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Asset protection trusts

Those who have built significant wealth are rightfully concerned about how best to use that wealth for family financial protection. As has often been noted, the wealthy want their heirs to have enough to be able to do anything, but not so much that they don't have to do something.

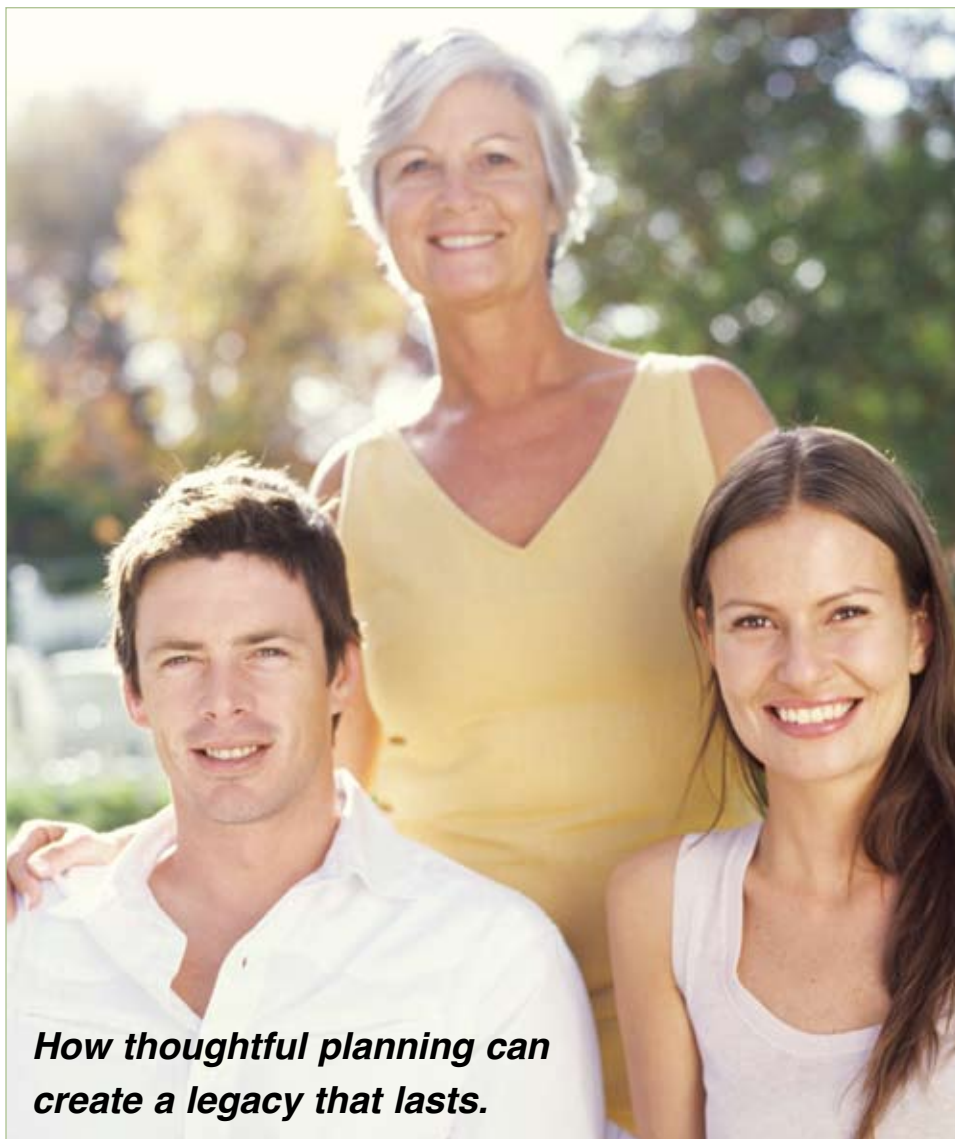
Trust planning comes immediately to mind when planning for a child who is a minor. The trust can provide for education funding and for getting a good financial start in life. Incentives can be built into the trust for achieving certain milestones, such as reaching a certain age or beginning a professional practice.

But what about when the children are fully grown, established in their careers and financially mature, in their 30s or even 40s? Even then, trust-based planning will be an excellent idea for many affluent families.

