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Clarification: June's issue on Grantor trusts addressed the tax consequences of a mandatory tax reimbursement clause. The article did not state that the use of such a provision would cause inclusion of the trust in the grantor's estate. This is why reimbursement clauses, if used, are generally discretionary.

Creative solutions that coordinate all your planning goals:
· Estate · Tax · Business · Personal
·Financial ·Asset Protection

Planning Potpourri

Trust in Follow Through: It's not only for your golf swing. If you set up a trust you must review it annually with your advisers. Are you adhering to the terms of the trust? Are there trustee, investment adviser or other actions to memorialize? Have you documented compliance with the prudent investor act? Have income tax considerations been addressed? Does the trust have appropriate property or liability insurance coverage? If the trust owns life insurance have you periodically evaluated the policy performance and options? Have you documented this? Tax laws change. Have relevant changes been considered? Advisers learn new tricks. Has your trust benefited? If the trust purchased assets from the grantor have all payments been made timely? If there is a guarantee with a fee, has the fee been paid? If assets purchased include interests in an LLC or other entity do the entity documents and tax filings reflect this? If corporate stock is purchased is the trustee participating in annual meetings, signing consents, etc? No estate or financial plan is designed to sit on a shelf.

Minimum Distributions: The penalty for failing to take minimum required distributions from your plan is huge. Have your investment manager put your plans on auto-pilot to automatically pay the minimum distributions so you don't have to remember.

Uglier Kiddie Tax: Kids subject to the Kiddie Tax pay tax at their parents income tax rate. The goal is to prevent parents from shifting income producing assets to their kids to save income tax (hey, why make saving for college easy). Now a child over age 18, but under age 24, who is a full time student, is caught in the Kiddie Tax snare unless their earned income exceeds ½ of the amount of their support. The Kiddie Tax won't apply to the first $1,700 of unearned income (inflation adjusted). The Small Business and Work Opportunity Tax Act of 2007.

Ashes Not Property: A divorcing couple's child had previously died and they could not agree on the disposition of their child's ashes. A Solomon-like division was not acceptable to the husband. The remains were not deemed property but rather a right subject to the mutual decision of the parents. The case was remanded for further decision. *Kulp v. Kulp*, No. 269 MDA 2006, March 12, 2007. PP

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Prudent Investor Act Primer

Yeah, everyone knows all about modern portfolio theory and all that stuff. Yawn. But an amazing number of people still think they can live on CDs for 25+ years of retirement - where's your inflation hedge? Individual trustees rarely seem to use investment policy statements (IPS) – try to catch an institutional trustee without one! Every family investment FLP/LLC is formed solely for non-tax reasons (well that's what you tell Judge Laro), yet how many even have an IPS? Well, its time to give your wealth manager a hug, and get an IPS for each investor: every trust, LLC or other investment entity. Give some respect to the Prudent Investor Act (PIA) (not as in Zadora). The rules vary by state. The trust, will or other governing legal documents can have significant impact on planning. Each investor's circumstances are unique and impact the conclusions.

PIA governs how assets owned in trusts, estates, guardianships and other fiduciary relationships are invested. Previously a fiduciary was required to invest to preserve principal. PIA recognizes modern portfolio theory, including the need for diversification and allocation of investment dollars amongst asset classes to maximize total return (capital appreciation, dividend and interest payments) while minimizing risk. Sitting on T-bills won't work, but an allocation to bonds, stocks, international bonds and equities, etc. in accordance with a plan that considers relevant goals and circumstances will.

Modern portfolio theory suggests that with properly diversified investments the rate of return can be maximized while minimizing the risk for that target rate of return. Under the Prudent Investor Act no investment is ever per se inappropriate. Rather each investment is to be evaluated in the context of the overall trust portfolio.

You face risks as a fiduciary making investment decisions. If the portfolio performance is less than some industry benchmark, you could be held personally liable for the differential. Ouch! Avoid this liability by having and following an IPS – an investment policy statement. This is a detailed document demonstrating why and how the investment plan was selected, and the reasonableness of the plan at inception. If you comply with the requirements and have considered all relevant factors you should avoid liability because the Prudent Investor Act is a process, not a performance guarantee. Alternatively, you could delegate investment management to an investment professional. This does not obviate you of all responsibility to monitor the investment professional, but does give you protection. Have periodic (annual or quarterly) meetings to review the IPS, investment results, etc. If the trust is organized in a state, like Delaware, which permits "direction" of investment management, the investment professional will assume almost all responsibility. This is a safer approach. If there a special relationship of the asset to the purpose of the trust, to the grantor, or the beneficiary, such as a closely held business, it must be addressed. The Prudent Investor Act generally requires a diversified portfolio unless the trust specifies otherwise. Trust language could state whether the business should be held, when it can be sold, and under what conditions. Any concentrated asset position (family business, prime real estate holding, significant position in a public company) should be ad-

(Continued on page 2)

Checklist: Senior Divorce-2

Seniors divorcing face different issues than young couples. This article concludes a checklist begun last month.

