

SPECIAL FOCUS

RETIREMENT, TRUST & ESTATE PLANNING

Words to the Wise

Use our retirement and estate-planning glossary to begin understanding the world of wealth planning.

You're a successful professional doing financially rewarding work. Sooner or later, you'll need to create a money management plan for your life now, for life in retirement, and for your loved ones after you die. For many business leaders and owners, though, creating that plan can be an intimidating prospect. For instance, "it can be very frightening to move money away from a privately held company and into the broader markets, where individuals no longer have the kind of control they used to have," says Darryl Meyers, a Minneapolis-based senior wealth management director at Wells Fargo.

He also finds that clients are put off by the intricacies of estate and gift transfer tax. "It's a tax system you don't deal with very often, and very sophisticated people who understand all the pros and cons of income tax strategies may falter when it comes to understand-

ing estate tax constraints," he says. What's more, he says, the language of financial planning is often unfamiliar, and sometimes confusing.

When people are intimidated or confused, Meyers adds, they sometimes refuse to do any planning at all, or do a halfhearted job. Either can be very expensive for them and their heirs.

Most money managers and planners do their best to help clients feel comfortable—from accountants to attorneys, bankers to financial planners, they see client education as part of their job. After all, no one is born knowing what a qualified personal residence trust entails. A little advance preparation can help you get even more comfortable. Read our glossary for an overview (we'll leave the fine print to the professionals) of some common terms in the retirement and estate-planning world.

Churning: "This happens when a broker excessively trades an account for the purpose of increasing his or her commissions rather than to further the customer's investment goals," says David Herbeck, an investment advisor at BPK&Z Financial Services, LLP, based in Golden Valley.

Cross purchase buy/sell plan: A plan in which the surviving owners of a business (not the business itself) agree to buy a deceased or departing owner's business interests. The purchase is made for an agreed-upon price or according to an agreed-upon formula.

Current yield: The interest rate paid by a bond or other fixed-rate investment, calculated by dividing the annual interest payment by the current market price. The annual return is fixed, so yield automatically falls if the price rises, and vice versa. Yield is a way of understanding the net profitability of a fixed-rate investment, and of comparing it to others like it.

Donor-advised fund: A charitable fund held by a community foundation for which fund donors can recommend eligible charitable recipients for grants.

Direct skip: An outright generation-skipping transfer, either by gift or at death, to a recipient, known as a "skip person," who is two or more generation levels below the transferor. This type of property transfer triggers the generation-skipping **transfer tax** (see below).

Durable power of attorney: A legal document that allows you to authorize another person (the attorney-in-fact or agent) to act on your behalf with respect to specified types of property, and which may remain in effect during any subsequent disability or incompetence of the principal.

Durable power of attorney for health care: A document that grants decision-making powers related to health care to an agent if the principal is not able to communicate his or her wishes. It generally provides for removal of a physician and the rights to medical records, to have the patient discharged against medical advice, and to have the patient moved or to engage other treatment.



by Ingrid Case

1035 exchange: Lets an investor use the cash value in one life insurance policy to exchange for another policy (or one variable annuity for another) without paying capital gains tax, as long as the second policy (or annuity) costs the same or more than the first.

Cash equivalents: Investments in securities of high liquidity and safety, such as money market funds or Treasury bills, that are considered virtually as good as cash.

Trust Primer

Trusts let you create “your own legal world, set up according to the rules of the trust type you choose, plus rules you add,” says Mary Shearen, a partner at Best & Flanagan. There are many different types, but some common trusts are listed here:

A-B trust: The A section of the trust is also known as the credit trust. It is often created at the death of the first spouse in a married couple, and holds assets of up to \$2 million—or \$3.5 million beginning in 2009. The money may benefit the surviving spouse, though it doesn’t have to, and then goes to the couple’s other heirs at the second spouse’s death. If drafted correctly, “it will not be taxed in the surviving spouse’s estate,” says Darryl Meyers, a senior wealth manager director at Wells Fargo. The B section of the trust is also known as the marital trust. It allows a spouse to put assets in trust to benefit a surviving spouse during the latter’s lifetime. It’s taxed in the surviving spouse’s estate, though the first spouse may designate the ultimate beneficiary. “A marital trust won’t escape estate tax, but it can delay it until the second spouse dies,” Meyers says. This is a classic trust for wealthy people who want to provide for a second spouse during his or her lifetime, but ultimately pass assets to children from a first marriage.

