

Trusts & Estates®

The Journal of Wealth Management for Estate-Planning Professionals—Since 1904



In Vogue—This photograph (34.3 cm. by 25.3 cm.) by Erwin Blumenfeld sold for \$56,250 at the Christie's Photography auction on April 8, 2011 in New York, p. 4.

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Special Report: The Fiduciary Professions

By R. Hugh Magill

The Changing Face of American Wealth

Estate planners and trustees should consider the distinctive social and demographic phenomena that shape their clients' needs

In 2008, the “boomer” generation had just begun to enter retirement when the great recession intervened, postponing plans for many, shattering dreams for some and suspending dialogue on a host of issues unique to wealth management and transfer for this generation. And while the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010’s (the 2010 Tax Relief Act) generous transfer-tax exemptions may be the catalyst for revisions to their clients’ wealth transfer plans, estate planners and financial advisors should consider several of the distinctive social and demographic phenomena that shape their clients’ needs and perspectives. **These changes should affect the way we think about how we’ll serve a new generation of clients.**

Changing Demographics

Data from the 2010 U.S. Census indicate that the geographic center of our population moved 25 miles south, to Plato, Mo., in the 10 years from 2000 to 2010. Hidden behind this positional phenomenon are several striking statistics: approximately 92 percent of U.S. population growth in the decade came from minorities; the

Hispanic population in the United States grew 43 percent from 2000 to 2010; and over 36 percent of the U.S. population comprises Hispanic, Black, Asian, Native American or other non-white individuals.¹ **Individuals and families among all of these groups are building and accumulating wealth, pointing to a need for estate planning and fiduciary services.** What gaps exist between this need and our ability to understand some of the unique perspectives and practices that will shape their approach to wealth management and transfer?

The 2010 *Wealth in Black America* study,² for example, revealed that affluent blacks feel significantly more responsible for supporting adult family members compared to non-blacks (52 percent to 36 percent) and that a majority of affluent blacks (52 percent) are currently providing financial support to their parents. **Maintaining this support, while providing benefits for a surviving spouse and children, will require a thoughtful allocation of financial wealth, balancing of beneficial interests and careful planning, including tailored discretionary standards that represent the perspective(s) of the client toward these relatives.** Managing the trusts that implement these benefits will require particular sensitivity to the comparative interests of these family members, while upholding the duty of impartiality across three or more generations.

Affluent blacks are also significantly more likely to hold interests in closely held businesses than their non-



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black counterparts, placing a premium on advisors' expertise in both business and estate planning. Estate plans for these and any other closely held business owners must carefully navigate the prudent investor rule's mandate concerning diversification, while providing guidance to the fiduciary about the circumstances under which to consider a sale of a business. Finally, a majority of affluent blacks indicated that they hadn't worked with an advisor in the previous five years to establish an estate plan. This is an opportune time to assist these clients with planning that ensures that their financial wealth will fulfill their unique personal and philanthropic objectives.

In the 1960s through the 1980s, many Muslim students and young professionals immigrated to the United States from Southeast Asia. These individuals established professional practices, built businesses, raised families and may now be planning for retirement. **Observant Muslims must follow Islamic laws of inheritance as they plan for not only the disposition of their assets, but also for their funeral arrangements and the administration of their estates.** The 19th century English barrister, academician and expert on both Islamic and Hindu inheritance, Almaric Rumsey of King's College, London, observed that Islamic inheritance law "comprises beyond question the most refined and elaborate system of rules for the devolution of property that is known to the civilized world."³

Shariah law allows a testator to bequeath up to one-third of his estate to either charities or to relatives or friends who don't have an enforceable share in the estate. The balance of the estate must be distributed to family members in accordance with complex Islamic rules of consanguinity. **Developing even a rudimentary understanding of Shariah-compliant estate planning can not only introduce us to a body of law with which many of us are unfamiliar, but also open doors to estate planning and wealth management opportunities that lie outside the traditional reach of our practices.**

