give copies of the Living Will to all his doctors and carry the Wallet Information Card, so that anyone who finds or treats the individual will know of its existence and where it is stored.

a. The Living Will allows an individual to die with dignity on one's own terms. Without one, the individual and his family may have to endure the emotional and financial nightmares that ensue when one is lingering. A Living Will alleviates the burden of decision-making during emotionally challenging times. The Living Will allows someone to "pull the plug". If an individual lacks a Living Will, there is a court process that must be followed; the appointment of a special guardian. An individual will be kept alive until the court decides otherwise, as the bills grow and grow. No one will be able to make this decision without court approval.

b. The living will is designed to be valid indefinitely. It is enforceable until it is changed or revoked. However, some states limit the duration of the document and those who honor it will want a recently executed one, so the Living Will should be renewed periodically.

c. Copies should be given to all health care providers. The original should be kept in a safe place preferably in a fireproof safe, which is both safer than a safe deposit box and more accessible in emergencies and on weekends.

d. The living will differs from a Medical Power of Attorney in that the latter deals with regular medical care; and the living will deals with terminal medical care. It holds harmless all who assist in carrying out the individual's desires, from the surrogate to the doctors and hospital staff.

***Note:***

The principal sets the standards that must be met before the power to "pull the plug." These standards must be validated by multiple doctors. The Living Will clearly states what the individual means by "terminal with no chance of recovery." Some Living Wills recognize as many as six conditions warranting implementation of the Living Will: (i) brain damage; (ii) brain non-function; (iii) irreversibly dying; (iv) persistent vegetable state; (v) advanced Alzheimer's; and (vi) locked in a condition where the brain cannot communicate with the outside world.

e. As with a medical power of attorney, several agents should be named so that decisions can be made as soon as possible. This person must be strong enough to "pull the plug" when the time comes. This person may be faced with angry relatives who do not know or share the individual's beliefs and will need to be strong enough to honor those wishes over others. It is important to discuss these wishes on dying with dignity with the family, and also discuss them in detail with the agent(s). However, the decision will be made by the highest priority agent who is available.

## C. Joint tenancy

A joint tenancy is a useful but limited mechanism for providing management of property for an elderly person who becomes incapacitated. A joint tenancy is a single interest in real or personal property held by two or more persons under one instrument or act of the parties. Each joint tenant has a right of survivorship in the property, thereby causing the property to transfer outside the will of the first decedent. Many jurisdictions, however, no longer presume a right of survivorship, and, therefore, a written statement or agreement expressing an intent to create this right may be necessary.

### *1. Tax issues*

a. Income from jointly owned property is attributed in equal shares to the co-tenants, and therefore, each incurs income-tax liability for each co-tenant's share of the income.

b. At the first co-tenant's death, the entire value of the jointly held property is included in the decedent's gross estate, but this value will be reduced to the extent that the surviving

joint tenant had an original ownership interest in the property that was never transferred to the decedent for full consideration, or the surviving tenant made an original contribution to the cost of acquiring the property.[2] If the joint tenants are spouses, however, only one-half of the value of the asset is included in the estate of the first to die.[3]

c. The creation of a joint tenancy is also considered a gift to the co-tenant,[4] and therefore, the transfer when made may be subject to gift tax, less the annual exclusion and the marital deduction.

***Note:***

Jointly owned property with survivorship rights suffers the tax disadvantage of precluding estate planning through testamentary disposition, such as where a trust could serve a more effective purpose than individual ownership of the surviving joint tenant.

### *2. Limitations*

a. A joint tenancy has other limitations:
   - It covers only assets actually subject to the joint tenancy; and
   - It creates no obligation or power in the co-tenant to use the asset or its income for the benefit of the donor-tenant in the event of incapacity.

b. Neither the durable power of attorney nor the revocable living trust involves a transfer of ownership, and therefore, neither creates the risks or tax liability associated with a joint tenancy.

### *3. Joint tenancy with non-spouse*

Sometimes a widow(er) may wish to create a joint tenancy with a child. The practitioner should advise such a client of the potential consequences of this step:

- The co-tenant's creditors and ex-spouse might try to utilize the jointly held property to satisfy obligations of the co-tenant;
- The creation of the joint tenancy may result in a taxable gift for which a gift tax return must be filed (except for a joint bank account if the co-tenant does not withdraw funds from the account); and
- The joint tenancy with right of survivorship may unintentionally disinherit other heirs, while giving the co-tenant a windfall.

[2] I.R.C. §2040(a).
[3] I.R.C. §2040(b).
[4] I.R.C. §2502(a)(1).

***Planning point:***

If the client is in business, the risk of disability or incompetency should be addressed in a **buy-sell agreement** or a salary continuation agreement. In each case, the same issues regarding a definition of incompetency or disability are reached. Such an agreement should provide for: (i) the suspension of the incompetent's voting rights or managerial authority during the period of incapacity; and (ii) the curtailment of the right of the other principals to benefit themselves during a period of incompetency by suspending the other principals' right to declare bonuses, dividends, and/or salary increases.

As with many qualified plans, incompetency or disability can be an event that triggers a payment of benefits. A buy-sell agreement or employment agreement establishes the procedure for a buyout of the incompetent's interest in the business if the disability continues. Whether the buyout should be mandatory or optional in the event of a particular condition that prevents the client from performing functions within the business for a specified period of time depends on a host of factors germane to the business.

# *II. The importance of durable powers of attorney, health-care directives, and living wills*

## A. Durable powers of attorney

### *1. In general*

Durable powers of attorney are important estate-planning instruments. A power of attorney is a legal instrument that allows the grantor (the principal) to select an individual (the attorney-in-fact or agent) to perform certain acts on behalf of the grantor. A durable power of attorney means that the power does not terminate if the grantor becomes incapacitated, and is used specifically to permit the attorney-in-fact to take action on the grantor's behalf in financial, tax, estate planning, and/or personal matters after the grantor has lost capacity. A durable power is generally immediate, that is, it gives the attorney-in-fact the power to act on the principal's behalf as soon as the power is granted. Most states permit a **springing power of attorney** that will not permit the attorney-in-fact to act until the principal becomes incapacitated. Regardless of the type of power of attorney, it becomes ineffective at the grantor's death.

### *2. Importance*

A power of attorney is important for many reasons. **First,** there are always times when a person may need someone to perform a legal act on the person's behalf because that person cannot attend to the act. **Second,** because an individual is four times more likely to be disabled than killed, a durable power is an effective means to enable someone to manage the assets for a disabled person, particularly if the disabled person's SERVICE business needs to be sold quickly before others in the same service business begin to poach (steal) clients or patients, Those in a service business would be well advised to draft a letter to clients or patients BEFORE disability explaining that the service business is being sold, such letter to be released upon sale, recommending the buyer. This puts a heavy burden on the holder of the power to find a good buyer. Without a power, the family would have to go through the costly court process of having an administrator, conservator, or guardian appointed. **Third,** a power of attorney allows the family to carry on the estate-planning objectives of the principal. In order to achieve significant estate-tax savings, many families have instituted gifting programs to transfer wealth from older to younger generations. If a principal did not have a power of attorney, then the family could not carry on the gifting program should the principal become temporarily or permanently disabled. Note also that a durable power of attorney may also be an important estate-planning tool in community-property states. Should one of the spouses become incapacitated, a durable power held by the competent spouse allows for the

continued management, sale, investment, and so forth of community property in instances where the consent or signatures of both spouses is required.

### *3. Sample language from a durable power of attorney*

**POWER OF ATTORNEY**
**OF**
**JOHN Q. CLIENT**

I, **JOHN Q. CLIENT**, of 1 Anystreet, Anytown, Anystate (hereinafter the "Principal"), do hereby make, constitute, and appoint **JANE Q. CLIENT** my true and lawful attorney-in-fact (hereinafter my "Attorney") to act in, manage, and conduct all my estate and all my affairs, and for that purpose for me and in my behalf, and for my use and benefit, and as my act and deed, to do and execute all or any of the acts, deeds, and things as provided hereinafter. This power of attorney shall continue in force and may be accepted and relied upon by anyone to whom it is presented until actual written notice of revocation of this power of attorney or of my death. In the event of my legal disability from whatever cause, this power of attorney shall not thereby be revoked but shall thereupon become irrevocable, and may be accepted and relied upon by anyone to whom it is presented despite such legal disability.

**ARTICLE I.**

*GRANT OF POWERS*

Attorney is authorized in Attorney's absolute discretion with respect to my person and my property, real or personal, at any time owned or held by me and without authorization of any court to hold the following powers:

**A.** To buy, receive, lease, accept, or otherwise acquire; to sell, convey, mortgage, pledge, quitclaim, or otherwise encumber or dispose of; or to contract or agree for the acquisition, disposal, or encumbrance of; any property whatsoever or any custody, possession, interest, or right therein, upon such terms as my said attorney shall think proper;

**B.** To make, endorse, accept, receive, sign, seal, execute, acknowledge, and deliver deeds, assignments, agreements, certificates, endorsements, hypothecations, checks, notes, mortgages, vouchers, receipts, consents, waivers, releases, undertakings, satisfactions, acknowledgments, and such other documents or instruments in writing of whatever kind and nature as may be necessary, convenient, or proper in the premises;

**C.** To make, do, and transact all and every kind of business of whatever nature or kind whatsoever, including the receipt, recovery, collection, payment, compromise, settlement, and adjustment of all accounts, legacies, bequests, devises, interests, dividends, annuities, demands, debts, taxes, and obligations, which may now or hereafter be due, owing, or payable by me or to me;

**D.** To deposit and withdraw for the purposes hereof, in either my Attorney's name or my name or jointly, in or from any banking institution, any funds that may come into my said Attorney's hands, which I now or hereafter may have on deposit, including full power to make deposits to and withdrawals from any checking account or savings account in my name in any financial institution;

**E.** To sign checks or otherwise make withdrawals from any checking or savings account in my name, and to endorse checks payable to me and receive the proceeds thereof in cash or otherwise; to open and close checking or savings accounts in my name, purchase and redeem savings certificates, certificates of deposit, or similar instruments in my name, and to execute and deliver receipts for any funds withdrawn or certificates redeemed; and to do all acts regarding any checking account, savings account, savings certificate, certificate of deposit, or similar instrument, which I now have or may hereafter acquire, the same as I could do if personally present;

**F.** To enter and examine the contents of my safe deposit boxes wheresoever located, and to remove the contents thereof, to make deposits therein, to terminate the use of any such safe-deposit box, or to open new safe-deposit boxes, and to transfer contents among such safe-deposit boxes;

**G.** To act as my Attorney or proxy in respect to any stocks, shares, bonds, or other securities or investments, rights, or interests I may now or hereafter hold, including the power to vote in person or by proxy at any meeting, to join in any merger, reorganization, voting-trust plan, or other concerted action of security holders, to make payments in connection therewith, and in general to exercise all rights of a security holder;

**H.** To make gifts to any one or more of the following persons or classes of persons listed below, each such gift to be not in excess of that amount which in the aggregate for that calendar year will qualify for the maximum amount allowable for the annual exclusion for federal gift-tax purposes under the provisions of the Internal Revenue Code §2503(b) or successor provision then in effect, provided that each such gift is made in a manner that will qualify for such annual exclusion; my Attorney may make such gifts in unequal amount and need not include all possible permissible donees as recipients of gifts in any one year:

(list names of potential donees);

**I.** To change the designated beneficiary on any and all of my life insurance policies, to effect loans on such policies either from the company issuing such policy or from other lending institutions by pledging such policies as security for such borrowing, to transfer by absolute assignment any and all of my incidents of ownership to any and all of such policies, and to exercise any other right vested in me as policy owner;

**J.** To create a Trust for my benefit designating one or more persons (including my Attorney) as original or successor trustees and to transfer to the trust any or all property owned by me, provided that the income and principal of such trust shall either be distributable to me or to the guardian of my estate, or be applied for my benefit or the benefit of my spouse and issue, and upon my death any remaining balance of principal and income of the trust shall be distributed to my estate; to revoke or amend any living revocable trust created by me or my Attorney, in whole or in part, provided that any such amendment by my Attorney shall not include any provision that could not be included in the original Trust;

**K.** To withdraw and receive the income or principal of a trust; to demand, withdraw, and receive the income or corpus of any trust over which I have the power to make withdrawals; to request and receive the income or principal of any trust with respect to which the trustee thereof has the discretionary power to make distribution to me or on my behalf;

**L.** To deal with all retirement plans of which I am a member including individual retirement accounts, rollovers, and voluntary contributions and make any and all elections including, but not limited to, the selection of designated beneficiaries and determination of minimum distribution choices;

**M.** To prepare, sign, and file joint or separate income tax returns for any year or years including, but not limited to, IRS Forms 1040, 1040A, and 2848 or the equivalents for all tax years for which this power of attorney is in effect; to prepare, sign, and file gift tax returns with respect to gifts made by me or by my Attorney hereunder; to consent to any gift or utilize any gift-splitting provisions or other tax election for the benefit of donees to whom I have regularly made monetary or other gifts in the past, as evidenced by earlier gift tax returns or canceled checks and to represent me in all tax matters;

**N.** To claim an elective share of the estate of my deceased spouse to the same extent as I personally could do under the provisions of the statute of my domiciliary state related to elective shares;

**O.** To disclaim any interest in property to the same extent as I personally could do under the provisions of the statute of my domiciliary state related to disclaimers of property;

**P.** To procure, alter, extend, or cancel insurance against any and all risks affecting property and persons, and against liability, damage, or claim of any sort;

**Q.** To borrow money and to encumber, mortgage, or pledge any and all of my property;

**R.** To deal with Attorney in Attorney's individual or any fiduciary capacity, in buying and selling assets, in lending and borrowing money, and in all other transactions, irrespective of the occupancy by the same person of dual positions;

**S.** To engage and dismiss agents, counsel, and employees;

**T.** To enter into, perform, modify, extend, cancel, enforce, or otherwise act with respect to any contract of any sort whatsoever;

**U.** To apply for a Certificate of Title upon, and endorse and transfer title thereto, for any automobile, truck, pickup truck, van, or other motor vehicle, and to represent in such transfer or assignment that the title to said motor vehicle is free and clear of all liens and encumbrances;

**V.** To acquire, purchase, exchange, and sell and convey real or personal property, tangible or intangible, or interest therein, on such terms and conditions as my Attorney shall deem proper;

**W.** To arrange for my entrance to any hospital, nursing home, health center, convalescent home, residential care facility, hospice, or similar institution, to form any contracts necessary to facilitate my entrance and to authorize medical, therapeutic, and surgical procedures for me, and to pay all bills in connection therewith;

**X.** To make transfers to my spouse residing in the community, even if my spouse is my Attorney, which are necessary to provide my spouse with the assets equal to the Spousal Resource Allowance as provided by Title XIX of the Social Security Act, §§1924(1) and (2), as amended, if I should reside in a convalescent home or similar facility; and

**Y.** In addition to the foregoing, my Attorney may act as my alter ego with respect to any and all possible matters and affairs not otherwise enumerated herein and that I as principal can do through an agent.

**ARTICLE II.**

*GOVERNING LAW*

This power of attorney is to be construed and interpreted as a general durable power of attorney. The enumeration of specific powers herein is not intended to, nor does it, limit or restrict the general powers herein granted to my Attorney. This instrument is executed and delivered in the State of Anystate and the laws of the State of Anystate shall govern all questions as to the validity of this power and the construction of its provisions.

**ARTICLE IV.**

*RELIANCE BY THIRD PARTIES*

I hereby declare that any act or thing lawfully done hereunder by my Attorney shall be binding on myself, and my heirs, legal and personal representatives, and assigns. No person or entity who relies in good faith upon the representations of my Attorney as to all matters pertaining to any power granted herein, and no person or entity who may act in reliance upon the representations of my Attorney shall incur any liability to me, my estate, my heirs, or assigns as a result of permitting my Attorney to exercise any power.

***Question to ponder:***

For both powers of attorney and living wills, state-specific forms are often the only acceptable forms. Has anyone been in a situation where a bank refused a power of attorney?

## B. Living wills and advance health-care directives

### *1. A brief history*

A living will or advance health-care directive is an important personal estate-planning instrument. Many people have strong opinions about whether they want to receive life-sustaining treatment in the event of an accident. History is replete with agonizing examples of people who were strapped to machines for long periods of time with little chance of ever recovering. Once a person is on one of these machines, the law generally prohibits doctors from removing the machines without costly court intervention. A living will or advance health-care directive is meant to bridge the gap between our often-reserved opinions about these matters and the court's unwillingness to remove the treatment once in place.

### *2. Legal significance*

These instruments allow the declarant-principal (declarant) to express views about the treatment and then appoint someone (a surrogate, attorney-in-fact, or health-care representative) to make these decisions for the declarant. The representative, however, only has power to act when the declarant-principal is unable to make the decision for the declarant and is: (i) in a permanent state of unconsciousness; or (ii) terminally ill.

### *3. Sample advance health-care directive and medical power of attorney*

ADVANCE HEALTH-CARE DECLARATION

I, **JOHN Q. CLIENT**, being of sound mind, willfully and voluntarily make this declaration to be followed if I become incompetent. This declaration reflects my firm and settled commitment to refuse life-sustaining treatment under the circumstances indicated below.

I direct my attending physician to withhold or withdraw life-sustaining treatment that serves only to prolong the process of my dying, if I should be in a terminal condition or in a state of permanent unconsciousness.

I direct that treatment be limited to measures to keep me comfortable and to relieve pain, including any pain that might occur by withholding or withdrawing life-sustaining treatment.