Charitable remainder unit trust or annuity trust (CRUT or CRAT): A type of split-interest trust, in which a person gets a specified interest in an asset and a designated charity receives the rest.

Charitable lead unit trust or annuity trust (CLUT or CLAT): The second type of split-interest trust, in which a charity gets the first interest in an asset, and an heir gets whatever remains. “This can help you leverage a later gift to heirs if you invest it well and beat the IRS’s expectations,” Shearen says.

Crummey trust: “A Crummey trust is a gifting trust,” Meyers says. It allows its originator to give anyone \$12,000 annually, but restrict that person’s long-term ability to access the money. “I put my money in, and I give the beneficiary a right to withdraw that amount for at least thirty days,” Meyers says. The right to withdraw that chunk of money then lapses, and the beneficiary gets the money at the trust’s ultimate disbursement, which can be whenever the donor states, subject to certain rules. A good way to get money out of an estate and credited to someone not yet mature enough to make good financial decisions, the Crummey trust is typically taxed in the beneficiary’s estate. “This, with the A-B trust, forms the basis of about 90 percent of estate planning,” Meyers says. It’s named for that rarest of birds: a man who fought the IRS and won.

Generation skipping trust (GST): Benefits multiple generations of a family. With proper allocations, heirs—including those who receive the final disbursement when the trust ends—can avoid paying estate taxes. Plan on naming an institution as a trustee, as the trust will likely outlive a single human manager.

Intentionally defective grantor trust (IDGT): This trust buys an asset from you at today’s value with a promissory note, and pays you interest over time. You pay no capital gains tax while you’re alive, and your heirs pay taxes only when they sell the asset. The asset’s value is frozen, for tax purposes, at the amount it was worth when you put it in trust.

Irrevocable life insurance trusts (ILITs): A trust created to own permanent life insurance coverage on either an individual or a couple. At the death of either the individual or the second spouse, the insurance company pays the trust. The trust passes that money to the heirs, who use it to pay estate tax on assets not in the trust. Heirs don’t owe tax on the life insurance payment, because its ownership was outside the estate, says Bradley Smegal, managing director of investments at Wachovia Securities, LLC.

Irrevocable trust: A trust that can no longer be amended or revoked by anyone. Most revocable trusts become irrevocable at some time—for example, when the person who established the trust dies. Irrevocable trusts typically get better tax treatment than do revocable ones, Shearen says.

Qualified personal residence trust (QPRT): “This trust is designed as a safe way to put an interest in a house in a trust, reserve the right to live there for a certain period of time, and after that, pass the property to a designated beneficiary at the taxable value that the property was worth when you started the trust, minus what the IRS says is the value of the retained interest,” Shearen says. If your cabin is worth \$1 million, for example, and the fair market rent of occupying it for 20 years is \$500,000, then gift taxes may be due on the difference of \$500,000—no matter how much the cabin appreciated in 20 years. “For most families who have valuable vacation properties, this is a really good way to go,” Shearen says.

Qualified terminable interest property (QTIP) trust: A type of marital trust that gives a surviving spouse trust income. On that spouse’s death, the trust’s assets generally go to other heirs named by the trust’s originator.

Revocable trust: A trust that can be amended and revoked, usually by the person who established it. This trust may become irrevocable when the only person who can amend or revoke the trust dies or becomes incompetent. Some planners, such as Shane Swanson, a partner at Minneapolis-based Parsinen Kaplan Rosberg & Gotlieb, P.A., use revocable trusts instead of wills. “In some cases, it doesn’t cost any more than a will, and it lets you avoid probate and conservatorship,” Swanson says. And a revocable trust can hold property located in multiple states, thereby allowing heirs to skip the hassle and expense of multi-state probate.

Spendthrift trust: In this trust, the trustee legally owns the assets. The beneficiary has a right to receive money according to trust rules, but can’t force money out of the trust. It’s a way to shelter capital from an irresponsible or incapable heir, while still giving that person some benefit from an inheritance. —I. C.

Fiduciary: A person who's responsible for the assets of another person and known as an executor, personal representative, trustee, guardian, conservator, or attorney in fact under a power of attorney or health care directive. "Fiduciaries have to understand the terms of the document they're dealing with, and follow the directions of that document," says Tim Ridley, a partner at Minneapolis-based Meagher & Geer. They must make reports to beneficiaries and sometimes to the courts, and they must prudently manage assets and act in beneficiaries' best interests. "[They] can't let [their] own interests take precedence," Ridley says.