Basic tools

A great variety of financial protection strategies may be implemented with careful trust planning. Among the choices to evaluate:

- **Gifts-to-minors trust.** For young children, contributions of up to \$13,000 per year to this sort of trust will avoid gift taxes. A married couple can together set aside \$26,000 each year for each child or grandchild, so in a few years a significant source of capital may be built up. Assets may be used for any purpose, including education funding, and will be counted as the child's assets for financial aid purposes. The assets of a gifts-to-minors trust must be made fully available to the child when he



How thoughtful planning can create a legacy that lasts.

or she reaches age 21. However, the child may be given the option of leaving the assets in further trust.

- **Support trust.** For an adult child who needs a permanent source of financial support, with the trust principal protected from the claims of creditors, a support trust may provide a solution. The beneficiary's interest is limited to so much of the income as is needed for his or her support, education and maintenance.

- **Discretionary trust.** The trustee has sole discretion

Asset protection . . . continued

over what to do with the income and principal, just as the grantor does before the trust is created. The beneficiary has no interest in the trust that can be pledged or transferred. When there are multiple beneficiaries, the trustee may weigh the needs of each in deciding how much trust income to distribute or reinvest, when to make principal distributions, and who should receive them. The trust document often will include guidelines on such matters.

- **Spendthrift trust.** The beneficiary is forbidden to transfer any financial interest that he or she has in the trust and may not compel distributions.

Here are examples of how these trusts may work.



Trusts in action

Creditor protection.

Robert's will divided the ownership of his closely held business equally among his three children at his death. Two of the children were active in the business; the third was not.

The transition was smoother than they had expected, and the business continued to prosper for several years. The first sign of trouble was when one child's marriage fell apart. His wife demanded part of his share of the business in the divorce settlement. When the third child lost his job, he wanted to sell his shares back to the company, but there was no plan in place to facilitate that. What's more, when that child's creditors discovered his ownership connection to the family firm, they also began to look to it for redress. The clouds thrown over the business affected management of the firm, and the business itself began to suffer.

One of the most frequent questions that we hear is: "How can I keep my money and property out of the hands of my son-in-law (or, sometimes, my daughter-in-law)?" The inquiry is understandable, given the high divorce rate in this country. Our answer: Use a trust to own and manage the property, and give your child the beneficial interest in the trust instead of the property. A carefully designed trust plan can protect assets in divorce proceedings and from improvident decisions by impulsive members of the younger generation.

Future flexibility. Alice tried to treat each of her four children fairly throughout their lives. That didn't mean she treated them equally. Three of the children went to college, two to graduate school. The fourth child developed substance abuse problems. The rehabilitation costs almost looked like college tuition expenses at times.

Alice isn't keeping score as she provides her children with financial help. Some families have unusual financial needs. Alice wants to apply her financial resources where she believes that they will do the most good. That may mean that the most financially successful of her children will get only a nominal inheritance, while others will get more. Yet she also knows that fortunes can shift over time—that the person who is successful today might suffer a reversal tomorrow. Thus, ongoing monitoring is an essential component of her long-term planning.



A discretionary trust plan for managing the inheritance of Alice's children can have this same flexibility built into it. The trustee can evaluate the status of the children and their families and adjust the trust distributions in accordance with the guidelines set down in the trust.

Capital foundation. With a net worth of more than \$10 million, Ralph and Sharon know that they are an estate tax target. For that reason the couple has been funding gifts-to-minors trusts for each of their four grandchildren for several years. They've chosen to use gifts of appreciated stock. Last year they transferred \$96,000 worth. This year they can give a total of \$104,000 to the trusts without gift tax or future federal estate tax. If stock prices stabilize and grow in the future, all of that resource accrues to the grandchildren free of transfer taxation.

Our invitation to you

We specialize in estate settlement and trusteeship. We are advocates for trust-based financial planning. If you would like a "second opinion" about your estate planning, if you have questions about how trusts work and whether a trust might be right for you, we're the ones you should turn to. We'll be happy to tell you more. □

The topsy-turvy muni market

The appeal of municipal bonds comes from two factors: historically, munis have a very low default rate, and the interest payments are generally free of federal income tax, as well as some state income tax (usually only for the state of issue). Because they are slightly riskier than Treasuries, munis normally have a slightly higher yield on an after-tax basis. In the past that has meant muni yields of 80% to 90% of Treasury yields. At 90% of Treasury yields, munis were considered “cheap.”