In addition, if I am in the condition described above, I feel especially strongly about the following forms of treatment:

| I do | I do not | |
|---|---|---|
| ( ) | ( ) | want cardiac resuscitation. |
| ( ) | ( ) | want mechanical respiration. |
| ( ) | ( ) | want tube feeding or any other artificial or invasive form of nutrition (food) or hydration (water). |
| ( ) | ( ) | want blood or blood products. |
| ( ) | ( ) | want any form of surgery or invasive diagnostic test. |
| ( ) | ( ) | want kidney dialysis. |
| ( ) | ( ) | want antibiotics. |

I realize that if I do not specifically indicate my preference regarding any of the forms of treatment listed above, I may receive that form of treatment.

I designate **JANE Q. CLIENT** as my surrogate to make medical-treatment decisions for me if I should be incompetent and in a terminal condition or in a state of permanent unconsciousness.

#### *4. Sample living will*

*LIVING WILL DECLARATION*
**OF**
**JOHN Q. CLIENT**

I, **JOHN Q. CLIENT**, residing at 1 Anystreet, Anytown, Anystate, do hereby voluntarily make the following declaration of my wishes, intending that this declaration shall be adhered to by my family, attending physicians, and all others who may be concerned, unless it shall be revoked by me, in writing, in the future:

If at any time I should have an injury, disease, or illness (whether physical or mental) that renders me in a terminal condition or in a state of permanent unconsciousness and I cannot express decisions regarding my treatment, and which without life-sustaining procedures, would within reasonable medical judgment lead to my death, then I direct that there not be instituted or continued any life-sustaining procedure, except as hereinafter provided, involving mechanical or other artificial means to sustain, restore, or supplant any vital function in order only to prolong my life artificially. In the event any such procedure or intervention has been commenced, I authorize its discontinuance and withdrawal.

Life-sustaining procedure as used herein shall not include: (i) the administration of medication or the performance of any medical procedure deemed necessary to alleviate pain; (ii) procedures for the administration of food and water; (iii) insertion of a cardiac pacemaker; (iv) temporary cardiopulmonary resuscitation, unless I am already in an otherwise terminal condition; and (v) receipt of an organ transplant only if there is a reasonable chance of restoring me to a comfortable and functional existence.

I intend that this directive remain effective until revoked by me by revocation endorsed hereon or by my destruction of this document. I further intend that this document be effective without having been made a part of my medical records or delivery to my physician or any similar restriction on effectiveness as may be provided in any applicable statute.

Should I become incompetent or physically incapable of communication, I authorize my surrogate, **JANE Q. CLIENT**, to make treatment decisions on my behalf to follow and interpret this Living Will Declaration.

This declaration shall remain in force and effect notwithstanding my subsequent incompetence or other incapacity or inability to alter or revoke it.

# *III. Reasons for having a revocable trust*

## A. Revocable trust

#### *1. Learning the client's needs*

Like other estate-planning tools, there are many reasons to use a revocable trust and many reasons not to use a revocable trust. The estate-planning team must fully understand the client's needs and desires before recommending and implementing a revocable trust.

#### *2. Defining a revocable trust*

A revocable trust is simply a trust that may be terminated by the grantor or another person, as directed by the terms of the trust. Additionally, the trust may allow the grantor to revoke the entire trust or a portion of the trust.

***Example:*** The Grantor, during his life, may at any time revoke this Trust or alter or amend any of the Trust provisions. Any amendment may be revoked, canceled, or further amended. If the Grantor is incompetent, such power to revoke, alter, or amend the Trust may be exercised by the Guardian or Conservator at the direction of a court of competent jurisdiction, or by an attorney-in-fact of the Grantor under a specific power to revoke or amend this Trust.

## B. Revocable living trust

### *1. In general*

A revocable living trust is a trust created by a competent grantor during the grantor's lifetime, which may be amended or revoked by the grantor at any time or at the end of a designated period. The trust may be funded at the time of its creation by transfer of assets to it, or it may remain unfunded until the occurrence of some event, such as the grantor's incapacity. Elderly persons fearing possible incapacity may find this trust a useful instrument for allowing them to retain control over their affairs while competent, yet providing management of their assets if they become incapacitated. The trust may also permit them to avoid probate after death, and to continue management of their property after their death.
The revocable living trust serves several purposes:

- Avoiding probate, guardianship and conservatorship proceedings;
- Controlling disposition of assets upon death; and
- Providing for beneficiaries.

***Note:***

Such arrangements do **not** provide asset protection for the assets transferred to the trust.

a. The original should be kept with other important legal documents. The trust is effective when it is signed and continues working for generations to come. It provides benefits to the individual, spouse, parents, children, grandchildren and any other beneficiary named in the instrument.

b. It eliminates probate proceedings upon death, disability, and disappearance. Also, it eliminates some state taxes.

c. Attractions.

(i) **What is most attractive to clients is that the clients are not really giving away property with a revocable trust.** During life, a client can simply revoke the trust at any time and regain ownership of the assets. Less than revocation, the settlor of a revocable trust can generally amend the trust at will. As a trust, it protects the property from falling directly into the hands of beneficiaries (or their creditors).

(ii) Another attraction is that in general, the initial trustee is the client himself. The successor trustee or trustees should be persons sophisticated enough to handle the responsibility.

(iii) An additional advantage – and a strong reason to avoid probate – is that the courts are not involved with a trust created in the lifetime of the settlor; this is not the case for trusts created under a will, which are subject to judicial review, and this can entail for such a trust annual accountings and required court approval when dealing with the assets. Assets that are not in the trust are subject to probate. Only these assets not in the trust are considered in determining probate

fees. With a pour-over Will, all assets not in trust will go to the Trust after probate.

(iv) It can provide spendthrift provisions and a discretionary distribution scheme that can serve to protect a beneficiary from his own recklessness, from a bankruptcy proceeding, or from equitable distribution in a divorce action. By requiring discretionary payments, waiting out an exposed period is easy.

(v) In a state that does not authorize a springing power (one taking effect upon the principal's incapacity), the grantor who creates a revocable living trust can fashion it to function like a springing power by requiring the trustee, prior to possible incapacity of the grantor, to obtain the grantor's approval for certain types of transactions. The trust may also continue in existence after the grantor's death and be used to distribute assets, unlike a power of attorney, which ceases at death.

(vi) The revocable trust also avoids many of the problems associated with a conservatorship, which may require court authority to purchase or sell assets. Court accountings are required, and an individual conservator is usually required to post a bond. A trust, on the other hand, avoids court supervision.

***2. Uses***

a. The trust arrangement can take several forms:

(i) Funded trust with full powers to grantor until disability or death, then to successor trustee;

(ii) Funded trust with grantor powers shared with co-trustee until grantor's disability or death, then full power granted to the co-trustee;

(iii) Funded trust with the grantor reserving no powers except revocation. The trustee has authority to pay or apply income and principal for the benefit of the grantor or other beneficiaries who depend upon the grantor for support; and

(iv) Unfunded trust with power of attorney authorizing funding.

b. Initial funding of the trust may be nominal. **Provision should be made for the trust to receive a "pour over" of the grantor's assets at the onset of disability or upon death**. A transfer upon disability is accomplished through a durable power of attorney executed at the creation of the trust. The agent, who should not be a trustee, is directed, upon the incapacity of the grantor-principal, to transfer all of the grantor's assets to the trustee or successor trustee for inclusion in the trust. At this point, the trust becomes irrevocable, at least during the incapacity of the grantor.

c. The trust must be coordinated with the grantor's will as to assignment of responsibility for distribution of the grantor's assets at the grantor's death. Generally, all of the decedent's estate or the residue of the decedent's estate pours over into the trust at the grantor's death. In this case, the trust should contain provisions similar to those typically put in a will, such as specific bequests and a maximum marital deduction. In some states, this arrangement permits a speedier disposition of the estate after death than probate does, saves probate costs, and offers more privacy than a will.

d. The powers of the trustee should vary with the grantor's status. Prior to incapacity, all dispositions of income and assets are subject to the grantor's approval or are made directly to the grantor. If disability occurs, any powers the grantor may have previously enjoyed should expressly terminate. At that point, the grantor and the grantor's dependents will become the primary beneficiaries of the trust, although other

 

beneficiaries may be named as well. The trustee should be given broad discretion to make payments of income or principal to the beneficiaries.

### *3. Tax consequences*

a. Trusts created to pay income to the grantor are basically disregarded as an entity for purposes of the federal income tax.[5] Therefore, the grantor incurs federal income-tax liability for all income earned by the trust, regardless of whether or not the grantor is incapacitated.

b. The grantor is also liable for estate tax on the trust's assets at the grantor's death.[6] The trust corpus is includable in the grantor's gross estate because a completed gift was never made and the grantor retained the right to revoke the trust.

c. There is no gift-tax liability incurred by the mere creation of the revocable trust, since it is not a completed gift. However, if the grantor becomes incapacitated and the trust becomes irrevocable, a completed transfer occurs at that time and gift-tax liability arises, even though the grantor still has an interest in the property.[7] A transfer is not considered a completed gift where the grantor retains some power over the disposition of the trust assets,[8] such as a testamentary power of appointment over the distribution of the trust principal following death.[9]

## C. Avoidance of probate

### *1. Purpose of probate and property subject to probate*

a. **Purpose of probate** -- Probate is a court proceeding to clear title to property passing from the decedent to those beneficiaries named in the decedent's will or entitled to take under the laws of intestacy. The probate process ends with a decree of distribution that evidences the recipient's title to the property normally free and clear of creditors' claims.

b. **Property subject to probate** -- Assets owned by the decedent are subject to probate. For example, bank accounts, stocks, bonds, cash, cars, real estate, and other assets in the decedent's name alone are subject to probate. If the title in the property vests by law in another person at the decedent's death, then the asset is not a probate asset. For example, life insurance, retirement plans, and property held as joint tenants with right of survivorship are assets that vest in someone else at the decedent's death and are nonprobate assets.

### *2. Dispelling the myth about probate and taxation*

**Many clients believe that probate and federal estate taxation are one and the same. This is perhaps the most popular misconception in estate planning. Whether an asset is or is not subject to probate has no bearing on whether the asset is subject to federal estate taxes.**

***Marketing opportunity:***

This misconception is a great way to open the door to estate planning with your clients. Send a letter to all of your clients that says, "Avoiding probate may be a great strategy, but it does not avoid Big Brother. However, I can tell you how." Clients will leap at the opportunity to avoid Big

5 I.R.C. §§671 and 677.
6 I.R.C. §§2036(a) and 2038(a)(1).
7 I.R.C. §2511(a).
8 Treas. Regs. §25.2511-2(b).
9 Rev. Rul. 54-342, 1954-2 C.B. 315.

Brother, particularly since many of these clients have joint assets only because they thought it avoided taxes.

### *3. Advantages and disadvantages of probate*

Professionals have made a living off of books and seminars on how to avoid probate. However, most of these books and seminars were written before the modernization of the probate code in many states and before competition began to affect estate administration fees.

a. **Advantages of probate.**

(i) **Court protection** -- One of the major nontax benefits of probate is court supervision. Beneficiaries are protected through court supervision because the court will make certain that the assets are distributed in accordance with the will. In most states, the executor must file an accounting of receipts and disbursements before the executor is discharged of personal liability. Creditors of the decedent are discharged by the probate process but not when the decedent's assets are governed by an inter vivos trust.

(ii) **Funding vehicle for tax purposes** -- A common estate-planning technique to avoid estate taxes involves the creation of a testamentary trust that is funded from probate assets that pass through the will. Thus, if all of the decedent's assets pass outside the will (i.e., nonprobate property), then tax savings may not be achieved. However, the same strategy could be implemented during life with a revocable or living trust and probate could be avoided, but such a trust can be complicated and costly.

b. **Disadvantages of probate.**

(i) **Delay** -- Probate is often criticized for the length of time it takes to administer the estate. Many states have attempted to modernize their probate code to speed up the process. Joint tenancy is still the fastest method of transferring property at death because once the tax clearances (if any) are obtained, the property can be transferred to the beneficiary. Practitioners must remember that some of the time involved in the estate process is a result of federal estate and state inheritance tax returns that are required whether the assets are probate or nonprobate.

(ii) **Cost** -- Critics of the probate process often cite the extreme cost of probating an estate. These critics argue that the executor and attorney are each entitled to a fee as high as five percent of the probate assets! However, in today's world of competition, these fees are more the result of poor hiring by the family. If the family had "bid" the job to several attorneys, no estate would ever be subject to a fee of five percent. Furthermore, estate and inheritance tax returns must be filed, regardless of the nature of the assets. Thus, a "base" fee will be common to both probate and nonprobate estates.

(iii) **Publicity** -- Another often-referenced disadvantage of probate estates is the loss of privacy. Since all probate estates are part of the public record, everyone can discover the assets a person owns at death. However, unless your client is John Kennedy or Jackie Kennedy Onassis, few people will go to the courthouse to discover what your client owned at death (but they might use the Internet in some states).

(iv) **Family psychology** -- Since the administration process is still somewhat time-consuming, the family will be reminded of the experience of losing a family member for a longer period of time.

### *4. Methods of avoiding probate*

There are at least three ways to avoid probate.

a. **Joint tenancy** -- Joint tenancy with right of survivorship is the easiest way to avoid probate. A joint tenancy is a property interest owned by two or more persons in equal shares where legal ownership vests in the surviving tenants by operation of law upon the death of a tenant. A joint tenancy may be referred to as joint tenants, joint tenants with right of survivorship, or tenants by the entirety (only where joint tenants are husband and wife alone).

(i) The creation of a joint interest is different from state to state, but generally involves a transfer to two or more persons or one person conveying to himself and another. The creation of a joint interest involves the application of law and tax advisors should consult an attorney familiar with applicable local law.

(ii) The tax characteristics of joint tenancies must be considered.

b. **By contract** -- Assets that are payable to another upon the death of the creator of the contract are not subject to probate. Common examples are life insurance, qualified and nonqualified retirement plans, partnership interests that, by the terms of the partnership agreement, pass to a named successor in interest, and payable-on-death accounts. All of these assets are easy to create, and the beneficiary will have near-immediate enjoyment of the property after death. Note, however, that property payable by contract beneficiary designation may wind up in the probate estate inadvertently. If the beneficiary designation becomes ineffective (for example, the beneficiary predeceases the grantor and no successor was named), the property may be payable to the estate. The treatment of this default transfer and its effect on probate will vary from state to state.

c. **Funded revocable (or living) trust** -- A properly drafted and funded revocable trust is the best way to avoid probate. However, the revocable trust is a complex legal document that can be expensive to create. A grantor creates the trust with the assistance of counsel and once executed, the grantor will fund the trust by transferring assets into the trust. Since the trust is funded during the grantor's lifetime, the trust, and not the grantor's will, controls disposition of the assets at death.

## D. Funded revocable or living trust

### *1. In general*

a. **Structure** -- The funded revocable trust is a method for the estate owner to avoid probate and still retain maximum flexibility in disposing of the estate. An individual (the grantor) creates a revocable trust, transfers assets to the trust, and reserves to the grantor during the grantor's lifetime all of the beneficial rights in the trust, including the right to revoke the trust. The trust becomes irrevocable on the grantor's incapacity or death. The trust assets are administered and distributed in accordance with the provisions of the trust. A revocable trust should be drafted with the assistance of counsel. A typical trust contains a number of provisions, including the following:

(i) Provision for naming the trustee of the trust. The trustee is responsible for investing the trust assets, distributing the trust assets to the beneficiary of the

 

trust, usually the grantor, and administering the trust. The grantor often serves as the initial trustee (known as a self-directed revocable trust). If or when the grantor becomes incapacitated or dies, a successor trustee will take over.

(ii) Provision identifying the trust beneficiaries, includes the grantor and the grantor's family.

(iii) Provision describing powers over trust assets. These powers are usually very broad, permitting the trustee power to invest trust property in all types of investments.

(iv) Provision stating that the grantor has the power to revoke, alter, amend, or terminate the trust prior to the grantor's death or incapacity. In most states, a trust agreement is irrevocable unless it specifically states that it is revocable. However, in some states, a trust agreement is revocable unless stated to the contrary.

(v) Provision stating that the income-tax burden of the trust shall be borne by the grantor. A revocable trust is a grantor trust for income-tax purposes, and accordingly all of the income will be reported by the grantor.

(vi) Provision for the payment of estate administrative expenses at death or other succession taxes from the trust estate at the grantor's death.

b. **Advantages** -- A funded revocable trust has two advantages over a will.

(i) All assets placed into the trust during the grantor's lifetime avoid probate at the grantor's death. However, the assets must be transferred into the trust during the grantor's lifetime in order to avoid probate.

(ii) The trust will control the assets in the event that the grantor becomes incapacitated. A revocable trust is superior to a durable power of attorney in controlling the assets of an incapacitated person because the trust document provides broader powers over the assets than a durable power of attorney. First, the law of trusts is far more developed and clearer than is that for a durable power of attorney. Second, because the trustee is the legal owner of the assets, a revocable trust does not encounter the resistance that is encountered when dealing with a power of attorney; the most notorious example of the latter has occurred when banks have looked at a perfectly legal power of attorney but balked at accepting anything other than their own form. Although this has abated somewhat, thanks to the legal community's efforts to gain industry acceptance through uniform language, on a practical level, this kind of consideration remains active.

### *2. Typical uses*

A funded revocable trust has several significant uses.

a. **Avoidance of probate** -- A funded revocable trust is the best technique for avoiding probate because the grantor has maximum control over how the assets will be disposed of at the grantor's death. Thus, the slow, often-costly process of probate can be avoided, particularly ancillary probate proceedings. The grantor will still need a last will and testament in order to transfer assets that are not in the trust. This will (known as a pour-over will) transfers all other property into the revocable trust at the grantor's death.

b. **Lifetime management** -- A revocable trust ensures that assets are managed during the grantor's lifetime. This is extremely important if the grantor is incapacitated and cannot manage the trust assets on his own.

c. **Privacy** -- All assets in a revocable trust avoid publicity because they are not part of the probate estate.

d. **Elective share** -- A revocable trust may be an effective technique for avoiding elective share rights of the surviving spouse or children, including illegitimate children.[10] If the surviving spouse or children are left out of the will or given a small inheritance, they may claim elective rights against the will. A revocable trust may be a means of avoiding the elective share. However, the Uniform Probate Code, in many jurisdictions, would subject the revocable trust assets to the spouse's elective rights.

e. **Will contests** -- The revocable trust may be less vulnerable to attack than a will because the trust will have been in existence before the grantor's death.

