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Legal Matters®

Estate Planning
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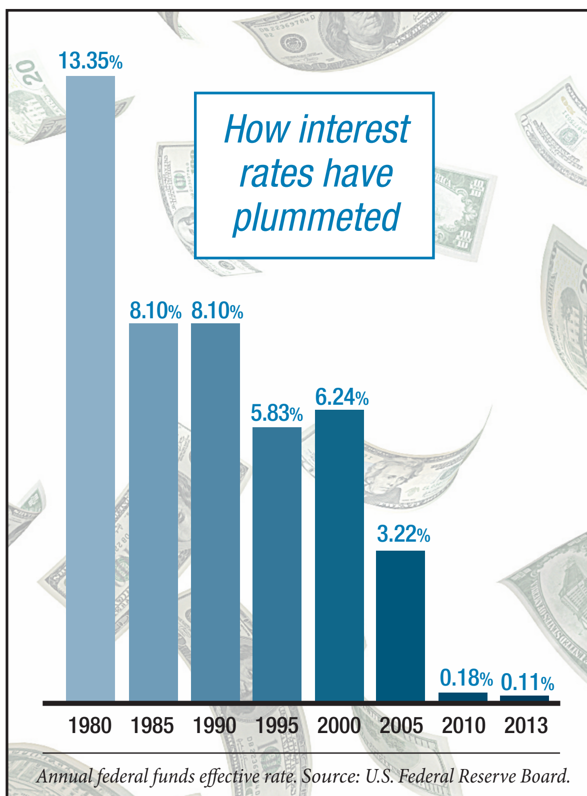
Long-term low interest rates are wreaking havoc on many trusts

For decades, it was very common for trusts to be set up like this: "The trust income will go to the first beneficiary, and when the first beneficiary dies, the trust assets will go to a second beneficiary."

Here are some common examples:

- A couple sets up a trust with the income going to a child, and when the child dies, the assets go to their grandchildren.
- A wife's will creates a trust that pays income to her second husband, and when he dies, the assets go to her children by her first marriage.
- A man sets up a trust where the income goes to his wife, and when she dies, the assets go to a charity.



Annual federal funds effective rate. Source: U.S. Federal Reserve Board.

That's all well and good when interest rates are healthy. But over the last few years, interest rates have plunged to historic lows, and stayed there.

The result in many cases is that the first beneficiary of a trust ends up getting a lot less income than he or she expected – or than the person who created the trust expected, for that matter.

This often puts trustees in a bind. Typically, trustees want to manage the funds fairly to help both the first beneficiary and the second beneficiary. They will invest some assets in bonds and other fixed-income instruments to produce income, and others in equities to create long-term appreciation. But recently, such

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What you need to know about the new ‘trusteed IRAs’

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If you don’t need all the money in an IRA after you retire, there can be big tax advantages in carefully leaving it to your children or other heirs. If it’s done right, the heirs can take out only the minimum required distribution each year, and the assets in the IRA can continue to grow tax-deferred for decades – and in some cases, for generations to come.

The problem with this planning technique is that it requires your heirs to be patient money managers. In the real world, many heirs withdraw the funds from an inherited IRA quickly, which destroys the tax advantages.

The traditional solution is to leave your IRA to a trust, in which a trustee can decide how to invest the IRA, when to make withdrawals from the IRA, and what distributions to make to your heirs.

Trusts have other advantages, such as that they can benefit a surviving spouse during his or her lifetime, and later benefit children from an earlier marriage. They can also shelter IRA assets from estate tax if your spouse is from another country and doesn’t have a large estate tax exemption.

Recently, though, some financial institutions have been pitching a new product called a “trusteed IRA.” The new product is similar to a trust, in that a trustee is appointed who will manage the IRA assets and limit future distributions to heirs.

The main advantage of a trusteed IRA is that the tax rates for trusts have risen recently, and at least for the near future, a trust might pay higher taxes than the beneficiary of a trusteed IRA.

However, trusteed IRAs also have a very big drawback, which is that you can’t pick the trustee and you don’t have any flexibility for special circumstances.

With a trusteed IRA, your assets will be managed by a money manager who works for the financial institution and likely has no familiarity with your family or your preferences. Plus, the trustee has no ability to bend the rules if the circumstances require. If your heirs ever need extra distributions to pay for education, health problems, starting a business, or any other contingency, they’ll be out of luck – whereas with a trust, you can pick a trustee who understands your heirs’ needs, and you can write the trust to give the trustee power to help them when appropriate.

Either way, it’s important to talk to an estate planner about how to choose the beneficiaries of an IRA. While the tax advantages can be huge, the rules are complex and technical and it’s very easy to make a mistake.

The danger of waiting too long to do estate planning

While any estate planning is better than none, the vast majority of problems occur when people procrastinate planning their estate and then do it in a hurry.

Some people never get around to writing a will or planning their estate until the last minute, when they have grown old and have a serious illness.

Other people write a simple will when they’re young, but never review or update it until something happens that makes them think that death is imminent.

While any estate planning is better than none, the vast majority of mistakes and problems occur when people procrastinate planning their estate and then try to do it in a hurry.

