PRACTICAL PLANNER NEWSLETTER
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Planning Potpourri

<u>How Much of an Emergency Fund do You Need</u>? You can have the best power of attorney to deal with emergencies, but if there is no cash your planning will be for naught. How much ready green do you need?

■ Emergency funds are not just cash in bank but can be satisfied from lines of credit, home equity lines, and other sources. It's important to think in very broad terms. But be practical. What hoops do you have to go through to tap an equity line? Will the lender let your agent tap into it? If you have a check book the agent may be able use the checks.

■ When evaluating emergency funds the scope of insurance coverage needs to be considered. If you have a good disability policy with say a 60-day waiting period, your needs for emergency funds are different then if you have no disability coverage. Similarly, if you have a good long term care policy, versus none, your emergency fund in your retirement years will differ.

■ How risky your investment policy is, and how long term your investment horizon is, all affect your need for emergency money. If you're focused on more short term and liquid investments say 40% equity 60% bonds/near cash, your need for emergency cash and funds will be less than if you're 70% equity and 30% bonds. You'll need the cushion to ride you through market ups and downs.

■ Consider your benefits at work. What type of support system is there? How secure is your job?

■ More than "cash" can be used for an emergency fund. Readily available resources, not actual cash, might suffice. Increase the lines on your credit cards, take out a home equity line, create a margin account for your securities. These all give emergency cash quickly in case an emergency creates a cash need while you're building up your investment reserves. This is common for post-divorce and young people.

<u>2007 Tax Returns</u>: Have your accountant email a PDF of all your tax returns to your estate and financial planners. This will enable them to access vital information if needed. The cost is negligible but the benefits potentially substantial. PP

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PRACTICAL PLANNER

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Trust & Estate Miscellaneous Deductions

Summary: This is tedious, but significant for many. Individuals can deduct miscellaneous itemized deductions, but have to first reduce them by 2% of adjusted gross income ("AGI"). The application of this limitation to expenses incurred by trusts, especially investment management fees, has been nettlesome. Understanding these rules is important for trustees, beneficiaries, and those advising trusts. The history is a bit sordid so we'll wind you through it.

<u>Statutory Background</u>.
Code Section 67(a) provides that an individual can claim miscellaneous itemized deductions for any tax year only to the extent that the deductions exceed 2% of AGI. These deductions are defined as any deduction other than certain enumerated deductions such as interest (IRC Sec. 163), taxes (IRC Sec. 164), casualty and theft losses (IRC Sec. 165), Contributions (IRC Sec. 170), medical and dental expenses (IRC Sec. 213) and so on. Since trusts and estates are generally taxed by applying the paradigm of individual income taxation, these rules have to be applied to trusts and estates. IRC Sec. 67(e) addresses this by stating that the AGI of an estate or trust shall be computed in the same manner as in the case of an individual, except that "…the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate…" This last phrase has spawned a lot of controversy.

<u>Court Cases</u>.
This issue has been hotly contested by the IRS. The 6th Circuit held advisory fees deductible without the 2% reduction. O'Neill, 994 F2d. 302. The Federal and 4th Circuits held that the reduction applied. *Mellon Bank*, 265 F.3d 1275, *Scott*, 328 F3d 132, and *Rudkin* 467 F3d 149.

<u>Proposed Regulation</u>.
The Treasury department, while the Supreme Court case in *Knight* (see below) was pending, issued proposed regulations. Prop. Reg. § 1.67-4. These classify costs which were not "unique" to a trust as being subject to the 2% floor. "Unique" to a trust meant costs that could not have been incurred by an individual property owner. If you don't see the word "unique" in the law above, and you read the law as containing the phrase "would not" instead of "could not" as the Regs provide, well you're starting to understand the confusion and frustration. The Regs also require Trustees to unbundle aggregated fees. If a trustee pays a lawyer or financial planner for several services, including those that are unique, and those that aren't, analysis of those fees is required. The IRS posited that judicial accountings, the cost of preparing a trust income tax return, a trustee bond, etc. are unique and hence fully deductible. The costs incurred for the custody or management of trust property, or investing trust assets for total return, are not considered "unique". These regulations will have to be modified in light of the Court's holding in *Knight*.

<u>Supreme Court Has the Last Word (not really)</u>.
The Supreme Court recently ruled in the case *Knight v. Commissioner*, 552 U.S. ___, 128 S. Ct 782 (1/16/08), that trust investment management fees are subject to this 2% reduction. The Court interpreted the phrase "which

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Checklist: Plan to 100

Summary: You eat your Wheaties and take your multivite and plan to live to 100+. Evaluate your planning to be consistent with your super centenarian aspirations. 100 is the new 80!

√ <u>Change Your Investment Plan</u>. You have to take a long term, practically perpetual, time horizon. It will be vital to maintain a broad allocation of investment resources and not shift to the allocation favoring fixed investments many seniors choose. Those cute pie charts adorning consumer financial magazines showing a decided shift toward fixed income investments as retirement age approaches may miss your optimally allocation by a couple of decades. Shifting your portfolio to predominantly bonds 20 years too soon could mean the difference between or postage stamp Mickey D's and Morton's Steak House.

