



THE TOGGLE SOLUTION

Like a light switch – a Trust Protector can be toggled on or off as needed.

BECAUSE ESTATE TAX LAWS ARE CHANGING MORE FREQUENTLY AND EVEN RETROACTIVELY, EVERY TRUST SHOULD NOW NAME A TRUST PROTECTOR.

Uncertain and changing estate tax laws make long-term planning difficult.

- Because of this uncertainty, in spite of the currently high estate tax exemptions, an “A-B Trust” is still the best planning solution for many clients,
- but only when the trust includes Trust Protector language to allow for balancing between potential estate tax savings and capital gains taxes.
- Older trusts rarely include Trust Protectors, or the specific powers the Trust Protector requires to make these tax planning adjustments,
- so it is important to have your clients’ trusts reviewed by an attorney familiar with this type of planning.

I have been helping clients with estate planning for many years. Clients would create their trust in a way that would preserve and distribute their assets based on their goals and the estate tax laws in place AT THAT TIME. Because the estate tax laws were relatively stable, one could create a trust knowing that it would stay viable into the foreseeable future. When the time came for the trusts to be administered, the trustee would distribute assets in the manner our clients expected when the plan was created.

In the last ten years, we’ve seen wild swings in estate tax exemption rates and other major aspects of the law. It is unsettling that Congress not only has the power to change the estate tax laws going forward but, as we saw in 2010, can also change the laws RETROACTIVELY. Even if clients are diligently keeping their trust updated with each change of the law, it may not be enough to protect and distribute their assets as they intend when the time comes.

YOUR CLIENTS MAY HAVE BEEN POSTPONING UPDATING THEIR TRUST UNTIL THE ESTATE TAX LAW “SETTLES DOWN.” OUR EXPERIENCE LEADS US TO BELIEVE THAT IS NOT GOING TO HAPPEN ANYTIME SOON!

Designating a “Trust Protector” and granting that person very specific powers allows flexibility in the trust to better weather changes in the estate tax laws as well as changes in a clients’ assets and family’s needs.

Because every life needs a good plan.

WHAT IS A TRUST PROTECTOR?

A Trust Protector is someone granted the authority to direct selected actions of the trustee of the trust, even if the settlor of the trust has become incapacitated or dies. Unlike a trustee who handles the day-to-day issues of a trust, a Trust Protector is called upon only when specific issues arise, such as a major change to estate tax law.

The person chosen to be Trust Protector:

- Is **not** a beneficiary of the trust
- Has a firm understanding of the tax laws that may affect the trust
- Is often an attorney, accountant or financial advisor

By adding a Trust Protector and granting them a specific set of powers, the beneficiaries will be able to avoid possible negative tax consequences while still carrying out the clients' primary intent.

WHY IS HAVING A TRUST PROTECTOR IMPORTANT TODAY?

While there is no substitute for keeping estate planning documents up-to-date, the inclusion of Trust Protector language is a powerful tool to help deal with the unexpected. The key is built-in flexibility!

Because estate tax exemptions are high today, but may be lower in the future, married clients with a trust that provides for setting up A-B Trusts following the first death face a particularly difficult challenge.

WHAT KINDS OF CHALLENGES DO CLIENTS FACE?

In the past it was easy. The opportunity to save on or eliminate estate taxes far outweighed the possibility of paying some capital gains tax. An A-B Trust was the go-to tool to create this outcome.

With today's higher estate tax exemptions, the A-B Trust may not save any estate tax, and may actually create an additional capital gains tax burden for the clients' beneficiaries.

Estate Tax vs. Capital Gains:

For clients with an A-B Trust — upon the death of the first spouse — two trusts are created. One trust is for the share of community property of the first spouse to die, equal to the available estate tax exemption, which goes into an irrevocable trust - the B-Trust. This trust is designed to avoid any estate tax on the assets held in the B-Trust upon the second death, regardless of the value of those assets or the amount of the estate tax exemption in effect at that time.

What is the potential negative trade off for achieving the estate tax savings within the B Trust? There is no adjustment in the basis for capital gains tax purposes of any asset in the B-Trust at the time of the second death. Generally this works out to be an overall tax advantage because, if there were an estate tax on all of the couple's assets, the tax would be calculated on the full value of the assets and be payable nine months from date of death. Currently capital gains taxes are at a record low of 15% for Federal and 9% for California for a total of 24%. The capital gains tax is calculated on the difference between the "basis" and the sale price. This tax is not payable until there is a sale, over which timing is controlled by the trust or beneficiaries. Because there is a step-up in basis after the first spouse's death, generally speaking, the assets have most likely already had a generous step up before being funded in the B-Trust.