If you wait until the last minute, it might be very difficult to locate all the documents you need to properly execute an estate plan. And you might not have sufficient time to take advantage of all the techniques that are available to save taxes and properly take care of your heirs.

In addition, last-minute changes to your will can be very disturbing to family members. A great many will contests are the result of heirs whose expectations were upset by eleventh-hour amendments.

Estate planning is a critical part of your overall financial planning. Most people would never buy a stock or other investment and then completely ignore it for 20 years. In the same way, you should review and update your estate plan every few years, or whenever there’s a significant change in your circumstances.

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Be careful if you donate to charity for a specific purpose

Bernard and Jeanne Adler donated $50,000 to an animal shelter in their hometown of Princeton, N.J. The gift was to finance a new structure for large dogs and older cats (whose prospects for adoption are limited), and the structure was to be named for the Adlers.

Before construction began, however, the shelter merged with another organization. After the merger, the new organization announced plans to build a smaller structure in another town, without specific facilities for large dogs and older cats and without naming anything for the Adlers.

The Adlers went to court and demanded that the shelter return their $50,000 gift.

The shelter argued that it had fulfilled the Adlers' intent as well as it could under its changed circumstances. But an appeals court said that didn't matter – the Adlers had made the gift with specific conditions, and if the conditions weren't met, the charity had to return the funds.

The moral of the story is that if you're making a charitable gift and you intend for the money to be used for a specific purpose, this needs to be very clearly spelled out in a contract or gift agreement, so that you have legal recourse if the charity takes your money and uses it for something else.

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Long-term low interest rates are wreaking havoc on many trusts

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an approach has had the effect of shortchanging the first beneficiary.

A trustee could shift all the investments to bonds to try to make up the difference. But doing so would harm the second beneficiary.

There's no perfect solution, but a different type of trust called a "unitrust" could make things easier in this environment.

Rather than paying the first beneficiary the interest each year, a unitrust pays the first beneficiary a fixed percentage of the trust's total assets. So for instance, a trustee could determine the total value of all the trust assets as of December 31 of each year, and then pay the first beneficiary 4 percent of that value.

This doesn't solve every problem, but it does prevent a first beneficiary from being punished when interest rates drop and stay low for a long time. It also allows a trustee to manage funds for the best possible overall return without having to worry about shortchanging one of the beneficiaries. The better the trust's investments do, the better off *both* the first and second beneficiary will be.

While a typical unitrust pays the first beneficiary a fixed percentage of the trust assets each year, a popular variation is to "average out" the value of the assets over a three-year period. For instance, a trust could pay the first beneficiary 4 percent of the average value of the trust on December 31 of the past three years.

This is a way of smoothing out the payments, so the first beneficiary's income doesn't fluctuate wildly from year to year depending on the market.

If you're setting up a new trust, or if you have an old trust that can be modified, it might be worth considering making it a unitrust.

In highly unusual circumstances, even a trust beneficiary may be able to make this change.

In one recent New York case, a trust created in 1983 was designed to pay income to a daughter, with the assets going to other children after the daughter died. Following the 2008 crash, the daughter's income from the trust dwindled considerably. The daughter went to court and asked a judge to convert the trust to a 4-percent-a-year unitrust, saying she needed the additional funds to pay for her health care.

The judge agreed and converted the trust. The judge said that doing so was in keeping with the intent of the trust, which was to adequately support the daughter. The judge also said that since the daughter was now elderly and the trust assets had grown over the years, there was little chance that upping the annual payout to 4 percent would dangerously deplete the trust assets for the other beneficiaries.

A lawyer can advise you about whether a unitrust makes sense in your situation.

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Have an estate plan? Great – but you need to follow through

One of the most common mistakes people make in estate planning is that they finally create a complete, thorough, highly advantageous estate plan – and then forget to follow through and put it all into effect.

It's not uncommon for people to have detailed documents drawn up, and then not get around to signing them. Or they create a trust, but forget to transfer assets in order to fund it. Or they decide whom to name as beneficiaries of their IRA, 401(k), bank and brokerage accounts – and then don't fill out the paperwork to make the change.

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A recent case involved Allen Kagan, a Minnesota pharmacist who had a $415,000 life insurance policy through his employer. Allen died of a sudden heart attack, and was survived by his new wife Arlene and three children from a previous marriage.

The life insurance policy said that if Allen didn't name a beneficiary, then by default the beneficiary would be his wife – Arlene.

The children claimed that Allen and Arlene "fought constantly" and had sought marriage counseling. After Allen's death, the children found a form on which Allen had designated the children as the life insurance beneficiaries, and cut out Arlene. Allen had signed the form – but he hadn't submitted it to the insurance company before he died.

The case went all the way to a federal appeals court, which sided with Arlene. Although the signed form suggested that Allen had intended to change his beneficiary, he never followed through, the court said. Because Allen never submitted the form, the court couldn't assume that he had fully made up his mind to do so. Therefore, Arlene got the money.

The bottom line is that the best estate plan in the world isn't worth the paper it's printed on if you don't follow up and take the necessary steps to make it a reality.