Gift exclusion: (currently \$12,000 annually) For an item or amount to be out of your estate in the eyes of the IRS, you need to truly give it away, no strings attached. "You can't retain an interest that gives you personal enjoyment of something," says Kristine Merta, a financial principal at Minneapolis-based Lowry Hill. For example, you can't give your child a vacation home with the stipulation that you be allowed to stay there for six months of every year. You can be invited, but issuing or withholding the invitation cannot be a condition of the gift. "Some people just can't give up control, and then they end up trying to fund trusts or make gifts on their deathbed," Merta says.

Joint tenancy with right of survivorship: A way of spreading a property's title between multiple people. When one joint tenant dies, the others automatically become the property's sole owners.

Qualified plans: Most retirement plans, including 401(k)s, are qualified plans, a technical term meaning that they're subject to certain rules. "These are terrific retirement funding vehicles. They are not good wealth transfer vehicles," notes Mary Shearen, a partner at Minneapolis-based Best & Flanagan, because the assets in them are potentially subject to 50 percent in income tax, plus estate tax on top of that. "Don't fund these with more than you really need in your retirement, and get a planner who really understands this very complex law," Shearen says.

Probate: The legal process of transferring property ownership to heirs. In many states, probate is an expensive hassle, but "Minnesota probate is the easiest and best probate in the country," Shearen says.

Tenancy in common: A type of joint asset ownership with no right of survivorship. If you own a home in common with someone else in a tenancy in common arrangement, either of you may will your share in the home to whomever you choose. Contrast with **joint tenancy**, above.

Transfer taxes: When assets change hands, both the Federal government and the state want a piece of the action. Gifts may trigger gift tax, after-death bequests may trigger estate tax, and handing property to your grandchildren may trigger generation-skipping tax. Each of these tolls is subject to complicated rules and exclusions, so a professional who deals with these taxes is the best person to help you navigate them.

Uniform Gifts to Minors Act (UGMA) and Uniform Transfer to Minors Act (UTMA): An account set up for the benefit of a minor child.

Universal life insurance: Life insurance proceeds aren't subject to income tax, but they are subject to estate tax. Handled correctly, a universal life policy can be a source of tax-free income, says Bradley Smegal, managing director of investments at Wachovia Securities, LLC, in Minneapolis. "Shop carefully for a universal life policy that's designed to let you contribute large amounts of cash on a regular basis, in pre-retirement," he says. Look for good policy asset management and an income guarantee feature, which allows you access to a specific loan amount. Borrow against the policy and you might pay around 1 percent on the loan—but no income tax on the borrowed amount.

Unrealized capital gain: The gain in value of an asset that an investor owns, but has not yet sold. Assets with unrealized capital gains are popular charitable gifts. For example, say you are holding stock that you bought for \$10 a share. Now it's worth \$200 a share. If you sell the shares, you'd pay capital gains tax on \$190 per share—the value by which each share has grown since you bought it. But if you give that stock to a charity, the shares would be valued at \$200 each, but you wouldn't pay capital gains tax on them.

Wrap fee: A charge for an investment program that bundles (or "wraps") together a number of services (brokerage, advisory, research, consulting, management, etcetera), with a single fee based on the value of assets under management. **TCB**

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Planning Misconceptions

Common knowledge is not the same as common sense.

Market volatility: "Volatility means things moving around a lot—the normal ups and downs of the market," says Carol Clark, an investment principal at Lowry Hill in Minneapolis. It's not the same thing as risk, she notes. "Risk means permanently losing capital, particularly through concentration in one company or industry. It's a huge risk to have all your assets in your firm, but people are more wiggled out by volatility," she says.

Procrastination, cost of: "If you have a big estate and no estate plan, doing nothing will cost your children \$1.04 million in taxes on a \$4 million estate. Do some basic planning, and they might pay \$199,200," says Shane Swanson, a partner at Parsinen Kaplan Rosberg & Gottlieb P.A.

Simplicity: "People who are very sophisticated always say that they want a very simple estate plan, but that may not be the best choice," Swanson says. "Once they understand that, they usually end up with a more complicated plan." Clients also typically opt for hiring a professional planner once they see that doing so can save them and their heirs money. "I saved a set of clients about \$55,000 on taxes, with a planning bill of just under \$3,000," Swanson says.

Taxes: No one wants to give the state more than necessary. Still, too many people plan only to avoid taxes, with little thought for the goals they hope their money will accomplish. "Figure out your goals, and then talk about the tax consequences of that," Swanson says. "Don't let the tax tail wag the dog." —I. C.