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What to do if your child is a spendthrift

Many people wonder about passing along their assets to a child who tends to overspend and hasn't shown an ability to manage money. They worry that such a child will blow through an inheritance quickly and won't have the money to live on as he or she gets older.

Fortunately, there are ways to provide for such children while at the same time protecting them from themselves.

For instance, you can put assets into a trust and give the trustee detailed instructions stating under what conditions and for what purposes the assets can be given to the child.

Many people who set up such a trust select a professional trustee or bank for this purpose as opposed to a family member, on the theory that a professional trustee will be less likely to give in to pressure from the child.

A trust can also be a good idea for children who are simply too young to be trusted with large amounts of money. A trustee can manage the money until the child reaches a certain age, at which point the child can receive the funds outright.

Trusts can also be used for children who have a history of gambling or addiction. And they can protect assets for children who are at risk for divorce or who are in a profession where there is a possibility of lawsuits (such as an obstetrician).

Some people go so far as to create trusts that specifically reward children for certain conduct. For instance, trust payments could be increased if the child earns a certain salary, performs community service work, does not relapse into an addiction, etc. These trusts can be very beneficial for certain children. However, it can be hard to set up the incentives with precision such that the trustee can verify exactly what payments are owed. Also, there's a danger that the trust will punish a child at the moment when he or she is most in need of support.

Yet another idea is to give a child a minority interest in a family limited partnership that is managed by a more responsible family member, who will make decisions about investments, dividends, etc. This allows the child to benefit from family assets without having too much control over them.

Legal Matters®

Estate Planning
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How to avoid common trust mistakes

Trusts can be the linchpin of a solid estate plan. But it's important to remember that you can't just set up a trust and forget about it. It's a good idea to periodically review how your trusts are working, to make sure you and your family are getting the full benefit of them. Not doing so can be costly!

Here are just a few things to consider, and some common mistakes to avoid:

► *Is your trustee still the best person for the job?* If your trust arrangement allows you to change the trustee, you should periodically give some thought to whether the person you've selected is still the best choice.

Picking a trustee is difficult, because trustees typically wear two hats: They must invest and manage the trust assets in order to maximize their value, and they must distribute them according to the terms of the trust and the wishes of the grantor.

The problem is that people who are good at investing and managing money are not always good at being sensitive to family needs, and vice-versa. That's why some people who create trusts name two trustees – one who is in charge of investments (perhaps even a professional or trust company), and one who is in charge of distributions (such as a family member). This can sometimes be a good solution if no one person is ideally suited to do both jobs.

► *Does the trust actually own what it's supposed to?* Sometimes people create an excellent trust plan, but forget to change the title to certain assets so that the trust actually owns or controls them in the way that was anticipated.


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If a trust is supposed to hold real estate, life insurance, shares of stock, retirement or bank accounts, family business units, etc., does it in fact do so? Changing the title to the assets can be complicated, but if it's not done properly, the trust won't work as intended. And if the assets have changed in any way over time, this needs to be reviewed as well.

► *How are the trust's bills being paid?* In most cases, the trustee's fees and other ongoing expenses should be paid out of the trust itself. But be careful – many trust companies will automatically send the bill to the person who set up the trust.

If the trust grantor pays the fees, this could cause problems. For instance, the payments might be considered a gift to the trust, which could potentially trigger the need to file a gift tax return or even pay additional taxes. Things can get even more complicated if the fees are paid by someone other than the grantor.

continued on page 3

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Planning for estate taxes vs. planning for income taxes

Traditionally, the federal estate tax was extremely burdensome to wealthier individuals, and the bulk of estate planning involved finding ways to minimize this federal tax.

In the last few years, though, the federal estate tax rates and exemption amounts have changed and become much less of a problem.

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On the other hand, federal income taxes, capital gains taxes and other investment taxes have gone way up. And many *states* have increased their income, estate and inheritance taxes.

As a result, these days smart estate planning involves looking at *all* the different possible taxes that heirs might be facing, and figuring out how best to reduce the overall tax burden.

Here's one example: Let's say Linda owns some stock that she bought years ago for $30,000, and it's now worth $100,000. She thinks it will continue to increase in value, and at some point she wants it to go to Adam.