Over the years, when the estate tax exemption was in the \$250,000 to \$1,000,000 range, the A-B Trust approach helped our clients save millions of dollars in estate taxes. However, with the estate tax exemption increased to \$5,000,000 for the balance of 2011 and 2012, unless a change is made, the efficacy of an A-B Trust is being questioned. Why put anything into the B-Trust if the total amount of the combined estate is less than the \$5,000,000 exemption?

WHY IS THE A-B TRUST STILL AN IMPORTANT PLANNING TOOL?

There are several important advantages to maintaining the existence and benefits of the A-B Trust.

- *The amount of the estate tax exemption after December 31, 2012 is totally unknown.*
If the law doesn't change by the end of 2012 the exemption will go back to \$1,000,000 and the rates will return to 55%. With the rancor and extreme polarity expressed by the political parties these days, good policy decisions seem to be out of the question and the estate tax laws are one of the hot button issues. So the future estate tax laws are, and will remain, uncertain.
- *The B-Trust insures that the wishes of the deceased spouse are carried out without the surviving spouse's future circumstances modifying that outcome.*
- *Unlike the surviving spouse's revocable A-Trust — the B-Trust is irrevocable and therefore, protected.*
This type of irrevocable trust, which fully benefits the surviving spouse as a source of income and principal if needed, may not be subject to the claims or lawsuits of creditors, or to anyone who might seek to take advantage of the surviving spouse. The assets in this trust are also not subject to division in a divorce of a future marriage.

How can the advantages of an A-B Trust be maintained while avoiding any negative impact for clients whose estates are valued at less than the current estate tax exemption?

WHAT IS THE SOLUTION?

If both spouses are alive, have an A-B Trust, and a combined estate of less than \$5,000,000 – they can modify their trust to include a provision appointing a “Trust Protector” with the power to create a “testamentary general power of appointment.”

Following the first death and the establishment and funding of the A-B Trust, if the tax circumstances warrant it, the Trust Protector would grant the surviving spouse this testamentary general power of appointment. The mere granting of that power to the surviving spouse will make the assets in the irrevocable B-Trust subject to estate tax upon the surviving spouse's death. But, assuming the value of the combined A and B Trust assets are less than the surviving spouse's available estate tax exemption, there will be no estate tax due. By being subject to estate tax, those assets will be eligible for an adjustment in basis for capital gains tax purposes following the surviving spouse's death.

So, given the right circumstances, the beneficiaries would have the best of all worlds from an estate and income tax standpoint:

- *Wishes Honored*
The intent of the deceased spouse for the distribution of the estate will be carried out.
- *No Estate Taxes Owed*
If the combined value of the two trusts and any other assets subject to the estate tax at the surviving spouse's death is less than the amount of the available estate tax exemption there will be no estate tax.

- *Reduced Capital Gains Tax*
The assets in the B-Trust will have a step-up (or adjustment) in basis to increase depreciation and reduce the potential amount of capital gains tax in the event of a sale after the surviving spouse's death.
- *Assets Protected*
During the lifetime of the surviving spouse, there will be an element of creditor and divorce protection for those assets.
- *More Flexibility and Less Uncertainty*
The timing for the use of the Trust Protector's authorized power is if and when it is needed therefore all parties involved can predict the outcome.

WHAT OTHER POWERS CAN BE GRANTED TO A TRUST PROTECTOR?

There are a number of other powers which may be granted to a Trust Protector. Here is a list of powers we suggest clients consider including in their trust:

- Power to remove and replace trustees
- Power to designate a mediator if other parties fail to do so
- Power to modify accounting decisions which are inconsistent with the UPAIA
- Power to transfer trust assets to another trust (called "decanting")
- Power to change withdrawal rights of a beneficiary
- Power to change beneficiary payout method from income to a Total Return Unitrust
- Power to modify income distribution
- Power to add or remove powers granted to a trustee
- Power to correct "scrivener errors"
- Power to make revisions to adapt to changes in the law

WHY DO WE CALL THIS THE TOGGLE SOLUTION?

A Trust Protector is not involved in the regular management of a trust. They simply remain available if a situation arises that requires their insight or action. Just as one would toggle a switch to turn on or off the lights—a Trust Protector is only called upon when needed.

NEED MORE INFORMATION?

This is a very simplified explanation of a complex issue. If you have questions or would like to discuss this issue as it relates specifically to one of your clients please don't hesitate to contact me at 805.856.3401.

Yours truly,



F. T. Muegenburg, Jr.
President, META law, inc.

Because every life needs a good plan.