Changing Family Structures

Further data from the U.S. Census Bureau point to changes in the nature and structure of what we think of when we refer to a "family." Illustrative statistics include a decline in the percentage of adults who are married (54.1 percent in 2010 versus 74.4 percent in 1960), an increase in the number of one-parent families (in 2006, 28 percent of households consisted of one-parent families; in 1960, 4 percent of households consisted of one-parent families) and increases in the number of both unmarried opposite-sex couples and unmarried and

married same-sex couples. (It's difficult to compile historical census data on same-sex couples due to changes in U.S. Census Bureau reporting standards over the last 20 years.) **Unmarried same-sex couples report the highest levels of household income among all reporting households,** while married opposite-sex couples are the most likely to own their own homes.⁴

The phrase "blended family" is commonly used today, although there appears to be no single definition of the type of family structure this implies. Statistical studies of U.S. households (for example, the U.S. Census and its annual American Community Survey) focus on "households" and characteristics such as the number of children (making no distinction among biological, step- or adopted children), marriage, gender, age and size.⁵ I'll use the phrase "blended families" to refer to any household with children, other than a married couple with its own biological or adopted children.

Many of our will and trust forms don't reflect the diversity of family structures that exist in the United States today.

Even without a universal definition of "blended family," several family statistics indicate that blended families are on the rise. Nonmarital cohabitation is increasingly common today, with the number of cohabiting couples in the United States having increased 15-fold since 1960. A substantial percentage of these cohabiting households (over 40 percent) include children,⁶ with 70 percent of these children representing the biological child of only one of the partners.⁷ The percentage of children under age 18 living with a single parent has also increased, to 25 percent in 2009, from 9 percent in 1960.⁸ And while divorce rates have declined somewhat since they peaked in the early 1980s, a new marriage today faces a probability of divorce or separation of between 40 percent and 50 percent.⁹

As we plan for individuals and families, several aspects of our approach bear reexamination. First, many of the will and trust forms on which we base our estate-planning documents don't reflect the diversity of family structures that exist in the United States today. Indeed, many of these forms were initially developed decades ago, and while they have undergone modifica-

tions to accommodate countless changes in federal tax and local trust law, few include sufficient alternatives to allow planners to readily adapt the forms to the unique objectives and needs of our client “families.”

Consider the myriad innovations in trust design over the last 30 years, including the many tax-qualified trusts (for example, qualified terminal interest property (QTIP), qualified replacement property, qualified personal residence and qualified domestic trusts), the trusts developed after changes in state trust law (for example, dynasty, asset protection and administrative trusts), trusts developed for special asset circumstances (for example, irrevocable life insurance, special purpose and directed trusts) and trusts developed for tax-advantaged wealth transfer (for example, grantor retained annuity, defective grantor and super-charged credit shelter trusts). Yet few trusts

The CRT can be adapted for married and unmarried couples without descendants.

have been broadly developed to accommodate unique family circumstances (the few exceptions that come to mind include special needs and incentive trusts). Many of our common will and trust forms inadequately address issues such as beneficial interests in non-spousal relationships, discretionary interests for stepchildren and inheritance rights for children of artificial reproductive technology.

While there’s little flexibility in the design of certain trusts (for example, marital trusts subject to Internal Revenue Code Sections 2056 or 2056A or charitable remainder trusts (CRTs) structured to qualify under IRC Section 664), can some of our common trusts be reexamined and redesigned to meet the unique needs of blended families?

Non-qualified CRT

The CRT can be adapted in some circumstances for married and unmarried couples without descendants. Since 1969, most charitable split-interest trusts have been drafted to comply with IRC Section 664, to qualify for this trust’s unique tax advantages. For some clients, though, additional flexibility in a split-interest trust’s

lifetime provisions may warrant structuring a testamentary trust as a non-qualified CRT. While this would entail a loss of the charitable deduction, with a \$5 million federal estate tax exemption, that deduction may be unimportant for some clients.

This would be appropriate for clients who are a couple (married or unmarried) and who wish to provide the survivor with more than a unitrust or annuity interest, while ensuring the eventual transfer of the remainder to a charity. This trust’s lifetime provisions could be structured to provide either mandatory or discretionary net income, unitrust or annuity payments, discretionary principal and even “5&5” withdrawal provisions (that is, the right to withdraw \$5,000 or 5 percent of the trust principal). Removing such a trust from Section 664’s strict tiering system would also facilitate investment of the trust’s fixed income allocation in municipal securities, which could be increasingly advantageous in a rising tax environment. Investments in business entities wouldn’t give rise to the problems associated with unrelated business taxable income.