In 2008 the relationship of these bond categories flipped. In early 2008 muni yields reached and breached yields of Treasuries of comparable maturities, then settled back later in the year. But in September the bottom fell out of the market as bond values declined precipitously. As 2009 began, municipal bond yields were 200% to 300% of Treasury yields, all along the yield curve. The table below compares the yields as of mid-January for highly rated bonds; weaker bonds had still higher yields.

What's going on?

External factors

The credit markets generally were battered in 2008, but market observers have identified several factors that have particularly affected municipal bonds:

- The financial health of the bond insurance industry began to fail in 2007, and that continued into 2008. The result has been that the market now appears to assign little value to bond insurance, based upon the similar yields of AAA-uninsured and AAA-insured bonds.
- The auction-rate bond market collapsed early in 2008.
- Hedge funds had to unload their municipal bond portfolios.

It's that last factor that weighted heaviest during the autumn market collapse. Hedge funds had to unwind some of their strategies; or they had to meet margin calls; or they had to raise cash to satisfy redemptions. When that happened, they were forced to sell the best assets that they owned—the municipal bonds.

The imbalance continues this year, as the institutional investors—banks and insurance companies—have not yet returned to the muni market.

What's next?

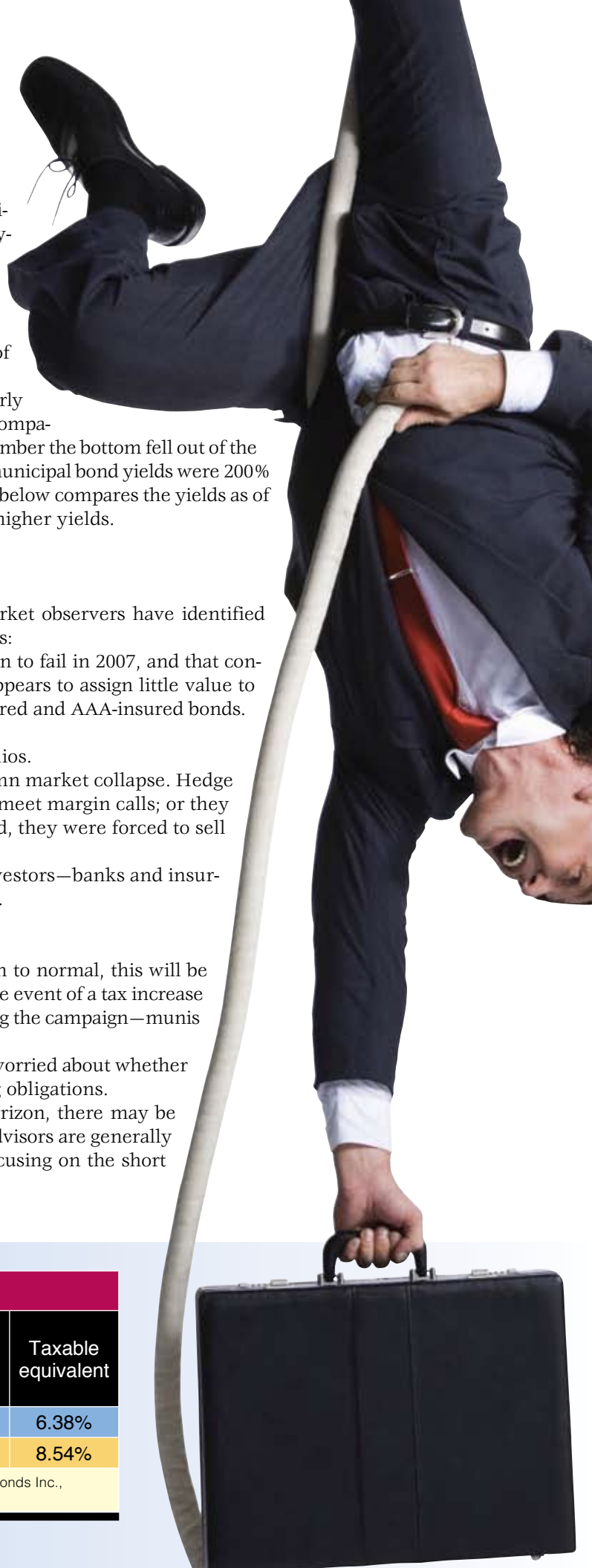
Should the relationship between munis and Treasuries return to normal, this will be seen as the buying opportunity of a lifetime. What's more, in the event of a tax increase on top earners—a consistent promise of President Obama during the campaign—munis instantly will become still more valuable.