√Beneficiary Designations: Divorcing seniors are likely to have substantial retirement accounts and other assets governed by beneficiary designations. These must be formally changed for every account (IRAs, pensions, insurance, brokerage accounts set up with beneficiary designations). The mere recitation of how beneficiary designations are resolved in a property settlement agreement should not be relied upon as sufficient. Change forms should be sent certified mail return receipt requested.

√Insurance: Life insurance planning is different as seniors are more likely to own policies with considerable value. Further, while younger couples can often purchase inexpensive term insurance to meet divorce requirements, seniors are less likely to be able to avail themselves of this option. If your ex-spouse is to maintain life insurance for you, it is even more important as a senior divorcee that you assure that your ex-spouse's coverage does not lapse since age and health problems are far more likely to make replacing lapsed coverage prohibitive or impossible. Confir-

(Continued on page 3)

...PRUDENT INVESTOR ACT PRIMER

(Continued from page 1)
dressed in the governing documents.

When investing trust funds, consider the following:
o What are the provisions of the governing state's law?
o What does the governing document require? If you are a trustee, you must understand the terms of the trust. Meet with an attorney and review your responsibilities, authority, etc.
o What are the generally economic conditions that affect the trust and the beneficiaries? What is the likely impact on the objectives of the trust and the investment strategies of inflation or deflation? Your wealth manager can provide guidance.
o What are the expected tax consequences of investment decisions? Consult with the CPA responsible for the trust income tax planning.
o What other resources do the other beneficiaries have and should they or must they be considered? What is each beneficiary's need for liquidity? If you are managing a trust for a child age 15 who will be in college in three years the need for liquidity is significant and must be addressed in determining an appropriate investment allocation. You may have to poll them, depending on state law and the terms of the trust.

The flip side of the Prudent Investor Act "coin" is the Principal and Income Act. The two work hand in hand. If you have to invest trust assets in a diversified portfolio to comply with the principal and income act, how can you be fair to the current beneficiary (the recipient who receives distributions during the primary term of the trust), while remaining fair to the remainder beneficiary (the recipient who receives the assets of the trust after the current beneficiary's interest ends). The trustee's investment dilemma is to invest to generate income for the current beneficiary, while protecting principal from inflation for the benefit of the remainder beneficiary.

The problems of investing trust monies can be illustrated with an example. Aunt Edna died naming you trustee of a trust under her will for her child John. John is the "income" beneficiary of the trust. All income is to be distributed to him each year. When John attains the age of 28 the trust assets (corpus) are to be divided among Aunt Edna's four children. How do you invest in a manner that is both fair to John assuring an income, while protecting the 3 sibs? The Principal and Income Act gives guidance to impartially resolve this conundrum, and rules so you can invest as modern portfolio theory requires. You could simply opt to buy high yield bonds to generate income for John. However, when the trust terminates and all children share equally in the remaining trust assets the sibs will have had their economic interest compromised because the investments that maximized income for John would not have maximized appreciation of principal for the sibs. If instead you invested in growth stocks, the sibs would love you, but John might starve.

Terms in red defined in the glossary at www.laweasy.com. For e-newsletter sign up at www.laweasy.com.

How do you reconcile this? The Principal and Income Act may permit you to use a total return uni-trust payment. This can be illustrated with an example. Assume Aunt Edna's $1M trust pays John 4% of the trust value each year. This gives John as the "current" or "income" beneficiary $40,000 per year. With this type of payment, instead of having to maximize income, the trust could invest for total return which would benefit all beneficiaries. If the trust principal increased in value from $1M to $1.1M, than 4% of the fair value, $44,000, would be paid. This gives you as trustee the flexibility to invest in an array of assets to maximize overall return without having to focus on income. It takes you out of the position of having to favor the current versus the remainder beneficiary, or vice versa. All beneficiaries benefit from a total return investment philosophy.