These advantages do come at a loss of the qualified CRT’s exemption from income tax. While a non-qualified CRT could be established during a client’s lifetime, its non-qualified status would result in a loss of the income tax deduction for the present value of the charitable remainder interest. When using this trust for clients in states that impose state death taxes with lower exemptions, consider certain adaptations. For clients who qualify for the marital deduction, the lifetime interest could be structured as a QTIP to qualify for a state marital deduction. Non-married clients would probably be best suited to a trust that the state’s exemption could shelter.

Wealth Allocation for Blended Families

The perennial questions of who should receive how much and when are compounded in blended families. When there’s sufficient wealth, thoughtful consideration of legal obligations, family needs, family relationships and philanthropic goals will lay a good foundation for analyzing and selecting among alternatives. When wealth is insufficient, planners need to assist clients in making compromises. Thoughtful communication with family members is wise in either set of circumstances.

When families comprise individuals with differences in legal entitlement, need, lineage, age and expectation, I think it’s wise to establish a hierarchy among the potential beneficiaries. Here’s an example:

| | |
|--|---|
| Former spouse | Obligations under settlement agreement or divorce decree |
| Current spouse | Obligations under pre- or postnuptial agreement, needs and expectations |
| Children | His ... hers ... theirs: legal obligations, needs and expectations |
| Grandchildren | His ... hers ... theirs: legal obligations (rarely), needs and expectations |
| Parents or other collateral relatives | Needs |

Once funds are allocated for any legal obligations,¹⁰ planners can assist families in considering questions such as what amount of wealth will be required to maintain a surviving spouse's lifestyle; are there anticipated, but unfunded needs of younger children (such as college and post-graduate education, weddings, downpayments on homes) that may have been satisfied for older children; will any of the children receive inheritances, and will these expectancies differ among the children; is a second spouse similar in age to children from a first marriage so that delaying their inheritance until the second spouse's death would be unworkable?

Families can then focus their attention on a "fair" allocation of wealth among the children. **If there's sufficient wealth to care for a surviving spouse and children, the 2010 Tax Relief Act's generous gift and generation-skipping transfer tax exemptions present a significant opportunity to make lifetime gifts in 2011 and 2012 to trusts for grandchildren or even more remote descendants.**

Spray Trusts

Consider whether the simple spray or sprinkle trust (that is, a trust in which the trustee has discretion to pay income out of the trust among a class of beneficiaries, as needed) is suited to the needs of a blended family with children of different parentage and who may be of significantly different ages. **Spray trusts can present significant challenges with respect to the trustee's fiduciary duties.** How should a trustee balance its duty to account with its duty of confidentiality, even with something as simple as the way in which discretionary distri-

butions are described in the trust ledger? How should a trustee structure fixed income investments when some beneficiaries' tax brackets suggest a need for taxable, and others, non-taxable, fixed income securities?

When a spray trust is the only workable solution to provide for multiple beneficiaries' needs, trustees need guidance on the priority of interests among different classes of beneficiaries. It may also be appropriate to incorporate different discretionary standards for dissimilar sets of beneficiaries. (See "A Simple Plan?" p. 50.) It's also wise to ascertain whether the grantor wishes larger discretionary distributions to be treated as advancements against a beneficiary's eventual distributive share. **One purpose for which spray trusts are well suited is to provide funding for grandchildren's education; such a trust can ensure funds are available for all grandchildren, even if a grandparent's death intervenes before all education is completed or if there are grandchildren born after a grandparent's death.** Donors will find that 2011 and 2012 provide an ideal environment for fully funding these trusts.

Trust Accounting

Another challenge in trust management for blended families lies in the area of trust accounting. Many states now mandate annual accounting (or "reporting" in the language of the Uniform Trust Code (UTC)) to not only current distributees of income or principal, but also to remainder beneficiaries. This requirement is codified in Section 813 of the UTC, which has been adopted in 22 states and the District of Columbia. Advocates of this broader accounting requirement cite a desire for more transparent trust management; and some institutional trustees favor the benefit of the accounting's commencement of the statute of limitations. **Is comprehensive accounting appropriate for all families, particularly those in which the current and remainder beneficiaries are unrelated and, perhaps, even adversaries?** Is family harmony promoted in circumstances in which generous benefits intended for the current beneficiary diminish the remainder share—while the remainder beneficiaries watch?