### *3. During life of grantor*

The revocable trust provides lifetime management of the trust estate during the grantor's lifetime. As a result, the grantor can ensure competent management through qualified professionals and avoid lifetime problems associated with a mental or physical disability. If the grantor does not transfer all of the grantor's assets to the trust, the grantor may need a durable power of attorney authorizing the attorney-in-fact to transfer those assets into the trust in the event of the grantor's incapacity. The grantor will receive all of the income from the trust assets and will be taxed on the income just as if the grantor held the assets in the grantor's own name.

### *4. After death of grantor*

After the grantor's death, several procedures must be done in order to ensure efficient administration of the trust and its purposes.

a. **Trust assets** -- A funded revocable trust gives the trustee the ability to buy, sell, or distribute trust assets much sooner than if the assets were subject to probate proceedings.

b. **Successor trustee** -- If the grantor was the trustee during the grantor's lifetime, a successor trustee must accept appointment. Ordinarily, the transfer of authority will require proof that the successor trustee is the trustee, such as a death certificate and a certified copy of the trust. These documents will be important for dealings with third parties, such as transfer agents and brokers.

c. **Tax releases** -- The trustee must obtain tax releases before the trustee can exercise any rights over trust assets. Some states impose an automatic tax lien upon the grantor's death. In such a case, the assets cannot be sold or distributed until the tax release is obtained.

d. **Creditors' claims** -- Probate assets are ordinarily subject to the claims of the decedent's creditors. The creditor has a specific period of time to collect against the estate or the right is lost forever. Whether assets in a revocable trust are subject to the claims of creditors depends on state law; though all states apparently permit claims where the settlor retains a beneficial interest in the trust, the mere power of revocation in itself is not always enough.[11] Some states, such as California, specifically direct that assets in a revocable trust be subject to creditors' claims.

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[10] See, e.g., Arkansas, Connecticut, Illinois, Indiana, Kentucky, Maryland, Michigan, and Ohio.

[11] New Jersey, for example, requires the trust to have been created in fraud of creditors in order for the creditors to force the exercise of the power of revocation. Massachusetts also does not execute the power if the settlor was not insolvent at the time the trust is funded.

## E. Transferring the assets to the revocable trust

### *1. Explaining the effect of the transfer to the grantor*

An important aspect of establishing the revocable trust is explaining to the grantor the effect of transferring assets into the revocable trust. Clients must understand that the trust is a separate jural entity and that if assets are not transferred to the trust, the trust DOES NOT OWN THEM. The grantor must understand not only the specific effect of transferring each individual asset but also the general effect of transferring assets to a revocable trust. The professional should explain the difference between legal ownership and equitable ownership.

a. **Legal ownership** -- The property interest that is enforceable in a court of law.

b. **Equitable ownership** -- The interest a person has when the person receives the benefit of a property.

Normally, a person who purchases an asset has both the legal and equitable ownership. The ownership, however, is divided into legal and equitable ownership when the asset is transferred into a trust. Once in a trust, the trustee has the legal ownership of the transferred asset and the beneficiary of the trust has equitable ownership. This separation of ownership is extremely important in recognizing the fiduciary relationship that exists between the trustee and the beneficiary.

### *2. How to transfer the assets*

a. **Stock transfers** -- **In transferring ownership of stock to a trust, it is helpful to send a letter to a broker delineating the change in ownership.** The broker may also require a copy of the trust document, or copies of specific parts of the trust instrument. These parts include the provisions identifying the original grantor of the trust, the trustees, successor trustees, and the notarized affidavit of the trust.

***Example:*** I represent Mr. and Mrs. John Smith, who executed a revocable trust with themselves as co-trustees. Their account number with your firm is #123456. In addition to this letter, I am enclosing the portions of the trust that I believe are necessary for you to transfer stock to the trust. These are the provisions identifying Mr. and Mrs. Smith as the grantor and the trustees and the notarized affidavit. Please contact me if any more information is required. We will contact you concerning which stock Mr. and Mrs. Smith wish to transfer to the trust.

In transferring stock of a closely held corporation, it is important to consult an attorney in order to identify any other potential state requirements. In addition, before transferring closely held stock, the professional should review any buy-sell agreements to determine whether the transfer is prohibited.

b. **Bond transfers** -- For publicly traded bonds, the grantor should follow the same procedures for stock transfers. If the bonds are bearer bonds, the grantor should attach a photocopy as an exhibit to the revocable trust.

c. **Promissory notes** -- If a promissory note is transferred, the grantor should fill out an assignment document, photocopy the note, and attach both as an appendix to the revocable trust. The assignment document should contain a description of the note and the names and addresses of the grantor and the trustees.

d. **Oil, gas, and mineral rights** – To transfer these rights, the grantor usually must fill in the trust information on the form that transferred the rights to the grantor. This does, however, vary from state to state and it is strongly recommended that the grantor follow the requirements proscribed by state law.

e. **Assets without formal documents** – To transfer these assets, the grantor should attach an assignment document that describes the assets in detail.

***Example of assignment document:***

We, John Smith and Jane Smith, do hereby sell, transfer, and assign, without consideration to:

John Smith and Jane Smith, Co-trustees
Under deed of trust dated March 1, 2023
For the benefit of Mr. John Smith and Mrs. Jane Smith, all right, title, and interest, which we have in the personal assets, more described as follows:
One gold ring, with diamond setting; One 1965 red Mustang; One antique clock
IN WITNESS WHEREOF, we have signed ____, _____, 2023.

f. **Assets with formal documents** -- The transfer of these assets depends on the type of assets and state law. Assets with formal documents include houses and cars.

g. **Bank accounts** -- The transfer of bank accounts requires the grantor to contact the bank. Before transferring assets like certificates of deposit or interest-bearing accounts, the professional must determine that there will be no loss of interest or assessment of penalties. If there will be penalties or a loss of interest, the client may be well advised to wait until the certificate of deposit matures before a transfer is made.

h. **Insurance beneficiaries** -- To make the trust the beneficiary of an insurance policy, the professional should inform the insurance company of the change through a letter and should complete a change-of-beneficiary form obtained from the insurance company. The professional need not transfer ownership of the policy into the trust, only make the trust a beneficiary.

### *3. Asset transfers*

a. **Due-on-sale clauses** -- One major concern in asset transfers centers on the transferring of real property subject to a mortgage where the mortgage contains a due-on-sale clause. Specifically, the Supreme Court and Congress have stated that a transfer of real property to a revocable trust is a sale for contract purposes. Thus, if a mortgage has a due-on-sale clause, then the transfer to the revocable trust would accelerate the mortgage requiring immediate full payment of the balance. However, if the beneficiary of the trust is the borrower and the occupant of the property, then there is no acceleration of the mortgage.[12] A transfer invoking a due-on-sale clause is not a sale for tax purposes.

b. **Transferring grant deeds** -- The professional should obtain a title report from a title company before transferring real property to a trust. The title report will disclose any defects in title. Once the property is transferred to the trust, the deed should be recorded in the Recorder of Deeds office to ensure clear title. The recording of the deed is necessary to maintain legal title and is necessary to allow the trust to transfer the property in the future.

[12] *Fidelity Federal Savings & Loan Assoc. v. Reginal de La Cuesta*, 468 U.S. 141 (1982); see also 12 CFR §591.5.

## SELECTED PROVISIONS OF A REVOCABLE LIVING TRUST

Section 1.04 Powers Reserved by Me as Grantor

During my lifetime, I shall retain the powers set forth in this Section in addition to any powers that I reserve in other provisions of this agreement.

(a) Action on Behalf of My Trust

During any period that I am serving as a Trustee of my trust, I may act for and conduct business on behalf of my trust without the consent of any other Trustee. During any period of time that my wife and I are serving together as Co-trustees, she may make all decisions and exercise all powers and discretions granted to my Trustee under this trust created under this agreement without the consent of any other Trustee.

(b) Amendment, Restatement or Revocation

I have the absolute right, at any time and from time to time, to amend, restate, or revoke any term or provision of this agreement in whole or in part. Any amendment, restatement, or revocation must be in a written instrument signed by me.

(c) Addition or Removal of Trust Property

I have the absolute right, at any time and from time to time, to add to the trust property and to remove any property from my trust.

(d) Control of Income and Principal Distributions

I have the absolute right to control the distribution of income and principal from my trust. My Trustee shall distribute to me, or to such persons or entities as I may direct, as much of the net income and principal of the trust property as I deem advisable. My Trustee may distribute trust income and principal to me or for my unrestricted use and benefit, even to the exhaustion of all trust property. Any undistributed income shall be added to the principal of my trust.

(e) Approval of Investment Decisions

I reserve the absolute right to review and change my Trustee's investment decisions; however, my Trustee shall not be required to seek my approval before making investment decisions.

Section 3.02 Trustee Succession During My Lifetime

During my lifetime, this Section shall govern the removal and replacement of my Trustees.

(a) Removal and Replacement by Me

I may remove any Trustee with or without cause at any time. If a Trustee is removed, resigns or cannot continue to serve for any reason, I may serve as sole Trustee, appoint a Trustee to serve with me or appoint a successor Trustee.

(b) During My Incapacity

During any time that I am incapacitated, my wife shall serve as my Trustee. If my wife is unable or unwilling to serve for any reason, then the following, in the order named, shall serve as my successor Trustee: Peter A. Client; and then Friendly State Bank and Trust Company.

If I am incapacitated, my wife, or if she is also incapacitated or deceased, the person appointed my guardian may remove any Trustee with or without cause.

If I am incapacitated and there is no named successor Trustee, my wife shall appoint an individual or corporate fiduciary to serve as my successor Trustee. If my wife is incapacitated or deceased, the person appointed my guardian shall appoint my successor Trustee.

All appointments, removals and revocations shall be by signed written instrument. Notice of removal shall be delivered to the Trustee being removed and shall be effective in accordance with the provisions of the notice.

Notice of appointment shall be delivered to and accepted by the successor Trustee and shall become effective at that time. A copy of the notice shall be attached to this agreement.

Section 3.03 Trustee Succession After My Death

After my death, this Section shall govern the removal and replacement of my Trustees.

(a) Successor Trustee

Upon my death, the following, in the order named, shall serve as my successor Trustee, replacing any then serving Trustee:

Cynthia M. Client; and then

Friendly State Bank and Trust Company.

(b) Appointment of Successor Trustees by My Wife

My wife may appoint the current or successor Trustees for any trust created under this agreement. She may amend or revoke any such appointment before the appointment becomes effective, but she may not do so after the appointment becomes effective, except as provided in subsection (c) of this Section 3.03. Any Trustee appointed by my wife to a trust of which she is a beneficiary must be an individual or corporate fiduciary that is not related or subordinate to my wife within the meaning of Section 672(c) of the Internal Revenue Code.

(c) Removal of a Trustee

My wife may remove a Trustee of any trust created under this agreement, with or without cause at any time. If my wife is unable to act, the primary beneficiary of any trust created under this agreement may remove a Trustee of the trust, with or without cause at any time.

A Trustee may be removed under this subsection only if, on or before the effective date of removal, the person or persons having the right of removal appoints an individual or a corporate fiduciary that simultaneously commences service as Trustee. The Trustee so appointed may not be related or subordinate to the person or persons having the right of removal within the meaning of Section 672(c) of the Internal Revenue Code.

Section 4.01 Trust Distributions During My Incapacity

During any period of time that I am incapacitated, my Trustee shall administer my trust and distribute its net income and principal as provided in this Section.

(a) Distributions for My Benefit

My Trustee shall regularly and conscientiously make appropriate distributions of trust income and principal for my general welfare and comfort under the circumstances existing at the time such distributions are made.

Distributions under this subsection shall include payments for any of my enforceable legal obligations. My Trustee may also make distributions for the payment of insurance premiums for insurance policies owned by me or by my trust, including but not limited to, life, medical, disability, property and casualty, errors and omissions and long-term health care insurance policies.

The examples included in this subsection are for purposes of illustration only and are not intended to limit the authority of my Trustee to make distributions for my benefit that my Trustee determines to be appropriate.

(b) Manner of Making Distributions

My Trustee may make distributions for my benefit in any one or more of
the following ways:

To me, but only to the extent I am able to manage such distributions;

To other persons and entities for my use and benefit;

To my agent or attorney-in-fact authorized to act for me under a legally valid durable power of attorney executed by me prior to my incapacity;

To my guardian or conservator who has assumed responsibility for me under any court order, decree or judgment issued by a court of competent jurisdiction.

(c) Distributions for the Benefit of My Wife or Dependents

My Trustee may distribute as much of the net income and principal of my trust as my Trustee deems necessary for the health, education, maintenance or support of my wife. My Trustee may also distribute as much of the net income and principal as my Trustee deems necessary for the health, education, maintenance or support of other persons that my Trustee determines to be dependent on me for support.

(d) Guidance for My Trustee Regarding Distributions

When making distributions under subsections (a) and (c), my Trustee shall give consideration first to my needs and the needs of my wife and then to the needs of those persons dependent on me. When making distributions under subsection (c), I request, but do not require, that my Trustee, in its sole and absolute discretion, consider other income and resources available to the beneficiaries. My Trustee may make unequal distributions, distributions to some but not all beneficiaries or no distributions.

A distribution made to a beneficiary under this Section shall not be considered an advance and shall not be charged against the share of the beneficiary that may be distributable under any other provision of this agreement.

(e) Power to Make Gifts

My Trustee is authorized to make gifts as provided in this subsection.

(1) Continuation of My Gifting

My Trustee is authorized to honor pledges and continue to make gifts to charitable organizations that I have regularly supported in the amounts I have customarily given. My Trustee may make gifts in order to assure the continuation of any gifting program initiated by me prior to the time I became incapacitated.

(2) Gifts Limited to the Annual Exclusion Amount

My Trustee may make gifts on my behalf, limited in amount to the federal annual gift tax exclusion amount, to or for the benefit of any remainder or contingent beneficiary named or described by class in this agreement for purposes my Trustee considers to be in my best interest or in the best interest of the beneficiary, including, without limitation, the minimization of income, estate, inheritance or gift taxes.

(3) Gifts in Excess of the Annual Exclusion Amount

Only an Independent Special Trustee appointed under the provisions herein may make gifts in excess of the annual federal gift tax exclusion.

If my Trustee determines that gifts in amounts in excess of the annual federal gift tax exclusion are in my best interest and the best interests of my beneficiaries, my Trustee, by unanimous vote if more than one Trustee is serving, shall appoint an Independent Special Trustee unrelated by blood or marriage to any Trustee to review the facts and circumstances and to decide whether such gifts should be made. I recommend, but do not require, that my Trustee select an independent certified public accountant, attorney, or corporate fiduciary to serve as the Independent Special Trustee under such circumstances. Neither my Trustee, nor the Independent Special Trustee appointed by my Trustee, shall be liable to any beneficiary for exercising or failing to exercise its discretion to make gifts.

(4) Gifts for Tuition

My Trustee may prepay the cost of tuition for any remainder or contingent beneficiary named in this agreement. My Trustee shall make such payments directly to the educational institution or by establishing and contributing to a Qualified State Tuition Program established under Section 529 of the Internal Revenue Code.

(5) Gifts for Medical Expenses

My Trustee may pay medical expenses for any remainder or contingent beneficiary named in this agreement as permitted under Section 2503(e) of the Internal Revenue Code. My Trustee shall make such payments directly to the medical provider.

(6) Gift Splitting Authorized
My Trustee is authorized to consent to the splitting of gifts under Section 2513 of the Internal Revenue Code or under similar provisions of any state or local gift tax laws.
(7) Gifts by Interested Trustees Limited to Ascertainable Standards
An Interested Trustee may only make gifts that are necessary for the health, education, maintenance or support of the person to whom gifts are made. The Trustee is not required to consider other income and resources available to the person to whom a gift is made.
(8) Methods of Making Gifts
My Trustee may make gifts of trust property under this subsection outright, in trust or in any other manner that my Trustee, in its sole and absolute discretion, deems appropriate.
By way of example and without limiting my Trustee's powers under this subsection, my Trustee is specifically authorized to make gifts by creating tenancy in common and joint tenancy interests or establishing irrevocable trusts including charitable or non-charitable split interest trusts. My Trustee may make gifts of trust property by establishing and contributing trust property to corporations, family limited partnerships, limited liability partnerships, limited liability companies or other similar entities and by making gifts of interests in any of those entities. To accomplish the objectives described in this subsection, my Trustee may establish and maintain financial accounts of all types and may execute, acknowledge, seal and deliver deeds, assignments, agreements, authorizations, checks and other instruments. My Trustee may prosecute, defend, submit to arbitration, settle or propose or accept a compromise with respect to a claim existing in favor of or against me based on or involving a gift transaction on my behalf and may intervene in any related action or proceeding.
My Trustee may perform any other act my Trustee considers necessary or desirable to complete a gift on my behalf in accordance with the provisions of this subsection.
(9) Standard for Making Gifts
It is my desire that in making gifts on my behalf, my Trustee consider the history of my gift making and my estate plan. To the extent reasonably possible, I direct my Trustee to avoid disrupting the dispositive provisions of my estate plan as established by me prior to my incapacity.

Section 5.01 My Trust Shall Become Irrevocable
Upon my death, my trust shall become irrevocable and my social security number may no longer be used to identify my trust. My Trustee shall apply for a separate taxpayer identification number for my trust.

Section 5.02 Administrative Trust
After my death and prior to the distribution of trust property as provided in the subsequent Articles of this agreement, my trust shall be an administrative trust but may continue to be known as the Thomas C. Client Living Trust. My administrative trust shall exist for a reasonable period of time necessary to complete the administrative tasks set forth in this Article.