On the other hand, the poor economy has many investors worried about whether state and local tax revenues will keep up with debt-servicing obligations.

Depending upon one's investment objectives and time horizon, there may be real opportunity in the municipal bond market. Investment advisors are generally recommending sticking to AAA- and AA-rated issues, and focusing on the short and intermediate maturities. □

Treasuries versus munis					
Maturity	U.S. Treasury yield	AAA insured municipal bond yield	Taxable equivalent	A-rated municipal bond yield	Taxable equivalent
10 years	2.64%	3.55%	5.46%	4.15%	6.38%
30 years	3.36%	4.75%	7.31%	5.55%	8.54%

Sources: M.A. Co.; *The New York Times*, January 23, 2009 (Treasury yields); FMS Bonds Inc., January 15, 2009 (municipal bond yields). Assumes 35% federal income tax rate.



No RMDs needed for 2009

Most retirees need to consume their IRAs in order to have a comfortable retirement. However, some of the most frugal make every effort to leave as much in their IRAs as possible, for as long as possible. The tax law frowns on such thrift for those who are age 70½ or older. They are required to take Required Minimum Distributions (RMDs) every year, geared to their life expectancy and the size of their IRA.

Most IRAs shrank drastically during 2008, but the RMDs had to be determined based upon the generally larger account value at the beginning of the year. A movement for some relief from forced realization of losses at the bottom of the market has yielded a partial solution. RMDs remain mandatory for the 2008 tax year but are waived for 2009. Note that those who turned 70½ in 2008, and who, therefore, have until April 1, 2009, to receive their first RMD, still must take it. (Normally, RMDs must be made by December 31.)

Bad IRA estate planning

Names fictitious, but the story is true. Before she remarried, Diane agreed that her will would include a qualified terminable interest property (QTIP) trust for her husband, Sam. At Sam's death the trust assets were to be divided among Diane's four children. Diane's main asset, an IRA, was to be the main trust asset as well. Diane's will was drafted appropriately to achieve this result.

Unfortunately, when Diane changed IRA custodians in a later year, she signed a new beneficiary designation form for the IRA. The new form listed her four children as the successor IRA beneficiaries, not the trust.

When the problem was discovered after Diane's death, the children did the right thing to restore Diane's promised testamentary plan. They disclaimed their interest in the IRA; that is, they legally refused to accept their share of it. Under the terms of the beneficiary form, that meant the IRA went to the estate, and under the terms of the will, the IRA went to the QTIP trust, just as Diane wanted.

But there is a problem. Federal law treats a disclaimer as a taxable gift unless it is "qualified" by meeting a number of rules. Among them, the disclaimant generally must renounce his or her *entire* interest in the property. Here, the children did not disclaim their QTIP trust remainder interests, and so eventually they *will* receive the IRA—they just have put it off until the future. In a Private Letter Ruling, the IRS has held that the disclaimer fails to meet federal gift tax requirements.

What's more, because the tax law now treats the property as having passed to Sam from the children and not from Diane, there will be no marital deduction for Diane's estate for the transfer of the IRA to the QTIP marital trust. □

They've achieved financial independence.



Having the resources to be financially independent is a blessing, but managing those resources wisely can be a burden. These are unprecedented times for investors, and the financial markets can be treacherous.

Why not enlist our help with your investment management? We have an array of investment services to meet a wide variety of needs. We've helped many others; let us help you and your family as well.

Call our trust professionals for an appointment.

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