In the past, it might have made sense for Linda to give the stock to Adam immediately. That's because any further increase in the stock's value would belong to Adam, not Linda, and when Linda passed away, her heirs wouldn't have to pay federal estate tax on it (which would have been as high as 55%).

Today, however, it might make more sense for Linda to leave the stock to Adam in her will. Since federal estate tax rates are lower and the exemption amount is higher, Linda's estate might not have to pay much (if any) estate tax as a result of keeping the stock.

Plus, if Adam received the stock as a gift and sold it, he'd have to pay capital gains tax on the $70,000 increase in value while it belonged to Linda – at today's higher capital gains rates. But if he *inherited* the stock and sold it, his capital gains tax basis would be increased to the stock's value as of the date Linda died, and he would avoid the tax.

As a further wrinkle, though, depending on the states where Linda and Adam live, there might be state estate taxes and/or state inheritance taxes, which now often kick in at much lower thresholds, and there might also be state income and capital gains taxes to consider. The state tax issues could further complicate the decision.

As you can see, it's still necessary to do careful tax planning in order to leave as much as possible to your heirs – it's just that the nature of that tax planning has changed. If you wrote your will years ago when the tax laws were quite different, you might want to review your estate plan now to see if it still makes sense under current conditions.

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.

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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 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 of the charity takes your money and uses it for something else.

How to avoid common mistakes in handling trusts

continued from page 1

If a trust was set up in part for asset protection purposes, then paying bills from the wrong account could even undermine the purpose of the trust. As an example, suppose you've created a trust for an heir so that the assets will be protected in case the heir gets divorced. If the income tax triggered by the trust is paid out of jointly owned marital property, this could mean that the trust assets will no longer be sheltered in a divorce.

The same is true if trust assets and marital assets are combined or commingled in various ways.

► *Are you coordinating distributions to minimize taxes?* Many trusts are set up such that if they pay out income, the beneficiary pays the income tax, and if they don't, the trust pays the income tax. The problem is that, under current tax laws, the rules for trusts and individuals are very different.

For instance, in 2015, individuals pay the highest tax rate only if they have income over $413,200 for single filers, and $464,850 if they're married and filing jointly. But trusts pay the highest rate if they have income over a mere $12,300! So even if a trust doesn't earn all that much income, it can be hit with high tax rates.

Making smart distributions, especially to beneficiaries who are in a lower tax bracket, can save both federal and state taxes as well as minimize the 3.8% surtax on investment income.

Many people now have their estate planner, investment advisor and accountant work together each year on a plan to minimize both income and capital gains taxes while furthering the non-tax purposes of the trust.

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The danger of waiting too long to do estate planning

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.

Converting to a Roth IRA can help with estate planning

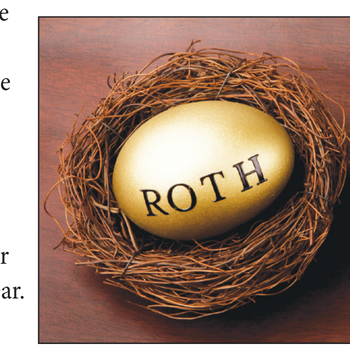
Converting a traditional IRA into a Roth IRA has many advantages and disadvantages, but what many people don't realize is that it can provide some estate planning benefits.

If you convert to a Roth, you'll have to pay income tax on the value of the IRA right away – just as if you received the entire amount as income. On the other hand, all future withdrawals will be tax-free, and there are no minimum required distributions during your lifetime.

Converting may make sense if (1) you have enough assets to pay the income tax without dipping into the IRA itself, and (2) you won't need to take distributions from the IRA during your lifetime and can leave it to your heirs.

One benefit is that your taxable estate will be reduced by the amount that you pay now in income tax, which is useful if your estate is large enough to be subject to the estate tax. While the federal estate tax now only affects estates of more than $5.43 million, many people are also subject to state estate taxes that kick in at much smaller amounts.

A second benefit is that you don't have to take minimum annual distributions. If you don't need these distributions, they will merely create unnecessary taxable income for you each year after you turn 70½, with the amount increasing each year. These distributions can push you into a higher tax bracket, reduce your itemized deductions, increase taxes on your Social Security benefits, and cause other problems. Often it's cheaper in the long run to pay the tax now all at once than to create tax headaches for yourself every single year after you turn 70½.



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