Section 5.03 Payment of My Expenses and Taxes
My Trustee is authorized but not directed to pay from the administrative trust: Expenses of my last illness, funeral and burial or cremation, including expenses of memorials and memorial services; Legally enforceable claims against me or my estate; Expenses of administering my trust and my estate; and Court ordered allowances for those dependent upon me.
These authorized payments are discretionary with my Trustee. My Trustee may make decisions on these payments without regard to any limitation on payment of such expenses imposed by law and may make payments without obtaining the approval of any court. No third party may enforce any claim or right to payment against my trust by virtue of this discretionary authority. My Trustee shall not pay any

administrative expenses from assets passing to an organization that qualifies for the federal estate tax charitable deduction or to a split-interest charitable trust or from the net income of property qualifying for the estate tax marital deduction, if such payment would result in a reduction in the estate tax marital deduction available to my estate under Section 2056(b) of the Internal Revenue Code or violate the provisions of Treasury Regulation Section 20.2056(b)-4(d).
My Trustee shall pay death taxes out of the principal of the trust property as provided herein. If, however, a probate estate is opened within six months from the date of my death, my Personal Representative shall pay claims, expenses and death taxes from my probate estate to the extent that the cash and readily marketable assets included in my probate estate are sufficient to pay such items unless my Trustee has already paid them.

Section 6.01 Distribution of Tangible Personal Property by Memorandum
I reserve the right to make dispositions of items of tangible personal property by a signed written memorandum executed after I sign this agreement that refers to my trust and lists items of tangible personal property and designates the beneficiary of each item. If I execute a memorandum, the memorandum is to be incorporated by reference into this agreement to the extent permitted by law.
I direct that upon my death, my Trustee distribute the items of tangible personal property listed in the memorandum, together with any insurance policies covering the property and any claims under those policies, as provided in the memorandum. If I leave multiple written memoranda that conflict as to the disposition of any item of tangible personal property, the memorandum with the most recent date will control as to those items that are in conflict. If the memorandum cannot legally be incorporated by reference, the memorandum will be treated as an amendment to my trust. I request that my Trustee follow my wishes and distribute the items of tangible personal property listed in the memorandum according to its terms.

Section 6.02 Distribution of Remaining Tangible Personal Property
My Trustee will distribute any tangible personal property not disposed of by a written memorandum to my wife, if she survives me. If she does not survive me, my Trustee will distribute the property to my children but not to their descendants, in shares of substantially equal value, to be divided among my children as my children agree. If my Trustee determines that a child is incapable of acting in the child's own best interest, my Trustee will appoint a person to represent the child in the division of the property. If my children are unable to agree upon the division of the property within six months after my death, my Trustee will make the division according to the Trustee's discretion. My Trustee may use a lottery or rotation system or any other method of allocation to determine the order of selection and distribution of the property. As an alternative, my Trustee may sell all or any portion of the property and distribute the net proceeds equally among my living children. My Trustee will not incur any liability to any party for decisions made by my Trustee with respect to the division or sale of my tangible personal property. Any decision made by my Trustee will be final and binding on all beneficiaries.

Section 6.03 Definition of Tangible Personal Property
For purposes of this Article, the term "tangible personal property" includes but is not limited to my household furnishings, appliances and fixtures, works of art, motor vehicles, pictures, collectibles, personal wearing apparel and jewelry, books, sporting goods, and hobby paraphernalia. The term does not include any property that my Trustee, in its sole and absolute discretion, determines to be part of any business or business interest owned by me or my trust.

If my Trustee receives property to be distributed under this Article from my probate estate or in any other manner after my death, my Trustee will distribute the property in accordance with the terms of this Article. The fact that an item of tangible personal property was not received by my trust until after my death does not diminish the validity of the gift. If property to be distributed under this Article is not part of the trust property upon my death and is not subsequently transferred to my Trustee from my probate estate or in any other manner after my death, then the specific distribution of property made in this Article is null and void, without any legal or binding effect.

Section 6.04 Incidental Expenses and Encumbrances
Until property distributed in accordance with this Article is delivered to the appropriate beneficiary or to the beneficiary's legal representative, my Trustee will pay the reasonable expenses of securing, storing, insuring, packing, transporting, and otherwise caring for the property as an administration expense. Except as otherwise provided in my trust agreement, my Trustee will distribute property under this Article subject to all liens, security interests, and other encumbrances on the property.

Section 6.05 Residuary Distribution
Any tangible personal property not distributed under this or prior Articles of this agreement will be distributed as provided in the Articles that follow.

# Setting Realistic Retirement Goals


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# Setting Realistic Retirement Goals

## *Learning objectives*

After studying this chapter, the reader will be able to:

- Discuss the variables that must be considered when planning for retirement;
- Understand the three-legged stool approach to retirement planning.
- Understand the fourth leg of the three-legged stool – continued earnings.
- Identify the success factors in building a retirement nest egg and describe the key financial considerations affecting the amount one can accumulate over time;
- Discuss the research studies suggesting that investors may be overly optimistic and overconfident in their ability to save for retirement.

***Quotes on Realism***

Being in control of your life and having realistic expectations about your day-to-day challenges are the keys to stress management, which is perhaps the most important ingredient to living a happy, healthy and rewarding life. --- *Marilu Henner*

Set realistic goals, keep re-evaluating, and be consistent. --- *Venus Williams*

# *I. The road from here to retirement*

It is hard to get where you want to be if you don't know where you are. That is the definition of being lost. Once you know where you must determine where you want to go. Then you can decide the best way to get there.

## A. Where are they now?

The first step in retirement planning is to determine where the future retiree is now. This requires a detailed inventory of resources will include current resources, income, and other cash flows. It will also include current obligations, current lifestyle, health, and other factors.

***Important reminder***

The following discussion includes the possible compilation of financial statements. The practitioner should always abide by all appropriate Audit and Accounting Standards when issuing financial statements.

### *1. Prepare a current balance sheet*

A practitioner assisting a client with retirement planning should first compile a current balance sheet. It should include all assets and all liabilities. This usually involves an extensive interview with the client, and perhaps the use of a checklist to help cover all of the necessary topics. If the client is a beneficiary of a trust and has access to the corpus of the trust, include the value of the trust.

a. The income tax return is a great place to start. Income reported on the return can often identify an underlying asset. Beware, not all assets generate income or expenses that are reported on the tax return.

b. Liabilities are important to identify because they represent cash outflow that hopefully will diminish over time. Part of a retirement plan is to have less debt (hopefully zero) at retirement.

c. Personal financial statements are usually prepared using fair market value. The fair market value can be compared to the basis in the property to determine the potential gain

if liquidated. The tax liability associated with the built-in gain (or tax-benefit of a built-in loss) can then be calculated. Remember, all resources and income to be used currently or in retirement must be considered at value net of tax.

d. In determining values of assets, remember that owners will place a sentimental value on items such as their homes, collectibles, automobiles, and similar assets. Consider using a range, or a discount.

e. Be sure that all liabilities are included. Consider contingent liabilities that could reduce net assets in the future.

f. Are the assets adequately insured to protect their value?

g. If the client is in an occupation that has a high frequency of tort claims, are assets adequately protected through a combination of entities (including trusts) and insurance?

### *2. Prepare an Income statement*

This is to capture current income to determine what must be replaced, project future increases, and determine potential income tax liabilities. Also, in preparing the income statement, the practitioner can determine Social Security earnings and potential for retirement plan contributions. Include tax exempt income in the income statement, and nondeductible expenses.

### *3. Cash flow statement*

Some people would consider an "income statement." However, cash flow and income flow are two different things:

***Examples of differences in cash flow and income***

| Item | Cash flow | Income Statement |
|---|---|---|
| Savings accounts | Considers deposits and withdrawals | Considers investment income only |
| Depreciation, depletion, and amortization | Disregarded. | Reduces income |
| Wages | Considers net wages | Considers gross wages |
| Trusts and estate distributions | Cash received | Only distributed income |
| S corporations and partnerships | Distributions received | Only income or losses allocated to the owner. |
| Equipment purchases | Cash outflow | Recognized over time through depreciation |
| Sale of assets | Cash inflow for proceeds | Only gain or loss is recognized |
| Debt payments | Reduced by total | Reduced by interest expense |
| And more…… | | |

### *4. Do they like to travel?*

Someone who travels frequently before they retire will likely travel more after they retire. Questions that the practitioner may consider are:

**a. How frequently do they travel?**

As stated above, this can be an indicator of travel in retirement. If someone does not travel much, ask why. It could be that they simply don't have the time. The possible scenarios are:

(1) They travel frequently, which indicates they will likely desire to continue traveling in retirement.
(2) They stay close to home because they prefer being at home, which indicates they probably will not travel extensively in retirement.
(3) They currently don't travel because of work or other circumstances but dream of the day when the chains are broken, and they gain their freedom! These are the non-traveling people who will make up for lost time and see all the many places on their bucket lists when they retire. Look for them to burn up the highways, skyways, and waterways when they retire. Who knows, by then they may even be able to soar through outer space!

**b. How do they travel?**

Some people prefer driving for all but the longest trips. Others will fly even on short trips. Some might take the bus or a train. Different methods, different costs. Some retirees buy their own travel trailer or motorhome.

**There are motor homes, and then there are motorhomes!**

If your client says they intend to buy a travel trailer and see the country when they retire, a follow up question is immediately necessary. Some people prefer a pull-behind travel trailer that may cost from a few thousand dollars used to several thousand new. They will then possibly buy a truck that costs $70,000 to pull it. Other people may prefer a self-propelled motorhome. There can be a wide variation in prices for motorhomes based on whether it is new or used, how old it is, the brand, how big it is. Some can cost several hundred thousand dollars.

**A Cruiser by Any Other Name:**

Anyone who was a teenager in the '50s, ´60s, or ´70s knows what a cruiser used to be. It was a person who cruised around town in a cool car looking for fun (that some people might consider trouble). To a military person, a cruiser is a type of ship. To bicycle enthusiasts, a cruiser is a type of bicycle with big tires and comfortable seat. Baby boomers have redefined the phrase. With their love for ocean cruise vacations, maybe they are the modern-day cruisers. Cruises, depending on when and where, are often much cheaper than traditional vacations.

**c. Where do they go when they travel?**

An air travel trip to Holland to see the tulips bloom is more expensive than a car trip to the beach. A trip to Vegas might be cheap on the hotel and meals but expensive on gambling money. Good questions are:

(1) Where did you go on your last three vacations?
(2) How did you get there?
(3) What did you do?
(4) Who went with you? (Sometimes retirees take the whole family on vacation, grandchildren and all.)
(5) What was your average length of stay?
(6) About how much did it cost? (Don't be shy, ask!)

**d. Do they plan to travel more or less when they retire?**

What is on their bucket list**?**

**Discussion Question**

Where did you go on your last three vacations? Is this indicative of what kind of travel budget you will need in retirement?

***5. How is your health? Your family's health?***

An individual that already has significant health issues will likely have more as they age. This causes unpleasant conversations that must be had in planning:

**a. What is your long-term prognosis?**

An individual with certain conditions and medical conditions in their history might likely have a shorter life expectancy than average and may experience a decline in health. This could cause changes to planning for:
(1) Target retirement age (may need to retire sooner).
(2) Increased medical costs.
(3) Disability contingent plan.
(4) Long-term health facility.
(5) Timing of drawing retirement distributions or Social Security.
(6) Housing costs (such as converting accommodate disabilities).

**b. Do you have a spouse or dependent with significant health issues or disabilities? If so, will this be a significant expense in retirement?**

Health issues and disabilities can cause a significant increase in the amount needed for retirement. This must be evaluated from several standpoints. If a disabled dependent qualifies for Medicare or Medicaid, benefits may be curtailed in the future to keep the system solvent. According to the Center for Medicaid and Medicare Services (CMS), U.S. health care spending increased 2.7 percent to reach $4.3 trillion, or $12,914 per person in 2021. National health expenditures accounted for 18.3% of GDP in 2021. The CMS projects national health care spending to grow at an average rate of 5.1% through

2030. Much of this increase can be attributed to expected increased prices in medical goods and services.[1]

**c. What is your family history?**

Longevity tends to run in families. So do diseases and disorders. In a world of rapidly changing technology and medical advancements, individuals have more access than ever before to genetic testing to identify or detect familial diseases and disorders. Genetic testing involves analyzing an individual's DNA to identify genetic variations or mutations that may contribute to the development of certain diseases or conditions. These tests can provide valuable information about an individual's genetic makeup and the potential risk of inheriting or passing on specific genetic disorders. While genetic testing can provide valuable information, it does not necessarily guarantee the development or absence of a specific disease or disorder. Genetic test results should be interpreted and discussed with a qualified healthcare professional or genetic counselor who can provide guidance, explain the implications, and discuss available options for prevention and treatment.

***Foreseeing the Future:***

As with most planning, when it comes to healthcare costs, we must make our best estimate based on the data available. Unfortunately, we do not have a time machine. The future of healthcare in the United States is very uncertain. Even if healthcare costs, investment growth, net worth, and income increase at the same rate, an individual's healthcare costs generally increase over time as a natural part of the aging process.

### *6. The National Retirement Risk Index*

The National Retirement Risk Index (NRRI) measures the retirement preparedness of Americans by determining the percent of households ages 30-59 who are "at risk" of being unable to maintain their pre-retirement standard of living during their retirement years. The NRRI is calculated as part of a three-step process, with retirement assumed to occur at age 65. First, the NRRI measures a household's retirement income as a share of pre-retirement income in order to determine a replacement rate. Pre-retirement income includes the household's earnings and return on assets on an annuitized basis. Next, the NRRI calculates each household's target replacement rate that would allow them to continue their pre-retirement spending and lifestyle during their retirement years. Finally, the NRRI compares the projected replacement rate (determined in step one) against the target replacement rate (determined in step 2) to measure the number of households "at risk" of not being able to maintain their pre-retirement lifestyle during their retirement years. A household is considered "at risk" of not being able to maintain the same level of consumption in their retirement years if their projected replacement rate is more than 10% below the target replacement rate. The NRRI is the percentage of all households that are considered "at risk" of not being able to maintain their lifestyle in retirement. The latest NRRI survey found nearly 50% of households were considered "at risk" during their retirement years.[2]

## B. Where will they be in the projectable future?

This includes potential career changes, increased or decreased earnings, increased liabilities, decreased liabilities, etc.

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1 Centers for Medicare & Medicaid Services NHE Fact Sheet.
2 The National Retirement Risk Index: Version 2.0. May 2023.

### *1. A building career*

A person in the building stage of a career has potential for increasing income in future years. For instance, a senior accountant at a CPA firm will likely continue to increase in earnings for the foreseeable future at a rate greater than the inflation rate. In the assessment of how much they can save for retirement, this needs to be estimated.

***Planning Point***

> A young person in the beginning of a career might tend to utilize all of her income, thinking that as income increases, she can prepare for retirement. Some people need to use all of their income to survive, and savings is not an option. For the young successful person who has excess funds, she needs to learn early to never increase the car payment or house payment beyond an amount that allows for adequate savings. It is never too early to start saving for retirement. In fact, the sooner the better. Some people near retirement age and find themselves still working, not because they could not afford to save for retirement when they were younger, but because they chose to spend in on a few more square feet in the house and a few more horsepower under the hood.

### *2. A mature career*

A mature career means this is as good as it gets. Planning for retirement means the person in a mature career has to use what they have now and the current level of earnings to plan for retirement. If a couple with established, mature careers and a nice house close to the country club cannot carve retirement savings out of their current budget, they may need to consider downsizing to a smaller, cheaper house farther from the country club. They should look at every element of their budget to where there is excess that can be converted to retirement savings. Sacrifice now or suffer later.

### *3. Do they have a budget?*

People who don't track the small expenses and don't utilize a budget are less likely to save for retirement. Why? If you don't know where the money is going, you cannot manage it, and you cannot reallocate it. If you don't know what is happening with your current resources, you have no roadmap to project where you will be in the future. Many people would be shocked at how much they spend for fast food and snacks in a year's time. Budgets can identify the small holes in the financial bucket through which, over time, large amounts can slip. Many people disregard small expenditures. A common thought is "don't sweat over nickels and dimes." Some budgeting ideas to consider include:

a. **Getting organized**: Create a monthly budget that allocates income within various categories such as housing, transportation, groceries, entertainment, savings, etc.

b. **Allocating funds**: Aim to allocate total income to each expense category, as well as savings. Whenever possible, save a certain percentage of total income each month. Consider automating savings by setting up automatic transfers to a separate savings account.

c. **Reviewing expenses**: Regularly review recurring expenses, such as subscriptions and memberships. Cancel or downgrade any services that are not being utilized or are no longer needed. Additionally, identify any non-essential expenses. This could involve reducing funds spent on dining out and entertainment expenses or finding cheaper alternatives for certain products or services.

d. **Comparison shopping:** Prior to making purchases over a certain dollar amount, consider comparing prices from different retailers or online platforms to ensure the item is competitively priced. Oftentimes, discounts, coupons, or promotional offers may be available.

e. **Meal planning:** Planning and preparing meals in advance can avoid impulse purchases and reduce food waste. Cooking at home is generally more cost-effective than eating out.

f. **Avoiding debt:** While it is often advantageous to use credit cards to earn points or cash back, it is important to try to pay off any credit card balance in full each month to avoid interest charges. If there is any existing debt, paying it off should be prioritized in the budget.

Budgeting is a continuous process that requires discipline and adjustments along the way. While it is important to remain committed to financial goals, one must be open to refining the budget as his or her circumstances change.

***Discussion Question***

If someone told you that they dropped dime in the post office parking lot and that you could have it if you go get it, you would likely laugh in their face. What if a dump truck breaks down in front of your house, and the driver says, "I have to unload my truck to fix it. If I can unload it in your yard, you can have the entire load. I just need to get my truck fixed." You look in the truck and it is full of nickels and dimes! Would you take it?

