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The Estate Analyst

THE MILLION-DOLLAR ESTATE & LLCS, BANKRUPTCY, TRUSTS

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The irrevocable living trust, without any bells or whistles, remains a potent and effective strategy.

The million-dollar estate is under attack.

A divorce, a mishap, a period of unemployment, bad health, high mortgage payments, debts, a lawsuit—any number of scenarios can trigger a downward spiral. Tragically, a nice $1-million estate is at risk of never reaching the next generation of beneficiaries.

There is, however, a simple solution that every estate and elder-law professional should be taking a fresh look at. In fact, it is a classic, the old-fashioned aspirin remedy of estate planning. The irrevocable living trust, without any bells or whistles, remains a potent and effective strategy. And we need it now, more than ever.

A QUOTIDIAN MILLIONAIRE

Making a million dollars is no longer the milestone it once was. Star athletes and executives routinely get bonuses of $1 million. There are millions of millionaires. According to Forbes, the top 400 wealthiest Americans are all billionaires. There are about 5,000 family offices around the United States, i.e., family fortunes of about $100 million or more. The top one percent of American households (1.6 million households) has in excess of $6 million.

To be sure, the million-dollar estate is not exactly the "common man's estate." The majority of households have little or no estate to speak of. About 30% of households have under $10,000 not including homes. Only 23% of households have wealth in excess of $75,000 not including the family home.

Of the top 10 percentile of Americans in terms of wealth, there are about 10 to 13 million households with over $1 million in assets (not counting the family home). Most of those millionaires are closest to the $1-million category.[1] However, that number may be greatly underestimated. Many estates are right around the $1-million mark and, lately, just under that $1-million plateau.[2]

Why are so many estates in this same layer of wealth? Is there some financial gravity or equilibrium that causes estates to arrive at that number? Does it simply reflect the average result from social economic variations of upper middle class folks? Have income levels leading up to this moment in history channeled all these households toward $1 million?

A MILLION-DOLLAR MELT DOWN

In any event, there are large numbers of estates in the million-dollar range and they are all at risk. The million-dollar estate can be diminished, dissipated, and decimated faster than an ice cube melting in the hot sun. An estate of that size is no longer a self-sustaining pool of wealth, but rather a plateau that requires ongoing income to be maintained.

For example, a working individual of pre-retirement age with a typical assortment of assets such as a personal residence, some growth stocks in an IRA or 401(k), some business-related assets, some life insurance, maybe a vacation cabin or time share, and some family trusts or 529 plans earmarked for college payments may have only a small portion of the estate that is actively invested to produce current income. There is enough income from current salary and generating more taxable income would expose it to higher tax rates. Equity growth is desired. Some risk is tolerable.

But a sudden job loss can mean current living expenses can only be met by dipping into savings or incurring more debt. Without steady income, even million-dollar estates can erode away in a few years. Any misstep in life can trigger a downward spiral of negative cash flow and debt.

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SAFE HAVEN INVESTING

Reconfiguring an estate to produce income has its limits. Selling the vacation cabin and shifting all investments during down markets may not leave much after capital gains taxes and commissions.

Currently, safe investments are hard to come by. Suppose after reconfiguring a $1-million estate into a house worth $350,000 and $650,000 of investment assets, the owner put the $650,000 in certificates of deposit yielding 2.6%. That would only produce $16,900 before taxes.

Even in a tax-free municipal bond fund producing 5.5%, that would only produce $35,750. That, plus unemployment won't maintain a family's lifestyle. So borrowing against equity in the house begins and portions of the $650,000 are tapped into. And credit card debts accumulate. And car loans. And soon there is only $500,000 producing $27,500 while the carrying costs or property taxes and utilities increase. And now there is interest on the borrowed amounts. A vicious cycle has begun.

For a young retiree, living alone with modest expenses and no longer receiving earned income, more assets can be devoted to producing income but conservative investments are called for since the remaining assets cannot be replaced. A slight negative cash flow may not be cause for alarm at first. What's $10,000 compared to $1 million. But then expenses continue to rise. One-time expenses arise. Family members need "loans" which aren't paid back. Retirement isn't free.