The moral of this tale is that the Prudent Investor Act should be evaluated when investing fiduciary monies and monitored periodically thereafter. PP

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...CHECKLIST: SENIOR DIVORCE PART 2

(Continued from page 1)
mation of payments and an arrangement to receive notice from the insurance company in the event of default is essential to protect the policies. Mandate in the property settlement agreement that periodic inforce illustrations will be prepared, and if policy performance becomes a problem, include a mechanism to address it. Seniors are more likely not to need life insurance coverage. Older policies might be sold to avoid future premiums and raise additional cash to divide between the spouses. The price which might be realized in a secondary market may substantially exceed the cash surrender value. Young couples rarely can avail themselves of this because coverage is needed to protect alimony payments and minor children. Seniors are more likely to have their insurance in a trust ("ILIT") in which case the trust and the trustees should agree to all actions as part of the overall settlement.

√Wills, Powers, Etc. Most divorcing spouses, other than perhaps cancelling powers of attorney, tend to wait to update their estate planning documents until after the divorce is settled so that the revisions can reflect the agreements. This is more dangerous for seniors. As soon as the divorce starts seniors should revise their wills, powers, living wills, health proxies and other documents. Name new agents on every document. Your will might bequeath to your spouse the lesser of the minimum required by state law (spousal right of election), or what the divorce agreement mandates. Once the divorce is finalized these documents should be revised again to reflect the settlement. What lawyer is used? In some cases, if both spouses and their matrimonial counsel can agree in writing to the parameters, the same planner may be able to revise both spouse's documents. This can be a significant cost and time saver, and more significantly, create less antagonism and facilitate joint post-divorce planning for insurance trusts, children's trusts and more. In other situations, one spouse may continue with the same attorney subject to approval by the other spouse and counsel, and the other spouse can hire a new attorney. Seniors divorcing often assume that adult children will take an "adult" view of the situation. Children, even though they are adults, often take the divorce really hard and too often take sides or worse. Seniors need to carefully consider whether children (who most likely were named as fiduciaries) should be left as agents. Seniors might initially name friends or advisers until the situation calms down, then change the documents back to the children. Estate tax planning needs to be revised. An annual gift program may no longer be feasible.

√Death: Husband and wife were divorcing. Prior to settlement they sold their home. Husband died. If the proceeds were included in his estate his creditors would take all. If wife took the proceeds before it reached his estate, she would take all. The court held that when the still married couple sold the house, that act destroyed the tenants by the entirety ownership of the house so that the funds would pass to Husband's estate, not the wife. *Matter of Schmitt*, 94939/06. The divorce had no bearing on the distribution of proceeds since an action for divorce abates at the death of either party. *Cornell v. Cornell*, 7 N.Y.2d 164.PP

RECENT DEVELOPMENTS

Voluntary Alimony Held Deductible: Most tax folks thought you had to have a legally enforceable obligation to pay alimony to claim a tax deduction. The court ordered payments be made and that they be included in the ex-wife's income. But, the order specified that the payments were not a legally actionable duty of the ex-husband. The key issue was whether this provision making the payments not legally enforceable nixed the payor's tax deduction. You can claim a deduction for alimony payments that meet the Code Section 215 requirements that payments: must end on the death of the payee, be made under a divorce or separation agreement, not be specified as being not taxable or non-deductible, are made to a legally separated spouse who is not part of the same household as the payor, etc. The IRS argued that since the payments were not made under a legally enforceable duty they could not be deducted as alimony. In *Webb*, TC Summary Opinion 2007-91 (not a binding precedent for other taxpayers) the court held that Code Section 71 did not require that the payments be made under a legally enforceable agreement.

FLPs and Discounts: Using an FLP to discount assets for estate tax purposes is akin to navigating between Charybdis and Scylla, not an easy task. In *Erickson*, T.C. Memo. 2007-207, the court frowned upon some of the usual negative facts: the taxpayer was diagnosed with Alzheimer's and was in her late 80s, FLP documents were signed under a power of attorney, insufficient liquid assets were left, assets were not transferred to the FLP on formation, transfers only occurred 2 days before death, post death FLP funds were used to meet expenses of the estate, etc. Judge Laro concluded that the aggregate of the facts demonstrated an implied agreement existed among the parties that the decedent retained the right to enjoy the FLP assets. Therefore, estate inclusion resulted. This case again provides a checklist of FLP (and LLC) problems to avoid. PP