### *4. What are projected asset values?*

Don't forget what may be their most valuable asset – their home.

### *5. Do they have a rich uncle?*

Some people are in line for an inheritance from a parent, other relative, or a very close friend. Don't overlook inheritances and trust distributions that will be received in future years, but don't forget that people change their minds.

## C. Where do they want to be?

### *1. Three approaches to retirement*

**a.** **Retire at a certain age.** Planning may involve accumulating enough resources to maintain current levels of income adjusted for inflation by the target age. As an alternative, the client may be willing to cut back on the budget at the target age in order to retire. They may be willing to sell the house and use the equity. If a client wants to retire at a certain age, one approach may be to:

(1) Determine current cash flow.

(2) Determine the desired lifestyle in retirement, including travel, housing, etc.

(3) Will they keep the home or downsize? Equity in the home can be a resource for retirement.

***Note:***

The decision on the home is sometimes driven by health issues. As people age, they sometimes need to swap the home with the high steps, staircases and narrow doors for a home that is more friendly to bad knees, bad hips, walkers, and wheelchairs. This could mean selling the house and having a smaller home built that is easier to maintain, is on one level, and wheelchair friendly.

(4) Would that lifestyle today, in current dollars, cost more or less than their current living costs? Estimate what adjustments would have to be made to the current budget to pay for that lifestyle in current dollars. Do a pro forma budget in current dollars. Don't forget

to adjust the budget for changes that are expected before retirement, such as the kids leaving, the house being paid off, etc.

(5) Compare current income and resources to the current cost of the desired lifestyle. See if income would need to increase or if it could decrease. This will determine if retirement funds need to replace income as adjusted for inflation, exceed income, or can be less than income.

(6) Once the budget for the desired lifestyle is determined in today's dollars, determine the future value of the budget based on projected inflation rates. It may be best to calculate a range.

(7) Devise a financial plan to reach the target dollar amount to fund retirement at the desired budget level over the life expectancy of the client beginning at the desired retirement age.

**b.** **Accumulate as much as possible, retire at a target amount.** This method is a little simpler. Accumulate as much resources as possible and retire when resources available for retirement maintain the desired lifestyle for the remaining life expectancy.

**c.** **The line-in-the sand method**. The client draws a line in the sand and declares that retirement will happen at a certain time. Often, this is Medicare age. The client then accumulates as much retirement resources as possible, retires at the target time, and adjusts the budget to the income and resources available.

***2. Can they get there?***

Sometimes as a consultant, our job is to give our clients a reality check. If the numbers show that their goals cannot be met, we must be prepared to talk them down to reality. Not everyone can retire and treat the world as their backyard. If they can't get to where they want to be, where can they go?

***Note:***

It is difficult to shoot down someone's dreams. Many people would love to retire and travel the world, but not everyone can get there. Help them realize that being able to spend more time with the grandkids, making the occasional car trip to the lake or the mountains, and NOT going to the office every day is a good Plan B.

## D. Case Study: A Little Ditty about Jack and Diane

Jack and Diane grew up together on farms in Nebraska. Jack dreamed of being a football star, but he blew out his knee his first year at the University. The let him keep his scholarship, and now he and Diane are well into building their careers. In interviewing them, John, their consultant determined:

1. They have a child on the way and intend to buy a much bigger home close to the country club. Their little pink house is not big enough anymore.
2. Savings and retirement funds are insignificant. They will have equity from selling their old home for a down payment on a new home, and the excess in their budget, which is very little, has also been saved to put down on the house. Once they buy the house of their dreams, they think they will have enough income to pay the bills and have a small emergency fund, but not much extra.
3. Earnings are expected to increase for both Jack and Diane at a rate higher than inflation because of advancements in their careers.

4. They have no budget and have no idea where all of the money goes. That is why they called for an appointment. They need help in determining why the work all the time and have no money.

John asked the magic question: Are you putting away anything for retirement? The answer, typical of many younger couples, is, "We can't afford it right now. It doesn't fit our budget." The problem is, they don't know what their budget is.

John advised them to track every penny they spend for a month. It was eye opening to Jack and Diane. They did not realize how much they were spending on snacks at the service station, fast-food drive throughs, movies, and coffee at shops. The amount they spent on gasoline was shocking. They had never thought about how much gas they used running back and forth to town buying a little bit at a time instead of consolidating trips.

After discussing these findings, the consultant helps them prepare a budget. They determine that they can buy a really nice home that is sufficient for their needs and a little farther from the country club and save $300 per month on the payment. They will also save approximately $200 per month on utilities and maintenance. They can save an additional $300 per month by buying more generic grocery brands and cutting down on snacks at the service station and drive-through fast food. This gives them a start of $800 per month that they can save for retirement.

The plan that is offered by the consultant:

1. Buy the cheaper house and put the recommendations in motion that result in a surplus of $800 per month.
2. Increase the $800 by a minimum of 3% each year as earnings increase. They will adjust the budget each year as earnings increase and can hopefully do more than 3%.
3. Contribute the $800 to a retirement plan.

Jack and Diane are concerned about putting the money into a retirement plan. Many younger couples are concerned about contributing to a retirement plan because they may have an emergency that requires them to withdraw the funds and be subjected to the 10% early withdrawal penalty.

John recommends a Roth IRA. Why? After the Roth has been established for five years, the annual contributions may be withdrawn with no tax and no penalty.[3] When adjusted gross income exceeds the limit for a Roth, they can simply contribute to a regular IRA and convert it.

Assumptions:

1. Jack and Diane agree to the plan.
2. They will increase their contribution by a minimum of 3 percent.
3. Roth is projected to earn 4 percent.
4. Inflation projected to average 2.5 percent.

[3] Treas. Reg. §1.408A-6, Question 4.

Jack and Diane's minimum deposits into the Roth IRA are:

| | Event | Date | Amount | Number | Period | End Date |
|---|---|---|---|---|---|---|
| 1 | Deposit | 07/01/2022 | 800.00 | 12 | Monthly | 06/01/2023 |
| 2 | Deposit | 07/01/2023 | 824.00 | 12 | Monthly | 06/01/2024 |
| 3 | Deposit | 07/01/2024 | 849.00 | 12 | Monthly | 06/01/2025 |
| 4 | Deposit | 07/01/2025 | 874.00 | 12 | Monthly | 06/01/2026 |
| 5 | Deposit | 07/01/2026 | 900.00 | 12 | Monthly | 06/01/2027 |
| 6 | Deposit | 07/01/2027 | 927.00 | 12 | Monthly | 06/01/2028 |
| 7 | Deposit | 07/01/2028 | 955.00 | 12 | Monthly | 06/01/2029 |
| 8 | Deposit | 07/01/2029 | 984.00 | 12 | Monthly | 06/01/2030 |
| 9 | Deposit | 07/01/2030 | 1,014.00 | 12 | Monthly | 06/01/2031 |
| 10 | Deposit | 07/01/2031 | 1,044.00 | 12 | Monthly | 06/01/2032 |
| 11 | Deposit | 07/01/2032 | 1,075.00 | 12 | Monthly | 06/01/2033 |
| 12 | Deposit | 07/01/2033 | 1,107.00 | 12 | Monthly | 06/01/2034 |
| 13 | Deposit | 07/01/2034 | 1,140.00 | 12 | Monthly | 06/01/2035 |
| 14 | Deposit | 07/01/2035 | 1,174.00 | 12 | Monthly | 06/01/2036 |
| 15 | Deposit | 07/01/2036 | 1,209.00 | 12 | Monthly | 06/01/2037 |
| 16 | Deposit | 07/01/2037 | 1,245.00 | 12 | Monthly | 06/01/2038 |
| 17 | Deposit | 07/01/2038 | 1,282.00 | 12 | Monthly | 06/01/2039 |
| 18 | Deposit | 07/01/2039 | 1,320.00 | 12 | Monthly | 06/01/2040 |
| 19 | Deposit | 07/01/2040 | 1,360.00 | 12 | Monthly | 06/01/2041 |
| 20 | Deposit | 07/01/2041 | 1,401.00 | 12 | Monthly | 06/01/2042 |
| 21 | Deposit | 07/01/2042 | 1,443.00 | 12 | Monthly | 06/01/2043 |
| 22 | Deposit | 07/01/2043 | 1,486.00 | 12 | Monthly | 06/01/2044 |
| 23 | Deposit | 07/01/2044 | 1,531.00 | 12 | Monthly | 06/01/2045 |
| 24 | Deposit | 07/01/2045 | 1,577.00 | 12 | Monthly | 06/01/2046 |
| 25 | Deposit | 07/01/2046 | 1,624.00 | 12 | Monthly | 06/01/2047 |
| 26 | Deposit | 07/01/2047 | 1,673.00 | 12 | Monthly | 06/01/2048 |
| 27 | Deposit | 07/01/2048 | 1,723.00 | 12 | Monthly | 06/01/2049 |
| 28 | Deposit | 07/01/2049 | 1,775.00 | 12 | Monthly | 06/01/2050 |
| 29 | Deposit | 07/01/2050 | 1,828.00 | 12 | Monthly | 06/01/2051 |
| 30 | Deposit | 07/01/2051 | 1,883.00 | 12 | Monthly | 06/01/2052 |

Jack and Diane's Roth IRA will increase as follows:

| Date | Deposit | Withdrawal | Interest | Net Change | Balance |
|---|---|---|---|---|---|
| 2023 Totals | 9,600.00 | 0.00 | 177.96 | 9,777.96 | 9,777.96 |
| 2024 Totals | 9,888.00 | 0.00 | 581.68 | 10,469.68 | 20,247.64 |
| 2025 Totals | 10,188.00 | 0.00 | 1,013.79 | 11,201.79 | 31,449.43 |
| 2026 Totals | 10,488.00 | 0.00 | 1,475.72 | 11,963.72 | 43,413.15 |
| 2027 Totals | 10,800.00 | 0.00 | 1,968.93 | 12,768.93 | 56,182.08 |
| 2028 Totals | 11,124.00 | 0.00 | 2,495.17 | 13,619.17 | 69,801.25 |
| 2029 Totals | 11,460.00 | 0.00 | 3,056.26 | 14,516.26 | 84,317.51 |
| 2030 Totals | 11,808.00 | 0.00 | 3,654.13 | 15,462.13 | 99,779.64 |
| 2031 Totals | 12,168.00 | 0.00 | 4,290.76 | 16,458.76 | 116,238.40 |
| 2032 Totals | 12,528.00 | 0.00 | 4,967.97 | 17,495.97 | 133,734.37 |
| 2033 Totals | 12,900.00 | 0.00 | 5,687.69 | 18,587.69 | 152,322.06 |
| 2034 Totals | 13,284.00 | 0.00 | 6,452.10 | 19,736.10 | 172,058.16 |
| 2035 Totals | 13,680.00 | 0.00 | 7,263.52 | 20,943.52 | 193,001.68 |
| 2036 Totals | 14,088.00 | 0.00 | 8,124.35 | 22,212.35 | 215,214.03 |
| 2037 Totals | 14,508.00 | 0.00 | 9,037.09 | 23,545.09 | 238,759.12 |
| 2038 Totals | 14,940.00 | 0.00 | 10,004.38 | 24,944.38 | 263,703.50 |
| 2039 Totals | 15,384.00 | 0.00 | 11,028.88 | 26,412.88 | 290,116.38 |
| 2040 Totals | 15,840.00 | 0.00 | 12,113.45 | 27,953.45 | 318,069.83 |
| 2041 Totals | 16,320.00 | 0.00 | 13,261.20 | 29,581.20 | 347,651.03 |
| 2042 Totals | 16,812.00 | 0.00 | 14,475.52 | 31,287.52 | 378,938.55 |
| 2043 Totals | 17,316.00 | 0.00 | 15,759.55 | 33,075.55 | 412,014.10 |
| 2044 Totals | 17,832.00 | 0.00 | 17,116.68 | 34,948.68 | 446,962.78 |
| 2045 Totals | 18,372.00 | 0.00 | 18,550.57 | 36,922.57 | 483,885.35 |
| 2046 Totals | 18,924.00 | 0.00 | 20,065.06 | 38,989.06 | 522,874.41 |
| 2047 Totals | 19,488.00 | 0.00 | 21,664.00 | 41,152.00 | 564,026.41 |
| 2048 Totals | 20,076.00 | 0.00 | 23,351.48 | 43,427.48 | 607,453.89 |

| | | | | | |
|---|---|---|---|---|---|
| 2049 Totals | 20,676.00 | 0.00 | 25,131.92 | 45,807.92 | 653,261.81 |
| 2050 Totals | 21,300.00 | 0.00 | 27,009.76 | 48,309.76 | 701,571.57 |
| 2051 Totals | 21,936.00 | 0.00 | 28,989.78 | 50,925.78 | 752,497.35 |
| 2052 Totals | 22,596.00 | 0.00 | 31,076.79 | 53,672.79 | 806,170.14 |
| On July 1, 2052 | 456,324.00 | **808,857.37** | 352,533.37 | 0.00 | 0.00 |

Jack and Diane, under these assumptions, will accumulate $808,857.37 in the Roth IRA by June 1, 2052 in 2052 dollars if they implement the plan on July 1, 2022. In today's dollars that would be $385,616.84 (present value of $808,857.37 discounted by the inflation rate of 2.5%).

Jack and Diane may be able to increase the deposit by more than three percent, or based on income tax rates, employer retirement availability, and other factors, they may add tax deferred retirement to the retirement plan. The amount that they are saving may eventually exceed the allowable Roth contribution amount. Keep in mind that the annual Roth limit will be increasing for inflation.

The goal is to plan with what you have and adjust over time for changes in income, income tax laws, the economy, and the individual's needs.

***Discussion Question:***

1. Roths are great for a young couple because the annual contributions may be withdrawn after five years with no penalty even though the taxpayer is under 59.5 years old. However, a young couple might ask, what if something happens during the five years and we need the money? What solution do you have?
2. Jack and Diane should eventually consider funding an employer retirement plan. What are the advantages of an employer retirement plan over an individual retirement plan?
3. Someone offers you $385,616.84 to live in a very nice but smaller home in a good neighborhood, cut back on groceries and eating out, like Jack and Diane are doing. Would you do it?

# *II. Building the retirement nest egg*

## A. Overview

Retirement is one of investors' biggest concerns. Yet surprisingly, few investors have a comprehensive road map to get them where they want to go. The right strategy and asset allocation plan can certainly help. But the best possible strategy is only talk without the discipline to make it happen.

Investors must actually make the deposits their plans require and stay the course during inevitable market downturns and economic changes.

Retirement plans have two equally important components: (i) building an adequate nest egg; and (ii) making it last forever.

***Note:***

This discussion is centered around the ideal situation. The clients have the means to accumulate enough retirement savings to maintain a high standard of living for their entire life expectancy with some left over. It is a good starting point. Adjust from there for the individual client's circumstances.

## B. The three-legged stool of retirement planning

### *1. Plan around three cash flow sources*

Many people go through life thinking that one day they will retire and draw Social Security. Social Security will not be enough for a good retirement. It is a good starting point. Through this chapter we will refer to three legs of the retirement plan stool. They are:

**Leg #1.** **Social Security:** Social Security is part of a retirement plan, but it is currently an unstable part. Latest projections show that by 2034 the Social Security reserve will run out.[4] This is one year earlier than projected in the prior year report. At that time, the fund's reserves will become depleted and continuing tax income will be sufficient to pay only 80 percent of scheduled benefits.[5]

**Leg #2.** **Employer Retirement Plans:** Two primary benefits of employer retirement plans are the employer match and the ability to accumulate earnings free of tax. Earnings that are not taxed accumulate faster than earnings that are subject to tax. The employer retirement plan is not necessarily funded with pretax dollars. Under current law, employer retirement plans may offer a Roth provision. Roths are funded with after tax dollars and are not taxable when withdrawn.

**Leg #3.** **Personal savings and other resources outside of the employer retirement plan.** This could be home equity, personal investments, trust fund money, etc. Also, this may be IRAs and Roths.

### *2. The other three-legged stool*

Another variation of the three-legged stool must be considered. The legs of this stool are:

**Leg #1.** **Social Security**

**Leg #2.** **Resources that will be taxable when used:** This includes taxable distributions from employer retirement plans and IRAs.

**Leg #3.** **Not taxable resources:** Savings outside of retirement accounts, home equity, Roth distributions, etc.

## C. Too much is never enough

A secure retirement requires lots of capital. With younger retirement and longer life expectancy, average retirees will spend almost as many years retired as they spent working. Most couples should plan for the survivor to reach at least the age of 95. Most people won't reach the age of 95, but there is a good chance with a couple that at least one of the two will exceed life expectancy. This builds in a cushion to ensure that they don't run out of retirement funds. The retirement period could easily be as much or more than one third of the longer survivor's life, but without much of a "paycheck," except for the amounts the survivor can draw on from the savings for retirement purposes.

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4 Social Security Administration Board of Trustees 2023 Annual Report.

5 Social Security Administration Board of Trustees 2023 Annual Report.

How big does that nest egg need to be? Most people find that they will need at least 70 percent to 100 percent of their pre-retirement income to live comfortably. Few of today's retirees expect to stay home and watch TV all day. They are younger, healthier, and anticipate a longer life than any generation before.

Most expect that, after parachuting out of the working world, they will hit the ground running with the newfound freedom to travel, pursue hobbies, and participate in community activities. Many financial planners working with active retirees find that their clients actually spend more money during their 60s and 70s than they did during their working years. The pace of spending slows down a bit once they reach their 80s, but increasing health expenses soon raise their total income needs again.

To figure out roughly how much capital retirees will need at retirement, some advisers use a rule-of-thumb that their clients should plan on withdrawing not more than 4.5 percent to, possibly, 5.5 percent from their retirement nest-eggs each year. Applying this 4.5-percent to 5.5-percent rule-of-thumb, history has shown that retirees have a reasonably high probability of having sustainable income and sufficient growth of income to hedge inflation, as well as growth of capital.