Flash forward 10 years and the $1 million has dwindled to $850,000. The cash flow problem is now $25,000 per year because the estate is producing less and expenses keep rising.

People are living longer. In fact, that expression has become part of the modern lexicon. People retiring at age 65 with a million-dollar estate can find themselves at age 75 with a shrinking estate...and more than a decade of retirement years ahead. The less obvious aspect of living longer is that retirement years may involve higher-than-normal costs.

When the last few years arrive and high maintenance health and living supervision is needed, the costs can eat up $100,000 per year. And with modern health care, those high maintenance years can go on for many years, wiping out large estates until there is nothing left to pass along to heirs.

By the time nursing-home-care starts exhausting assets, the prospect of Medicaid becomes evident. By then, it may be too late to save any part of the estate because of the look-back rule.

Medicaid is administered by individual states with some variations in state laws and rules, but it is a Federal program and the five-year look-back rule applies in all states. If a person needs $80,000 a year to remain in a nursing home and has $20,000 of Social Security income, it will take $60,000 per year of the person's savings to supplement living expenses.

If someone with $300,000 left is in this position and tries to transfer it and then applies for Medicaid, the look-back rule will be applied. The end result is that the applicant will have to spend down the entire remaining estate before Medicaid will take over.

So to save any portion of the $1-million estate from the Medicaid look-back rule, estate planning transfers need to take place a lot earlier at a time when assets are much higher.

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OUR OLD FRIEND

Trusts have been used for centuries and never go out of style. Fiduciary returns for trusts continue to increase in number.[3] However, it would be understandable if some practitioners considered alternatives to irrevocable living trusts for the million-dollar estate over the past 20 years or so.

The unified estate and gift tax exemption reached an exemption equivalent of $500,000 by 1986, so from that point forward a married couple using QTIP or other testamentary trusts could avoid all transfer tax on a million-dollar estate.

Avoiding probate via trusts became unnecessary as more states adopted probate-friendly statutes. Moreover, many family assets are now steered directly to beneficiaries via life insurance, IRAs, TOD accounts, and jointly owned assets, all of which can avoid probate if set up properly.

In 1993, a highly condensed income tax rate for trusts made smaller trusts more expensive (and led to greater planning emphasis on "defective" trusts that could be taxed at the grantor's tax bracket.

So if one is not saving estate taxes or needing to avoid probate, why set up a separate trust that exposes income to a highly condensed tax rate schedule? Several standard reasons justify trusts—creditor protection, control over wasteful spending, and secure investment management through a fiduciary, for instance. Now, however, the end-of-life pattern leading to catastrophic or long-term health care expenses and ultimately the need for Medicaid provides a compelling incentive. Trusts can provide an ideal solution.

AN EXAMPLE

Mr. M. is an 85-year-old man with $1 million. Being conservative with his investments, he has $200,000 in tax-free municipal bonds, $600,000 in certificates of deposit and $200,000 in taxable stocks. His Social Security and pension net him $25,000. His investments are netting him $25,000. His living expenses are $50,000. He is in financial equilibrium.

Mr. M. wants his son and grandchildren to benefit from his $1-million estate and if he dies now, his heirs will receive all of that $1 million. He is, however, not inclined to die at this time. Yet he is mindful of the uncertainties of life and knows that five years from now, at age 90, he may be in need of advanced medical assistance and perhaps require full-time nursing care that could total $100,000 per year.

One Solution: An irrevocable trust can work quite well for Mr. M. in several respects. First, the gift in trust falls within the $1 million lifetime gift exclusion. Second, it reduces the size of his potential taxable estate which is relevant for Mr. M's state level estate taxes. Third, he can transfer the municipal bonds and the CDs to a trust without incurring capital gains. Fourth, his position in tax-free bonds would avoid tax at the trust's high tax rate. In fact, converting some portion of the CDs into additional tax-free investments held by the trust could be useful as well. Fifth, the transfer of funds into the irrevocable trust would start the clock on the five-year Medicaid look-back rule.