Boomer Generation Estate Planning

As boomers return to the estate-planning process, they face a number of issues that are distinctive to their generation. These include philosophical issues such as,

- What will our legacy be?
- How much wealth (for children) is too much?
- When and how should we discuss wealth with our children?

A Simple Plan?

Trustees can have a hard time fairly balancing interests of disparate beneficiaries

An early experience with a spray trust introduced me to the challenges of these seemingly simple estate-planning devices. We served as trustee of a small trust established by a great grandfather for his great grandchildren. There were eight beneficiaries from four different families, with an age span of roughly 25 years between the oldest and youngest members of the class. In its early years, the trust had to navigate the throwback rule in a high interest rate environment, resulting in larger discretionary distributions of trust income to the older beneficiaries. Years later, in a period of lower interest rates and dividends, younger beneficiaries didn't enjoy a similar level of trust income distributions, leading them to question the benefits received by their older cousins. Over its term, the trust had retained its market value notwithstanding substantial discretionary distributions, but an oversight in the trust's design required the trust to be distributed to the great grandchildren in equal shares when the youngest attained age 18, leaving the last beneficiary's college education to be funded separately. Discretionary distributions to an educational account helped to mitigate this problem, but the substantial increases in tuition costs over the 25 years spanning the beneficiaries' college educations wouldn't allow for a solution that all beneficiaries perceived to be fair.

—R. Hugh Magill

- How can we facilitate good family communication and governance?

They face new **practical concerns**, including

- How will we provide for aging parents and dependent children ... often at the same time?
- How will we ensure continued care for disabled, adult siblings?
- How will we provide for non-marital partners who don't enjoy many benefits available to spouses?
- How will we treat descendants of different lineage?

And last, they're presenting estate planners and trustees with **challenging tactical issues** such as

- What is the best situs for our wealth?
- How can we protect assets from creditors' claims?
- Can we change beneficial interests, trustee duties and trustees in irrevocable trusts?

Our ability to guide boomers on these issues will require us to expand our understanding and enrich our expertise with new creativity. And our best discussions with our clients won't begin with taxes; they will begin by helping families to explore and express their unique gifts and attributes, thus laying a foundation for financial

wealth to be informed by and contribute to the rich intellectual, social and emotional attributes that define each of the families that we are privileged to serve. ■

Endnotes

1. U.S. Census Bureau, 2010 Census Data.
2. *Wealth in Black America: 2010 Study of Financial Attitudes and Preferences of Affluent Blacks*, The Northern Trust Company, <http://tiny.cc/ncl4x>. Survey participants consisted of U.S. residents, age 18 or older, with \$250,000 or more in annual household income or \$1 million or more in investable assets.
3. A. Moohummudan Rumsey, *Law of Inheritance* (1880).
4. Data drawn from U.S. Department of Commerce, Bureau of the Census, "Household and Family Characteristics: March, 1978;" "Counting Same-sex Couples: Official Estimates and Unofficial Guesses" (Martin O'Connell and Daphne Lofquist, April 2009); U.S. Census Bureau, "Current Population Survey Reports, America's Families and Living Arrangements: 2010," www.census.gov/population/www/socdemo/hh-fam.html.
5. See, for example, the U.S. Census Bureau's American Community Survey, 5-Year Estimates 2005-2009.
6. "The State of Our Unions, Marriage in America 2010," National Marriage Project at the University of Virginia, at p. 76, www.virginia.edu/marriageproject/pdfs/Union_11_12_10.pdf.
7. Susan L. Brown, "Family Structure and Child Well Being: The Significance of Parental Cohabitation," *Journal of Marriage and the Family* 66 (2004).
8. U.S. Census Bureau, "Current Population Survey Reports, America's Families and Living Arrangements: 2009," www.census.gov/population/www/socdemo/hh-fam.html.
9. "The State of Our Unions," *supra* note 6 at p. 71.
10. Matrimonial counsel who negotiate estate-planning obligations often fail to consider appropriate trust structures and provisions in settlement agreements and divorce decrees.