To put this in tangible terms, this means that for each $1 dollar of retirement income clients anticipate they will need (above their expected Social Security and employer-provided pension income), they should plan to accumulate a nest egg of at least $18 to $22. (For instance, for each $10,000 per year of retirement income retirees expect they will need to fund through their nest egg, they should accumulate about $182,000 to $222,000.) (*This topic is addressed in considerable depth in later chapters*.)

## D. Success factors

Success in the accumulation phase is directly related to three variables: starting early, systematically depositing an adequate amount, and attaining reasonable rates of return. The math is basically elementary. The relationship between ***time***, ***amount*** invested, and ***rate*** of return with the probability of successfully accumulating the ***target*** amount desired is fairly well known. The dreary realities are that successful retirement planning requires strict discipline and that retirement plans be given high priority as early as possible in one's working career.

The "magic" of compounding rewards those who start early. Delays, over time, may make it almost impossible ever to attain a reasonable goal absent some very serendipitous monetary windfall.

## E. Million-dollar countdown

How much would someone need to invest per month to get to $1 million? Is $1 million enough to secure one's financial future? Is it more than enough? Less than enough?

What does it take for someone to become a millionaire?

### *1. Amount, Rate, Time, and Target*

To set the stage for this discussion of the "million-dollar countdown," we need to specify an analytical framework with which to start.

Four actions are the primary (but not complete set of) keys to successful retirement planning:

a. Determining the desired or required ***target*** accumulation;
b. Setting the ***time*** horizon over which to achieve the ***target*** accumulation;

c. Estimating the ***rate*** of return one can reasonably expect to earn on investments; and

d. Based on the prior three actions, determining the periodic (e.g., monthly, quarterly, yearly) ***amount*** one needs to deposit consistently to reach the ***target*** accumulation with a reasonable probability of success.

When the periodic ***amount*** determined in step d. is just not feasible, people must adjust the ***target*** amount, ***time*** horizon, assumed ***rate*** of return, or some combination thereof until they can find an alternative plan that comes most close to meeting their original plan.

The following discussion uses the 4-factor analytical framework of time-value described above to sequentially address the "million-dollar countdown" questions, also posed above.

**Table 1** shows the ***amount*** one would have to save monthly or annually invested at various ***rates*** of return ranging from 2.5 percent to 15 percent over various investment ***time*** horizons ranging from 10 to 40 years to reach a ***target*** accumulation of $1 million. **Table 1** values assume a person would like to accumulate this $1 million target sum by age 65, for instance, and then determines the monthly or annual savings that the person would be required to investment over ***time*** horizons ranging from 10 to 40 years correspond to current ages of 55 to 25, respectively.

**Table 1** shows that to accumulate a $1 million nest egg, people who are 25 years old and have 40 years until their anticipated retirements at age 65 might need to save somewhere between $44 and $1,221 per month, or $524 and $14,654 per year, depending on how they invest the money and what rate of return they earn. For many people, the numbers shown in **Table 1** might seem as though such a savings plan would be feasible, if not particularly easy.

Most people age 55 who want to accumulate $1 million by age 65 will probably have quite a problem, because they would have to save somewhere between $3,824 and $7,347 per month, or between $45,928 and $88,164 per year, to reach their goal. That is a pretty hefty challenge!

**Table 1**

| **Who Wants to be a Millionaire!** | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Annual Rate of Return** | | | | | | | |
| | | **2.5%** | **5.0%** | **7.5%** | **10.0%** | **12.5%** | **15.0%** |
| **Level *MONTHLY* Savings Required to Reach $1 Million Goal** | | | | | | | |
| **Years** | **10** | 7,347 | 6,465 | 5,680 | 4,984 | 4,368 | 3,824 |
| | **20** | 3,222 | 2,459 | 1,856 | 1,387 | 1,028 | 758 |
| | **30** | 1,875 | 1,224 | 777 | 483 | 295 | 179 |
| | **40** | 1,221 | 673 | 354 | 179 | 89 | 44 |
| **Level *ANNUAL* Savings Required to Reach $1 Million Goal** | | | | | | | |
| **Years** | **10** | 88,164 | 77,589 | 68,176 | 59,825 | 52,441 | 45,928 |
| | **20** | 38,667 | 29,514 | 22,272 | 16,647 | 12,347 | 9,103 |
| | **30** | 22,498 | 14,689 | 9,328 | 5,796 | 3,545 | 2,145 |
| | **40** | 14,654 | 8,079 | 4,244 | 2,154 | 1,069 | 524 |

Please take a few moments to note in **Table 1** how much an increase in either the period of ***time*** that a person has to save for the ***target*** goal or the ***rate*** of return a person earns on investment affects the ***amount*** the person needs to save each month or year.

Obviously, starting early is one of the principal keys to success. But if a person cannot start early, he or she should **start now or as soon as possible!**

As will be discussed in more detail later, when people have longer-term investment time horizons, they can afford to invest a greater proportion of their investment assets in what, generally, are considered higher-risk, higher-return assets. The "riskier" higher-return assets actually become less risky than the "safe" investments as the investment horizon lengthens!

The effects of longer ***time*** horizons and higher ***rates*** of return are exponential. Earning a higher ***rate*** of return for a longer period of ***time*** more than proportionally lowers the required ***amount*** of monthly or yearly investment to reach the desired ***target*** balances.

The longer is the ***time*** horizon until retirement, the more aggressive people can afford to be with how they can invest their money (excluding, of course, what they set aside for emergency funds and any other short-term needs). If investors will not be spending the money in the next few years, they should not be overly concerned about short-term fluctuations in value. For virtually any investment other than a guaranteed interest bond, returns will fluctuate period to period over time, usually within reasonably predictable ranges that vary among the different investment asset classes and the length of the investment time horizon until the investor plans to liquidate the funds.

### *2. Inflation*

Unfortunately, **Table 1** leaves out an important factor: **price inflation**. If a person invests for 30 or 40 years to accumulate $1 million, it will not buy what $1 million will today, or what it will buy in just 10 years, or in 20 years. The purchasing power of the money will almost certainly erode as a result of inflation.

Although inflation rates have been relatively low prior to the COVID-19 pandemic, there has been a recent spike in inflation. Even small rates of inflation can significantly erode purchasing power over longer horizons. **Table 2** shows, over various investment ***time*** horizons and at various assumed ***inflation*** rates, the ***target*** balances investors would actually have to accumulate to have the equivalent purchasing power of $1 million today.

***Mini-Case 1***: For example, even assuming inflation is just ***2 percent***, investors need to accumulate almost $1.5 million in ***20 years*** to achieve the same purchasing power as $1 million today.

Assuming a **4*-percent*** inflation rate, which is probably a much better conservative long-term assumption, investors would need to accumulate over a ***20-year*** investment horizon more than two times as much ($2,191,123 vs. $1 million) as they would if there were no inflation.

At a ***4-percent*** inflation rate, investors would need to accumulate nearly $5 million over a ***40-year*** investment time horizon to have the same purchasing power as $1 million today.

At an inflation rate of ***7 percent*** for a ***40-year*** period, investors would need to accumulate just short of $15 million to give themselves the same purchasing power as $1 million today.

**Table 2**

| Who Wants to be a Millionaire! | | | | | | | |
|---|---|---|---|---|---|---|---|
| Future Amount That is Equal to $1 Million Today (In Millions of $s) | | | | | | | |
| | | Inflation Rate | | | | | |
| | | 2.0% | 3.0% | 4.0% | 5.0% | 6.0% | 7.0% |
| Years | 10 | 1.219 | 1.344 | 1.480 | 1.629 | 1.791 | 1.967 |
| | 20 | 1.486 | 1.806 | 2.191 | 2.653 | 3.207 | 3.870 |
| | 30 | 1.811 | 2.427 | 3.243 | 4.322 | 5.743 | 7.612 |
| | 40 | 2.208 | 3.262 | 4.801 | 7.040 | 10.286 | 14.974 |

**Table 3** reproduces the results of **Table 1**, except that the goal is not a nominal $1 million, but rather the future "real" value of $1 million, that is, the inflation-adjusted value of $1 million. The amounts people need to invest each month or year rise dramatically compared to the amounts shown in **Table 1**, especially for the longer periods.

**Table 3**

| Who Wants to be a "Real" Millionaire! | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Level *MONTHLY* Savings Required to Reach $1 Million Inflation-Adjusted Goal | | | | | | | | |
| | | | Annual Rate of Return | | | | | |
| | | Goal* | 2.5% | 5.0% | 7.5% | 10.0% | 12.5% | 15.0% |
| Years | 10 | 1,480,244 | 10,875 | 9,570 | 8,408 | 7,377 | 6,465 | 5,661 |
| | 20 | 2,191,123 | 7,060 | 5,388 | 4,066 | 3,039 | 2,253 | 1,661 |
| | 30 | 3,243,398 | 6,081 | 3,970 | 2,521 | 1,566 | 958 | 579 |
| | 40 | 4,801,021 | 5,863 | 3,232 | 1,698 | 862 | 428 | 210 |
| Level *ANNUAL* Savings Required to Reach $1 Million Inflation-Adjusted Goal | | | | | | | | |
| Years | 10 | 1,480,244 | 130,504 | 114,850 | 100,916 | 88,556 | 77,625 | 67,984 |
| | 20 | 2,191,123 | 84,724 | 64,668 | 48,801 | 36,476 | 27,053 | 19,945 |
| | 30 | 3,243,398 | 72,970 | 47,641 | 30,254 | 18,800 | 11,498 | 6,957 |
| | 40 | 4,801,021 | 70,355 | 38,786 | 20,376 | 10,343 | 5,134 | 2,516 |
| * Assuming 4% annual inflation rate. | | | | | | | | |

***Mini-Case 2***: For example, people age 45 who are: (i) hoping to accumulate $1 million adjusted for inflation by age 65; (ii) anticipate a 4-percent inflation rate; and (iii) expect to earn a 10-percent rate of return would need to save not just $1,387 per month or $16,647 per year, as shown in **Table 1**, but rather $3,039 per month or $36,476 per year, as shown in **Table 3**. That amount is about $1,650 more per month, or about $19,830 more per year than before adjusting for inflation. In this case, a 4-percent inflation assumption more than doubles the level of required periodic savings amounts!

**Figure 1**

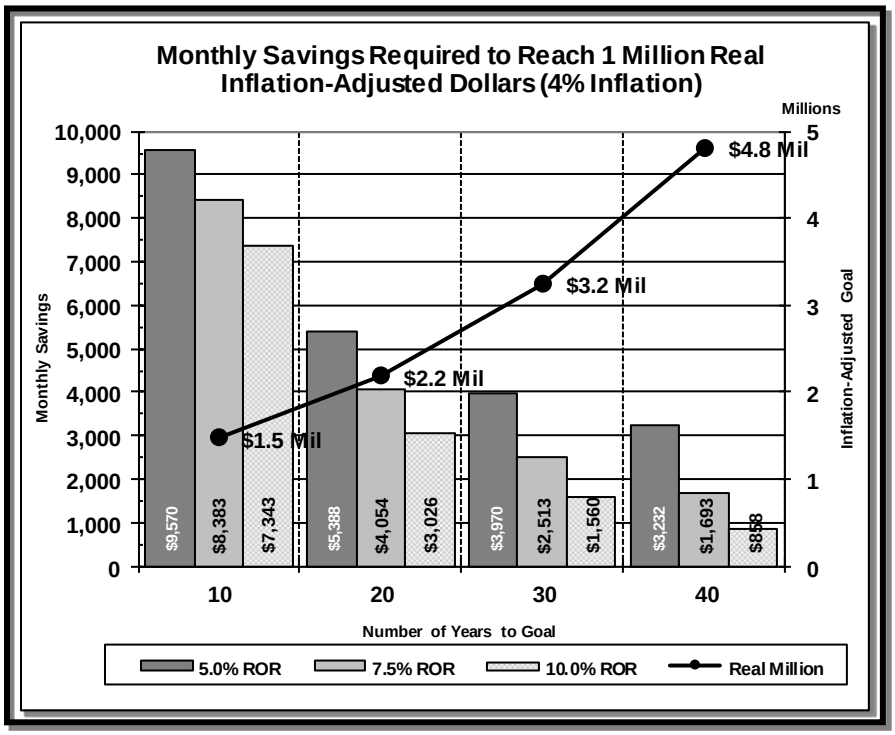


**Figure 1** shows selected results from **Table 3** graphically, to better visualize the effects of changes in the assumed rate of return and the assumed accumulation period.

If investors have a longer period to accumulate the target of $1 million in real inflation-adjusted dollars, the amount they have to accumulate goes up, as a result of the effects of inflation, but the amount they have to save each month still goes down, as a result of the additional savings and the additional years of compound growth with reinvestment.

For many people, these amounts may seem to be incredibly high monthly amounts, probably beyond their means. Unfortunately, there are other factors that make the results even more discouraging -- for example, **taxes**.

### *3. Taxes on salary and wages and investment income -- Part I*

Death and taxes are two certainties of our existence. Neither are topics most of us like to contemplate, but we must. The timing of our deaths, or rather the length we expect to live, is an important factor in determining how much we need to accumulate to assure our financial independence and security in retirement. Is a million dollars enough? We will address that issue later.

Taxes, on the other hand, are immediate and ubiquitous. Nearly every dollar of salary or wages earned is subject to federal income tax and state and local income taxes. Employees' earnings below the Social Security wage base $160,200 (in 2023) incur, directly, an additional 7.65 percent in Social Security retirement and Medicare tax payments (as well as an additional 7.65 percent, indirectly, through their employers' contributions). All earnings above the Social Security wage base are still subject to a direct 1.45 percent tax for Medicare (and an additional 1.45 percent indirectly through employer contributions).

Furthermore, above certain threshold levels of AGI (described later) an additional Medicare tax of 0.9 percent kicks in as well.

How people accumulate their nest egg can make a huge difference in their "cost." When people save money in qualified retirement plans, deductible IRAs, §403(b) tax-deferred annuities, or certain other tax-preferred vehicles, they defer some or all of the taxes on the investment earnings until they ultimately take the money from their plans. The tax rules for these types of retirement investment vehicles, in most cases, also permit the owners to invest with pretax dollars.[6]

On the other hand, if people invest outside these types of tax-preferred plans, they will have to pay federal, state, and local income taxes and Social Security taxes on their wages or salaries in the year they earn them, and will have only the after-tax amounts available for investment to reach their real $1 million goal.

Obviously, avoiding or postponing some or all of these taxes can be a great boon. Let us see how much these taxes affect the amount a person has to "earn" each month before taxes, in order to have enough left after taxes to be able to systematically invest the amounts that are necessary to reach their real inflation-adjusted $1 million goal. We will look at these required "earnings levels" for investments both outside of and inside of an employer-sponsored elective-deferral type of plan.

***Special note:***

On December 22, 2017, the TCJA was signed into law, described, almost certainly correctly, as "The Most sweeping Tax Reform in Over 30 Years." It includes 59 major sections, which cannot be summarized here. However, some of the most relevant changes to the tax law for retirement planning purposes is the change in the marginal tax rates, including 7 individual brackets. The highest marginal tax rate fell from 39.6 percent to 37 percent. In addition, the TCJA substantially increased the standard deduction for all filing classifications, but the deduction for personal exemptions is effectively suspended to zero. The TCJA retains the 0-, 15-, and 20-percent capital-gains rates with the same breakpoints between the rates under previous law, indexed for inflation. The TCJA provides a deduction for "Qualified Business Income" (QBI). This provision permits an individual taxpayer to deduct 20 percent of qualified business income (QBI) from a partnership, S corporation, or sole proprietorship. A taxpayer with $100,000 of QBI potentially can get up to a $20,000 deduction. (This provision is designed to give small business partnerships, S corporations, or sole proprietorships with "qualified trade or business income" effective tax rates closer to those of incorporated businesses.) The TCJA suspends the Pease limitation on itemized deductions, eliminates the ability to recharacterize a Roth IRA conversion after December 31, 2017, and makes no changes to the 3.8-percent net investment income tax or the 0.9-percent Medicare tax.

Due to rulings and mandatory requirements on budgeting procedures, debt limits, and tax scoring, as well as political give and take, all of the provisions of the TCJA identified and discussed above are temporary and generally scheduled to expire 1/1/2026.

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[6] Amounts employees **elect** to have reduced from their salaries and invested by their employers in retirement plans, such as §401(k) plans, §403(b) plans, salary-reduction SEPs, or SIMPLE IRAs, are treated as **taxable** compensation for Social Security and Medicare tax purposes, but not for federal (and usually state) income-tax purposes. So, these contributions are before-tax contributions for federal (and usually state) income-tax purposes, but after-tax contributions for employment-tax purposes. Amounts **employers** may contribute to such plans as matching contributions, or any non-elective amounts employers contribute to qualified pension or profit-sharing plans on behalf of their employees are treated as before-tax contributions for both federal (and usually state) income-tax purposes and employment-tax purposes. By the way (but you already know this), there is the possibility that the Social Security and Medicare systems may go broke. It is the gorilla roaming the halls of Congress and is discreetly ignored.