Mr. M should retain his taxable stocks so that taxable income is taxed at his own tax rate. He should retain a sufficient amount of principal to last him for whatever number of years he feels comfortable with, but at least five years for Medicaid purposes. The trust should allow trustees the discretion to supplement his income in the future without requiring such support. He should not retain so much control as undermine the legitimacy of the trust. On the other hand, he is not required to impoverish himself. He must be comfortable with the amount he retains to live on.

Irrevocable living trusts can certainly benefit younger grantors in a host of other circumstances unrelated to Medicaid. Creditors, divorces, second marriages, and wasteful spending can afflict both grantors and beneficiaries, yet assets protected in a trust can continue to provide financial security. Intellectual properties can be preserved as well.

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PERFECTING TRUSTS

Clearly, estates exceeding $1 million can and do take advantage of irrevocable living trusts. Many of these trusts go beyond the plain vanilla trust and include clauses that can provide tax savings, flexibility, grantor preferences, and additional protections. But for the large number of estates in the million-dollar category, the prospect of many choices or complex planning should not be used as an excuse to defer planning with trusts until it is too late. The simple trust concept itself is of great value.

TECHNICAL REFERENCES

1. The exact number of millionaires depends on whom you ask. Some studies count household wealth and others look at individual net worth, and still other exclude the value of the primary residence. Spectrum Group says the number of U.S. millionaires fell from 9.2 million to 6.7 million in 2008. A report for Barclays in 2007 came up with 16.6 million. A 2005 survey by TNS, a market research company, found there were 8.9 million millionaires in the U.S. and another 24.5 million "emerging affluent" households with between $100,000 and $500,000. Yet a 2006 Merrill Lynch study concluded that there were only 2.67 million American millionaires out of 8.7 million worldwide. As a general concept, there are 116 million American households and about 10% of them are in the high net worth category. That would be 11.6 million households, and about 10 million of them may be closer to the million-dollar estate level.

2. The actual number may be much higher for several reasons. Including the estates on the cusp which would be in the million-dollar range in a better housing and stock market, and those which would be included if primary homes and other overlooked assets were included, there could be 25 million estates or households in this category. That's potentially about 20% of the nation's population.

3. In 2003 there were 3.7 million fiduciary tax returns filed for trusts and estates.

LLCs, Bankruptcy, Trusts

The rise of the LLC has democratized the formation of businesses for liability protection and has affected the dynamics of how wealth is shifted in many ways.

The limited liability company did not catch on in the United States until the 1990s. Wyoming was the first state to permit LLCs in 1977, Florida followed suit in 1982, and by 1996, all 50 states were on board. By the year 2000, LLCs made up 5% of all businesses and in some states, 10%. In Connecticut, more than 20,000 LLCs are now being formed annually. Many states make it possible to set up LLCs online for fees of about $50. Most new business formations are LLCs.

LLCs and FLPs have been designed in recent years as wealth-shifting vehicles because of their transfer tax properties of discounting valuation of partnership shares. In addition, numerous one-person LLCs are formed to isolate liability of individuals or protect specific assets.

Meanwhile, despite tougher rules, the number of American bankruptcies rose by 62% in 2008. Under the 2005 bankruptcy reform it became more difficult to qualify for a Chapter 7 "fresh start" bankruptcy in which assets are liquidated and debts are cancelled. More individuals are directed into Chapter 13 bankruptcies in which a five-year repayment plan applies.

As a result, LLCs should be sure operating agreements protect solvent members from another member's bankruptcy if possible. Some state laws limit creditors to charging orders. For single-member LLCs, however, the LLC will be exposed to the member's personal bankruptcy liability.

An alternative is the irrevocable living trust. Set up a trust for others during good times (without fraudulent intent) and those funds remain secure in bad times. As the Girl Scouts say, make new friends but keep the old; the former is silver, the latter is gold.

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