***4. Taxes on salary and wages and investment -- Part II***

**Single:**

| If taxable income is: | The tax is: |
|---|---|
| Not over $11,000 | 10% of taxable income. |
| Over $11,000 but not over $44,725 | $1,100 plus 12% of the excess over $11,000. |
| Over $44,725 but not over $95,375 | $5,147 plus 22% of the excess over $44,725. |
| Over $95,375 but not over $182,100 | $16,290 plus 24% of the excess over $95,375. |
| Over $182,100 but not over $231,250 | $37,104 plus 32% of the excess over $182,100. |
| Over $231,250 but not over $578,125 | $52,832 plus 35% of the excess over $231,250. |
| Over $578,125 | $174,238.25 plus 37% of the excess over $578,125. |

**Head of Household:**

| If taxable income is: | The tax is: |
|---|---|
| Not over $15,700 | 10% of taxable income. |
| Over $15,700 but not over $59,850 | $1,570 plus 12% of the excess over $15,700. |
| Over $59,850 but not over $95,350 | $6,868 plus 22% of the excess over $59,850. |
| Over $95,350 but not over $182,100 | $14,678 plus 24% of the excess over $95,350. |
| Over $182,100 but not over $231,250 | $35,498 plus 32% of the excess over $182,100. |
| Over $231,250 but not over $578,100 | $51,226 plus 35% of the excess over $231,250. |
| Over $578,100 | $172,623.50 plus 37% of the excess over $578,100. |

**Married Filing Jointly and Qualifying Widower:**

| If taxable income is: | The tax is: |
|---|---|
| Not over $22,000 | 10% of taxable income. |
| Over $22,000 but not over $89,450 | $2,200 plus 12% of the excess over $22,000. |
| Over $89,450 but not over $190,750 | $10,294 plus 22% of the excess over $89,450. |
| Over $190,750 but not over $364,200 | $32,580 plus 24% of the excess over $190,750. |
| Over $364,200 but not over $462,500 | $74,208 plus 32% of the excess over $364,200. |
| Over $462,500 but not over $693,750 | $105,664 plus 35% of the excess over $462,500. |
| Over $693,750 | $186,601.50 plus 37% of the excess over $693,750. |

**Married Filing Separately:**

| If taxable income is: | The tax is: |
|---|---|
| Not over $11,000 | 10% of taxable income. |
| Over $11,000 but not over $44,725 | $1,100 plus 12% of the excess over $11,000. |
| Over $44,725 but not over $95,375 | $5,147 plus 22% of the excess over $44,725. |
| Over $95,375 but not over $182,100 | $16,290 plus 24% of the excess over $95,375. |
| Over $182,100 but not over $231,250 | $37,104 plus 32% of the excess over $182,100. |
| Over $231,250 but not over $346,875 | $52,832 plus 35% of the excess over $231,250. |
| Over $346,875 | $93,300.75 plus 37% of the excess over $346,875. |

**Estates and Trusts:**

| If taxable income is: | The tax is: |
|---|---|
| Not over $2,900 | 10% of taxable income. |
| Over $2,900 but not over $10,550 | $290 plus 24% of the excess over $2,900. |
| Over $10,550 but not over $14,450 | $2,126 plus 35% of the excess over $10,550. |
| Over $14,450 | $3,491 plus 37% of the excess over $14,450. |

The tables above show the 2023 marginal federal income-tax rates by filing status and income level. It also shows the long-term capital-gains rates for recognized capital gains on regular investment assets. ***Mini-Cases 3 through 5*** show how much a married person needs to earn before tax for each dollar of investment, both outside of and inside of employer sponsored elective-deferral plans.

***Mini-Case 3:*** Married persons with taxable income less than $89,450 are in the 12-percent federal income-tax bracket for 2023. If they are not self-employed, they also pay 7.65 percent for Social Security and Medicare, a total of 19.65 percent. If they are self-employed, they pay 15.3 percent for Social Security and Medicare, but get to write off half of that amount. Their effective marginal tax rate is around 26 percent. In addition, many people will also pay state income tax, which varies by state. Assume that for someone that is not self-employed the combined federal and state tax rate is about 28 percent. That means that married people with taxable income less than $89,450 **have to earn about $1.39 before tax in salary or wages for each dollar they wish to invest to meet their goal if they invest outside of a tax-deductible retirement plan**.

In the case where they may make **elective deferrals to tax-deductible retirement plans** (§401(k)s, §403(b)s, salary-reduction SEPs, SIMPLE IRAs, or deductible IRAs), these taxpayers still have to pay the Social Security and Medicare taxes, but not federal income taxes (and usually not state or local income taxes). Therefore, their effective marginal combined tax rate on wages and salaries for elective amounts contributed to their plans is 7.65 percent. In this case, **they would have to earn about $108.28 before tax in salary or wages for each $100 they elect to contribute to tax-deductible retirement plans.**

***Mini-Case 4:*** Married persons earning more than $89,450 but less than the Social Security wage base, are in the 22-percent federal income-tax bracket, and still pay the Social Security and Medicare tax of 7.65 percent. Assuming, once again, that their state income-tax rate is 5 percent, their **total effective combined marginal-tax rate is about 34 percent**. **In order to save $1 outside of tax-deductible qualified plans or IRAs, they will need to earn about $1.52 before tax**.

In the case of contributions to an elective-deferral tax-deductible type of retirement plan or deductible IRA, they will pay no federal income tax (nor, generally, any state of local income tax) on the amounts contributed, but they will pay the Social Security and Medicare tax, so their effective combined marginal-tax rate on the earnings contributed to the plan would be 7.65 percent. **Thus, in this case, they would also have to earn $108.28 in before-tax salary or wages to contribute $100 to a tax-deductible elective deferral type of plan.**

***Mini-Case 5:*** For married persons earning more than the Social Security wage base, but less than about $250,000 when the additional Medicare tax of 0.9 percent kicks in, their Social Security and Medicare tax rate is only 1.45 percent.

For taxable income up to about $190,750, their federal income-tax rate is 22, so if the state tax rate is still assumed to be 5 percent, their effective combined marginal-tax rate is about 27 percent plus Social Security on the portion up to the Social Security limit and 1.45 percent Medicare.

The higher the rates go, the more tax you pay, as it has been for years.

In the top tax bracket of 37 percent for married filing joint taxpayers with taxable income of over $693,750 for 2023, they will pay 37 percent federal tax plus the assumed state amount of 5 percent, plus the maximum Social Security amount

plus 1.45 percent Medicare on wages plus the extra .09 percent of Medicare. We will assume a marginal rate of 45 percent.

**Mini-Cases 3 through 5** show that the effective combined marginal tax rate on earned income can range from a low of about 28 percent for earned incomes below $89,450 to about 45 percent under our assumptions. For each dollar of after-tax investment required to reach the $1 million goal outside an elective-deferral plan, the pretax wages or salaries needed are $1.39 and $1.82, respectively.

If before-tax money will be invested in an employer-sponsored elective-deferral plan, then the effective combined marginal-tax rate on earned income can take on one of three values. Below the Social Security wage base the tax rate is 7.65 percent. Above the Social Security Wage base but below the threshold AGI amount for the additional Medicare tax ($125,000 for marrieds filing separately, $200,000 for heads of households and singles, and $250,000 for marrieds filing jointly) the tax rate is 1.45 percent. On earnings above the threshold levels by filing class, the tax rate is 2.35 percent. These rates correspond to pretax earnings of about $1.083, $1.015, and 1.024 respectively, for each $1 of investment needed within the plan to meet the $1 million goal.

Furthermore, assuming people want $1 million to **spend**, they must also account for the taxes that they will ultimately have to pay on the investment earnings. If they invest inside of qualified retirement plans, they defer income taxes on ordinary investment income and capital gains until the money is withdrawn, but then it is all taxed at ordinary income-tax rates. Therefore, the proportions of the total return they earn that are attributable to ordinary investment income and to capital gains are immaterial for tax purposes.

When people invest outside of qualified plans, they will pay ordinary income tax on the investment interest income as it is earned. They will also pay tax at ordinary income-tax rates on any recognized short-term capital gains. Most dividends paid on stocks and mutual funds are qualified dividends taxed at favorable rates. They will pay the long-term capital-gains tax rate on any recognized long-term capital gains, but that tax may be deferred almost indefinitely by simply buying and holding the investments until the end of their target accumulation periods. Consequently, how people invest the money, their portfolio turnover, and the proportions of the total return that are attributable to ordinary investment income and capital gains are all-important factors in determining the timing and the amount of the tax they will pay on the investment returns.

Whether or not investors will be able to earn any particular rate of return depends heavily on how they invest their money. However, they will be much more likely to earn higher effective rates of return by investing more heavily in appreciating assets, such as growth stock, growth stock mutual funds, real estate, and the like.

For illustration purposes, let us assume the money is invested in a moderately conservative (for longer investment horizons) portfolio allocated 75 percent to S&P stocks and 25 percent to intermediate-term bonds. Over the past 25 years, the ordinary investment-income, qualified dividend income, and capital-appreciation components of the return on a portfolio weighted this way comprised about 20 percent, 10 percent, and 70 percent of the total return, respectively.

**Tables 5 and 6** show the level amounts investors would have to **earn** in salary or wages each month or year, before tax, in order to make the after-tax investments outside of qualified retirement plans that are required to reach their $1 million inflation-adjusted after-tax target. These tables assume the combined tax rate on wages or salary is either at the lower end (28 percent) or at the higher end (45 percent) of the

ranges described in ***Mini-Cases 3 through 5***, respectively, of the possible combined effective tax rates on wages or salary income.

The analyses assume taxpayers pay taxes on the ordinary income and qualified dividend components of returns when earned. The tax rates on the ordinary income component of investment earnings are assumed to be the same as the tax rates on wages and salary, less the corresponding Social Security and Medicare taxes. Therefore, the tax rates on investment income in **Tables 5 and 6** are assumed to be 20 percent and 41 percent, respectively. The federal tax rate on qualified dividend income is assumed to be the same as the federal tax rate on capital gains, 5 percent and 15 percent, respectively. The state tax rate on qualified dividends is assumed to be 5 percent and on capital gains 5 percent. Therefore, the combined state and federal tax rate on qualified dividends for low- and high-income taxpayers is assumed to be 10 percent and 20 percent, respectively. Similarly, the combined state and federal tax rate on capital gains for low- and high-income taxpayers is assumed to be 10 percent and 20 percent, respectively.[7]

**Table 4**

| Who Wants to be a "Real" Millionaire! | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Level *MONTHLY* Before-Tax Earnings Required To Reach $1 Million Inflation-Adjusted After-Tax Goal Outside Qualified Plan**** | | | | | | | | |
| | | | **Annual Before-Tax Rate of Return***** | | | | | |
| | | **Goal*** | **2.5%** | **5.0%** | **7.5%** | **10.0%** | **12.5%** | **15.0%** |
| **Years** | **10** | 1,480,244 | 15,253 | 13,613 | 12,122 | 10,773 | 9,558 | 8,468 |
| | **20** | 2,191,123 | 10,048 | 7,884 | 6,106 | 4,677 | 3,550 | 2,674 |
| | **30** | 3,243,398 | 8,780 | 5,971 | 3,938 | 2,535 | 1,602 | 1,000 |
| | **40** | 4,801,021 | 8,587 | 4,994 | 2,756 | 1,464 | 758 | 387 |
| **Level *ANNUAL* Before-Tax Earnings Required To Reach $1 Million Inflation-Adjusted After-Tax Goal Outside Qualified Plan**** | | | | | | | | |
| **Years** | **10** | 1,480,244 | 183,937 | 164,167 | 146,204 | 129,958 | 115,324 | 102,194 |
| | **20** | 2,191,123 | 121,165 | 95,081 | 73,653 | 56,424 | 42,830 | 32,274 |
| | **30** | 3,243,398 | 105,872 | 72,006 | 47,500 | 30,581 | 19,333 | 12,067 |
| | **40** | 4,801,021 | 103,546 | 60,224 | 33,237 | 17,659 | 9,148 | 4,668 |
| * Assumes 4% annual inflation rate. | | | | | | | | |
| ** Assumes combined tax rate on wages or salary is 28% and the after-tax earnings are invested outside a qualified plan. | | | | | | | | |
| *** Assumes ordinary investment income is taxed at 20% when earned; qualified dividends are taxed at 10%; and capital gains are taxed at 10% at end of term. | | | | | | | | |

Even in the low-tax case (**Table 5**), the amount one actually has to earn in wages or salaries ranges from about one-half again as much to twice as much to reach the $1 million inflation-adjusted after-tax goal as was shown in **Table 3** when taxes were ignored. Not surprisingly, in the high-tax case (**Table 6**), the amounts needed are even higher, ranging from about twice as much to over three times as much as was shown in **Table 3**.

[7] The analyses in the following tables assume that the favorable tax rates on qualified dividends and capital gains will continue. Of course, for those taxpayers with high income, the amounts required to become a millionaire will be greater than the amounts shown in the following tables.

**Table 5**

| Who Wants to be a "Real" Millionaire! | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Level *MONTHLY* Before-Tax Earnings Required To Reach $1 Million Inflation-Adjusted After-Tax Goal Outside Qualified Plan**** | | | | | | | | |
| | | | **Annual Before-Tax Rate of Return***** | | | | | |
| | | **Goal*** | **2.5%** | **5.0%** | **7.5%** | **10.0%** | **12.5%** | **15.0%** |
| **Years** | **10** | 1,480,244 | 18,666 | 17,483 | 15,265 | 13,792 | 12,411 | 11,146 |
| | **20** | 2,191,123 | 12,493 | 10,109 | 8,065 | 6,355 | 4,953 | 3,827 |
| | **30** | 3,243,398 | 11,090 | 7,895 | 5,437 | 3,645 | 2,392 | 1,546 |
| | **40** | 4,801,021 | 11,019 | 6,807 | 3,972 | 2,221 | 1,206 | 643 |
| **Level *ANNUAL* Before-Tax Earnings Required To Reach $1 Million Inflation-Adjusted After-Tax Goal Outside Qualified Plan**** | | | | | | | | |
| **Years** | **10** | 1,480,244 | 223,992 | 209,796 | 183,180 | 165,504 | 148,932 | 133,752 |
| | **20** | 2,191,123 | 149,916 | 121,308 | 96,780 | 76,260 | 59,436 | 45,924 |
| | **30** | 3,243,398 | 133,080 | 94,740 | 65,244 | 43,740 | 28,704 | 18,552 |
| | **40** | 4,801,021 | 132,228 | 81,684 | 47,664 | 26,652 | 14,472 | 7,716 |
| * Assumes 4% annual inflation rate. | | | | | | | | |
| ** Assumes combined tax rate on wages or salary is 41% and the after-tax earnings are invested outside a qualified plan. | | | | | | | | |
| *** Approximates tax on investment income as an estimate. For purposes of this example, the amount is negligible. | | | | | | | | |

As one can see, getting to a real million is not easy. In fact, it appears darn near impossible. However, investors are definitely more likely to get there if they start early, invest wisely, and realize it will require them to save a significant portion of their pre-retirement earnings.

### *5. Other considerations*

The examples use a level payment. In reality, the payments can be increased each year for inflation. Also, payments can increase as a person receives increases in income above inflation. If the person invests in retirement plans, the tax savings should be considered. The point is, start early. Realize that $1,000,000 in the future is not the same as $1,000,000 now. You must account for inflation when estimating retirement needs.

## F. Special Note: The SECURE Act 2.0

On December 29, 2022, President Biden signed the SECURE Act 2.0 of 2022 ("SECURE 2.0") into law as part of the Consolidated Appropriations Act, 2023. SECURE 2.0 expands on many retirement provisions included in the original Setting Every Community Up for Retirement Enhancement Act (SECURE 1.0), signed into law in 2019. SECURE 1.0 was the most significant retirement legislation passed in over a decade and included 30 provisions primarily aimed at expanding access to retirement savings programs. SECURE 2.0 includes over 100 retirement-related provisions, making it an opportune time to evaluate and reassess one's tax planning strategies. Some of the more significant provisions for the individual are set out below.

### *1. Increase in age for Required Beginning Date for mandatory distributions*

SECURE 1.0 raised the age requirement for required minimum distributions ("RMDs") from age 70 ½ to 72. This provision allowed individuals to let their retirement savings accumulate for a longer time period if they did not need to rely on retirement savings to cover living expenses. Under SECURE 1.0, the Required Beginning Date ("RBD") was April 1 following the calendar year in which the IRA owner attained age 72.

SECURE 2.0 further increases the age requirement for RMDs to age 73 starting on January 1, 2023, and to age 75 starting on January 1, 2033. It is important to note that individuals can postpone taking their first RMD as long as they continue to work full or part time for the employer offering the plan.

The new SECURE 2.0 provision applies to distributions required to be made after December 31, 2022 for individuals who attain age 72 after such date.

| Tax Year | Birth Date | RMD Age |
|---|---|---|
| Through 2019 | Before July 1, 1949 | 70 ½ |
| 2022 through 2022 | July 1, 1949, through 1950 | 72 |
| 2023 through 2032 | 1951 – 1959 | 73 |
| 2033 and beyond | 1960 and beyond | 75 |

On March 7, 2023, the IRS provided guidance regarding the new SECURE 2.0 changes to RMDs. IRA owners who attain age 72 in 2023 will not have an RMD for 2023. IRA owners who attain age 72 in 2023 will have a required beginning date of April 1, 2025, instead of April 1, 2024. SECURE 2.0 did not change the required beginning date for IRA owners who attained age 72 prior to January 1, 2023. IRA owners who attained age 72 in 2022 are required to take 2022 RMDs by April 1, 2023. [8]

Since financial institutions have not had a sufficient time to incorporate SECURE 2.0 updates to their internal systems, Notice 2023-23 states that the IRS will not consider RMD statements provided to an IRA owner who will attain age 72 in 2023 to have been provided incorrectly, provided the owner is notified by April 28, 2023 that no RMD is actually required for 2023.

### *2. Higher catch-up limit to apply at age 60, 61, 62, and 63*

Under current law, employees who have attained age 50 are permitted to make catch-up contributions under a defined contribution retirement plan. The limit on catch-up contributions for 2023 is $7,500, except in the case of SIMPLE plans for which the limit is $3,500.

SECURE 2.0 increases these limits to the greater of $10,000 or 50 percent more than the regular catch-up amount in 2024 (2025 for SIMPLE plans) for individuals who have attained ages 60, 61, 62 and 63. The increased amounts are indexed for inflation after 2025. Additionally, SECURE 2.0 requires the catch-up contributions to be made as Roth contributions. However, an exception applies to workers with earnings of $145,000 or less – they can continue to make traditional contributions. This new SECURE 2.0 provision is effective for taxable years beginning after December 31, 2024.

### *3. Treatment of student loan payments as elective deferrals for purposes of matching contributions*

To assist employees who may be unable to save for retirement due to obligations to repay student loan debt, SECURE 2.0 permits such employees to receive matching contributions by reason of repaying their student loans. Specifically, SECURE 2.0 allows an employer to make matching contributions under a 401(k) plan, 403(b) plan, or SIMPLE IRA with respect to "qualified student loan payments," defined as any indebtedness incurred by the employee solely to pay qualified higher education expenses of the

[8] Notice 2023-23.

employee but limited to the limitation applicable under §402(g) for the year (or, if lesser, the employee's compensation), reduced by the elective deferrals made by the employee for such year. The limitation under §402(g) for 2023 is $22,500. Employees must certify annually to the employer making the matching contribution that payment has been made on the loan.

Governmental employers are also permitted to make matching contributions in a §457(b) plan or another plan with respect to such repayments. For purposes of the nondiscrimination test applicable to elective contributions, SECURE 2.0 allows a plan to test separately the employees who receive matching contributions on student loan repayments. The new SECURE 2.0 provision is effective for contributions made for plan years beginning after December 31, 2023.

### *4. Contribution limit for SIMPLE plans*

Under pre-SECURE 2.0 law, the annual contribution limit for employee elective deferral contributions to a SIMPLE IRA plan is $15,500 (as indexed for inflation in 2023) and the catch-up contribution limit beginning at age 50 is $3,500 (as indexed for inflation in 2023). Additionally, under pre-SECURE 2.0 law, the small employer (under 100 employees) of a SIMPLE IRA is required to either make matching contributions on the first three percent of compensation deferred or an employer contribution of two percent of compensation (regardless of whether the employee elects to make contributions).

Under SECURE 2.0, the annual deferral limit and the catch-up contribution at age 50 is increased by 10 percent for employers with no more than 25 employees. Under SECURE 2.0, an employer with 26 to 100 employees is permitted to provide higher deferral limits, but only if the employer either provides a four percent matching contribution or a three percent employer contribution. These changes are effective for taxable years beginning after December 31, 2023.

### *5. Modification of age requirement for qualified ABLE programs*

ABLE programs are tax-advantaged savings programs for certain individuals with disabilities. SECURE 2.0 increases the age by which blindness or disability must occur for an individual to be an eligible individual by reason of such blindness or disability for an ABLE program. Prior to SECURE 2.0, the individual's disability or blindness had to occur before age 26, but SECURE 2.0 increases the age requirement to age 46. This new SECURE 2.0 provision is effective for taxable years beginning after December 31, 2025.

### *6. Special rules for certain distributions from long-term qualified tuition programs to Roth IRAs*

SECURE 2.0 permits beneficiaries of 529 college savings accounts to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA. Such rollovers are subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. Additionally, the rollover cannot exceed the total amount contributed to the account more than five years before the rollover. Roth income limit restrictions are not applicable to the 529 plan Roth conversion.

As a result of this new provision, individuals will have the option to avoid the penalty on a non-qualified withdrawal of leftover 529 plan funds. This new SECURE 2.0 provision applies to distributions after December 31, 2023.

### *7. One-time election for qualified charitable distribution to split-interest entity; increase in qualified charitable distribution limitation*

SECURE 2.0 allows for a one-time, $50,000 distribution to charities through charitable gift annuities, charitable remainder unitrusts, and charitable remainder annuity trusts, effective for distributions made in taxable years beginning after the date of enactment of this Act. Additionally, SECURE 2.0 indexes for inflation the annual IRA charitable distribution limit of $100,000, effective for distributions made in taxable years ending after the date of enactment.

### *8. Roth plan distribution rules*

Under pre-SECURE 2.0 law, owners of Roth-designated employer retirement plan accounts, such as 401(k) plans, were required to take pre-death distributions. SECURE 2.0 eliminates this requirement, effective for taxable years beginning after December 31, 2023. Prior to SECURE 2.0, individuals with Roth-designated employer retirement plan accounts would have to transfer such accounts to a Roth IRA in order to avoid taking RMDs. In other words, individuals with Roth-designated employer retirement plan accounts are required to take RMDs, just as individuals are not required to take RMDs from Roth IRAs.

### *9. Surviving spouse election to be treated as employee*

SECURE 2.0 provides that a surviving spouse may elect to be treated as their deceased spouse for purposes of the RMD rules, effective for calendar years beginning after December 31, 2023. As a result, a surviving spouse that is older than the decedent spouse may use the decedent spouse's age to delay the RMD until the start date in which the decedent spouse would have been required to take an RMD.

### *10. Optional treatment of employer matching or nonelective contributions as Roth contributions*

Under pre-SECURE 2.0 law, plan sponsors were not permitted to provide employer matching or nonelective contributions in their 401(k), 403(b), and governmental 457(b) plans on a Roth basis. In other words, matching contributions could only be made on a pre-tax basis. Prior to SECURE 2.0, certain plan participants could elect to convert vested account balances (including any employer matching and non-elective contributions) by utilizing a Roth in-plan conversion. In order to convert any vested account balances, the plan sponsor had to offer the Roth in-plan conversion option. In other words, prior to SECURE 2.0, plan participants could essentially receive employer matching and nonelective contributions on a Roth basis through the Roth in-plan conversion.

SECURE 2.0 permits defined contribution plans to provide participants with the *option* of receiving matching or nonelective contributions on a Roth basis, effective on the date of enactment. However, such employer contributions may only be made on a Roth basis if the contribution is nonforfeitable, meaning the plan sponsor must fully vest such matching or nonelective contributions.

It is important to note that providing employer contributions to a Roth account could create withholding issues, as employer contributions made on a Roth basis are subject to income tax at the time contributed.

## G. Risk is necessary

Paradoxically, not taking enough investment risk may guarantee failure. Risk actually decreases over time. Strange as it may seem, over longer periods the risky asset is the high-probability shot.

The S&P 500's long-term (40-year) average simple historical return is about 13 percent, and it has demonstrated an annual standard deviation of about 16 percent. This represents considerable variability and uncertainty of returns year to year. Based upon the history for the last 40 years, there is a 95-percent chance that returns in any year will be between about -15 percent and +37 percent. Alternatively, there is a five percent or 1-in-20 chance that returns in any given year will fall **outside** this range.

However, if investors are planning to invest for a long period, say 30 years, the return in any given year is not particularly important. The performance in the exceptionally good years will offset the performance in the exceptionally bad years. As the term of the investment horizon lengthens, the average annual compound rate of return investors can expect to earn over the entire period becomes more and more predictable. Based upon the returns for the S&P 500 for the past 40 years, investors can be 95 percent confident that they will earn 10 percent or more on an annual compound return basis over a 30-year investment horizon.

In contrast, over the same 40-year period, the simple annual return on one-year Treasury bills has averaged about a 6.1 percent with a standard deviation of 2.62 percent. Based upon these historical returns, investors can be 95 percent confident that they would earn **no more** than a 6.76-percent annual compound rate of return on one-year Treasury bills over a 30-year investment horizon. So, the 10-percent return for stocks, which is close to a worst-case estimate over a 30-year period, is still about 3.25 percent higher than the 6.76 percent for T-bills, which is the best-case estimate for one-year Treasury bills. In other words, even if investors experience a bad 30-year period for stocks, they can expect to earn about 1.5 times more than they would with T-bills, even if T-bills have one of their best 30-year periods.

Bonds and other savings alternatives do not offer enough real total return to meet reasonable economic needs later. A portfolio investing heavily in equities like domestic and foreign large –cap, small-cap, and emerging-market growth and value funds has the highest chance of a successful outcome over long time periods.

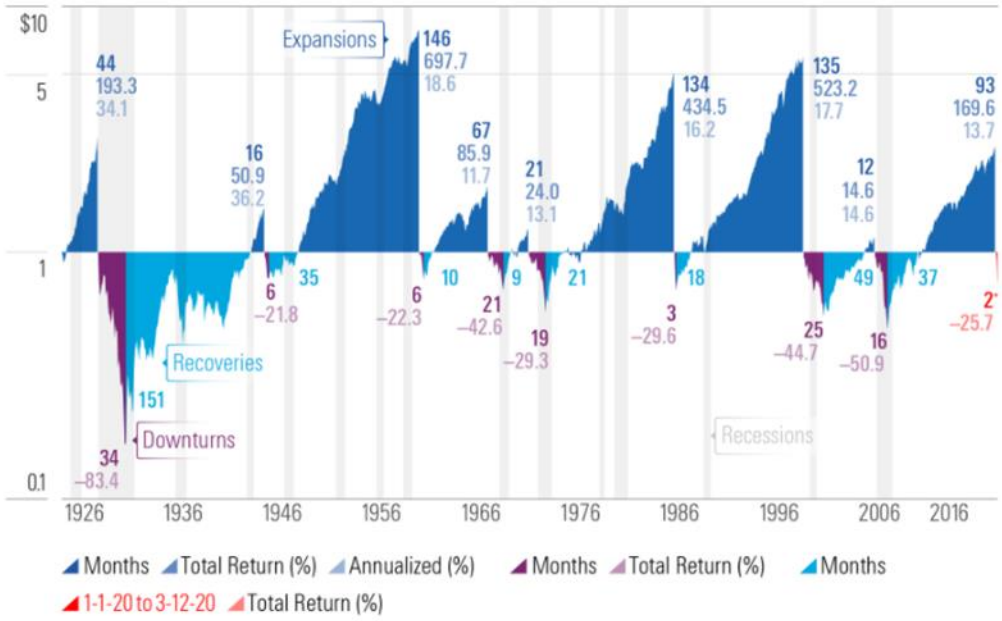
The moral is clear: invest early, invest lots, and invest in a diversified portfolio of equities to get reasonable long-term performance.

***Practice note:***

While it is tempting to believe that one can perfectly time entering during stock market low points and selling at market peaks, the reality is that this outcome is rarely achieved. One of the biggest mistakes that an individual can make is waiting for the market to dip and potentially missing out on market returns. The investor who is able to stay the course during market booms and downturns is likely to outperform the investor who tries to time the market.

**Bear Markets Are Painful, but Markets Rise Over the Long Term**

Growth of 1 USD from 1926–2020




Source: Stocks—Ibbotson Associates SBBI U.S. Large Stock Index. *March 1 to March 12 return calculated for the S&P 500 because the Ibbotson Associates SBBI U.S. Large Stock index does not have daily data.

## H. Maxing out the savings rate

Experience has shown that an investor saving between 20 to 25 percent of income over a working career generally can expect to achieve economic security. Maxing out contributions on IRAs, §401(k)s, profit sharing, or pension plans should go a long way toward meeting the goal. Current tax deductions and tax-deferred compounding make the whole process both more efficient and somewhat less painful.

To some people, the idea of spending somewhat less than their total income plus credit-card limits is a foreign concept. However, they may wish to consider the consequences of this current lifestyle choice. Failure to attain one's retirement goal will result in delayed retirement or drastic cuts in lifestyle later on.

If based on the circumstances of one's life, 20 to 25 percent is not attainable, then what is? 5 to 10 percent is better than nothing. Be like Jack and Diane in the case study earlier in the chapter. They are just two American kids doing the best that they can!

## I. Weaknesses of software solutions

A word of caution if you are using retirement-planning software, such as that provided by some leading mutual fund companies: these calculators do not distinguish between average return rates and the range of possible outcomes. For example, if you plug an average 10-percent rate of return into one of these tools, the software does not point out that the range of possible returns for that portfolio may fall between six percent and 14 percent three quarters of the time over a long period. You now have a 50-percent chance of falling short of your goal, because in context, “average” means that 50 percent of the time you will do better, and 50 percent of the time you will do worse than projected.

A more conservative rate-of-return assumption may make better sense. By saving somewhat more based on the lower range of possible outcomes, you can improve your chances of meeting your objective from 50 percent to 90 percent. Now you have minimized any chance that you will not reach your objective, and even set yourself up for a possible positive surprise.

Many other assumptions your software is making may be overly optimistic. If expected returns are based on the past index performance, they do not account for expenses and they assume that every penny is invested every second. That is worth maybe one percent to two percent per year. If your software calculates arithmetic averages rather than compound returns, that is worth another 1.5 percent. Finally, these programs usually assume that the next 30 years will look just like the past 30 years. Who knows how much to discount that? Perhaps two percent is appropriate, so you might want to give the final “expected” return a four-percent to five-percent haircut. We are still making a guess, but now it is one that is educated and conservative.

## J. Keep it real

Investors need to recognize that all models are very crude approximations of reality, so it pays to err comfortably on the side of conservatism. Few investors lament having too much money when retirement rolls around. On the other hand, for those who are a little too optimistic in their planning, there is always McDonald’s.

## K. Relying on averages

Place one hand on a hot stove, and the other on a slab of dry ice. Any statistician will tell you that on average, you are comfortable -- but, of course, you know it is not so. The market’s average returns hide very long periods of both very weak and very strong performance. What is more, averages are derived from past returns, but future returns are unlikely to exactly mirror the past. Naively relying on “average” numbers without considering the market’s wide variations can lead to disaster.

The models we use to describe market behavior become critical to our retirement planning. We often say that stock prices follow a random walk, in which each price change is independent of the one that preceded it. But studies have shown that there is more serial correlation than a random distribution would predict. In other words, both winners and losers repeat more often than they should. We also typically say that stock-market returns are normally distributed, but actually there are far more very good and very bad periods than there should be if market returns mapped out as a true bell-shaped curve; the “tails,” as they are called, are too fat.

For instance, based on the average daily market volatility of the preceding 50 years, the crash of 1987 should happen just once in 55 million years. (A statistician would say that the crash was a 16 sigma

event, or outside of 16 standard deviations from the average.) So, investors can all go back to sleep, right? Well, not quite. It would be foolish to build a plan that did not take into account at least one more good crash during our lifetimes.

Getting more and bigger winners than you should is not catastrophic. But what if the losers are bigger and more often than we expect? How might that affect the plan? And if some of those big losses show up during the first few years of retirement, will you be able to recover?

Imagine that you retired in 1972. You had $500,000 invested in equities and planned to withdraw eight percent ($40,000) each year for income. From 1973 to 1974, the market dropped 50 percent, and you made your withdrawals as expected. In just two short years, you were down more than 60 percent. Your remaining capital was about $200,000, so depleted that it could never recover under the weight of your planned annual $40,000 withdrawals -- which, after the disaster, amounted to 20 percent of the remaining capital.

Investors must assess both the probabilities and the potential consequences of their strategies. For example, we know that if we play Russian roulette with the typical revolver, we have but a one in six chance of losing.

Unfortunately, while the probability of losing is low, the consequences of a loss could ruin your whole day. The consequences of failure for a retiree, while not quite so absolute, are still unacceptable. Nothing can turn those golden years into a nightmare faster than being broke.

Given the possibility of market crashes, the wide variation of investment returns in the short term, and the consequences of failure, retirees must adopt strategies with the highest probability of success. They will want to build in a little extra padding for safety. The market neither knows nor cares whether you have retired. It can go down at any time, and stay there for several years.

## L. Planning guidelines

Do not expect to ever see an average year. From this profound axiom, we can derive the corollary: Do not expect retirement to be a long string of average years.

Conceptually, at least, it is easy to structure an accumulation program. But the game changes at retirement. Both economically and psychologically, the stakes get higher. Time is no longer on your side. With no more salary coming in, there is no way to make up for investment mistakes. Risk takes on an entirely new meaning.

The retiree looks at whatever the retiree has accumulated and somewhat fearfully asks two questions: How much can I safely withdraw? How can I structure my account to maximize the probability that it will last forever?

We often hear people say that the best plan is to die happy having just spent their last dollar. But amortization is out of the question. The time horizon of one’s retirement is long and not easily predicted. After all, if investors plan to spend their last dollar at their average projected life expectancies, what happens if they miscalculate and live another five years? Remember that by definition half of all people will live longer than the median age of death for the group (actually, **more** than half can expect to live **beyond** the life expectancy for their age group). In any event, drawing down one’s nest egg over a long

period of time does not really add much to one's income. Even if retirees do not care whether there is anything left over for the kids, there is no alternative to keeping the principal intact, if possible.

As if the problem was not already tricky enough, investors must expect at least modest amounts of inflation, so retirees' income requirements will grow throughout their lives. The longer is a retiree's time horizon, the more inflation will eat into buying power.

Retirees will soon discover that they are unlikely to meet any reasonable income needs using fixed-income investments alone. They must usually endure some equity risk to meet their objectives. The trick is to generate at least the required minimum return at the lowest possible risk level. Too little risk, and the portfolio may not generate enough return, while too much risk may "blow up" the portfolio during a string of bad years.

As objectives and risk tolerance are now quite different during the payout phase, the asset-allocation plan we had put together during the accumulation phase must change. In addition to balancing the potential returns one seeks against the risk of failing to meet return expectations, plans should include a good pad for safety. As a matter of policy, investors will want to begin the process of completing the transition to an appropriate portfolio payout posture several years in advance of their expected retirement dates.

The old schoolbook "low risk" income solution for retirees, widows, and orphans was to load up on money-market funds, municipal bonds, convertible bonds, utilities, real estate, preferred stocks, and other high-dividend-paying or interest-bearing securities. But this income-only approach generates an inefficient portfolio with far higher risk per unit of return than is necessary.

A far more efficient (lower risk) solution is to invest for total return rather than income. Investors can more effectively control risk by varying the ratio of stocks to bonds in their portfolios than by purchasing the "low risk" income portfolio.

A variation of a "balanced" portfolio, including a diversified global-equity portion and a short-term bond portion, will generally come closest to meeting all the conflicting criteria. However, if available capital falls short of what is required, something will have to give. Either investors must delay retirement, or retirees must curtail their lifestyles.