√ <u>Constrain Your Spending</u>. If you will have to live on your resources that long you really need to limit spending to probably not more than 3-4% per year of the investment base. Most folks way over estimate the portion of their investment assets they can spend each year. Bear in mind you need to inflation

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...TRUST AND ESTATE MISCELLANEOUS DEDUCTIONS

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would not have been incurred if the property were not held in such trust" as requiring an inquiry as to whether the particular cost "would customarily" be incurred by an individual. Effectively the trustee must ask the following theoretical question of every cost: "Would this cost have been commonly or customarily incurred had the property been held by an individual and not in this trust?" In making this theoretical determination the trustee should consider custom, habit, natural disposition or probability. If the cost would be uncommon, or unusual for an individual to incur, the trust could deduct it in full without regard to the 2% floor. If the trustee can demonstrate that a particular cost was incremental to the cost and individual would have customarily incurred, then that excess can be deducted without regard to the 2% floor. For example, if an investment adviser charged a supplemental fee to trust accounts, that would be fully deductible. For many costs this would be the accounting equivalent of splitting the dead sea. Similarly, if a trust had an unusual investment objective, or requires the special balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper, it would be deducible in full. Fiduciaries will have to determine which costs are subject to this restriction. This may require breaking certain aggregate fees and costs into their components in order to make the appropriate allocation to determine deductions. After all the paperwork, little may be deductible without being subjected to the 2% floor, which will likely eliminate many deductions. In 2008 bundled costs will have to be divided based on *Knight*.

<u>**IRS Notice**</u>.
The IRS recently issued Notice 2008-32 on how trust deductions should be handled in light of the cases above. The IRS will issue new Regs consistent with the *Knight* case. The revised Regs will eliminate the concept of "unique" and apply the Supreme Court sanctioned paradigm discussed above. These Regs will also have to guide trustees on how to parse aggregate or bundled fees which include in a single amount costs which would be incurred by an individual and costs which are uncommon or unusual for an individual to incur. For tax years prior to 2008 trustees will be permitted to deduct in their entirety bundled fees. Bundled costs will be deductible for 2007 without allocation. Implicit in the ability to claim this deduction is that the costs are bundled. These include deductible components which are uncommon for an individual to incur, as well as non-deductible components, e.g., investment management fees. This means investment management fees that do not include some amount for services won't be deductible in 2007. If a trust return is on extension, you'll need to figure this out. If you filed, review the position your accountant took in this regard. Fees paid to third parties, such as advisory fees, are to be treated separately from bundled fees. If they don't meet the Supreme Court test they are not deductible even in 2007.

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<u>**Practitioner Comments to the IRS**</u>.
Tax practitioners are submitting comments to the IRS suggesting methods of addressing these issues in the new set of regulations. Recommendations include specifying that certain types of costs, such as tax return preparation, not have to be parsed into costs commonly incurred by individuals and those that are not; that as a safe-harbor taxpayers can choose to elect a reduction in the 2% floor amount in lieu of engaging in more complex accounting; safe-harbor amounts that can be deducted without having to resort to more detailed analysis (e.g., any otherwise qualifying deduction under $X can be deducted without regard to the 2% floor), etc. While most of the proposals seek to create certainty and avoid costly and administratively burdensome accounting, the details of the issues involved remains daunting .

<u>**Conclusion**</u>.
The issue of trusts deducting various fees was seemingly resolved by the Supreme Court in Knight, but the issues, planning and administrative burdens have yet to be known. PP

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...CHECKLIST: LIVING TO 100

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protect your spending power for lots of decades to come so the principal balance must grow in absolute dollar terms to protect your future cash withdrawals.

√ <u>**Redefine Disability Planning**</u>**. Disability insurance becomes irrelevant at some age and stage of your work life. But disability planning means much more than mere insurance. Reliance on the simple powers of attorney will be insufficient. For the long term, consider the following modifications to a typical power: eliminate the gift provisions, or restrict them, you'll need your money. Provide compensation for the agent. If someone has to manage your legal and financial affairs for years, perhaps decades, compensation becomes critical to obtain the help you'll need. Name a succession of individuals younger then you to avoid your outliving all of your agents.**

√ <u>**Use a Revocable Living Trust**</u>**. If you'll be living to 100 you'll need the best structure to protect you, assure your resources will be used for your benefit and to minimize the problems that could arise. A revocable trust is a much more sophisticated and broad based document that becomes increasingly important as you age. For someone living to 100 the advantages of a well thought out, detailed, and funded revocable trust increases. You can be a trustee of your trust along with a bank, professional trustee or other trusted person. They can help relieve many of the tasks you would have to perform and protect you and keep you in control longer.**

√ <u>**Rethink Estate Planning**</u>**. You have to be cautious about giving away gifts and engaging in aggressive planning as you may need your assets to live on. Different techniques might make more sense to use. For example, instead of giving assets to intended heirs, transfer assets to a trust formed in one of the states that permits you to be a beneficiary of your own trust, yet remove the assets from your estate. Examples include Delaware, Alaska and Nevada. This way, you can engage in planning to reduce estate taxes but still retain the ability to benefit from your assets should you need them.**

√ <u>**Modify the Terms of Estate Planning Techniques**</u>**. It might be advantageous to modify the way many standard estate planning tools are used if you anticipate considerable longevity. For example, qualified personal residence trusts (QPRTs) should be evaluated as potentially longer term strategies rather than the shorter durations typically used for them. A charitable remainder trust (CRT) which pays an annuity for life should be re-evaluated as a charitable remainder unitrust (CRUT) for which the annuity amount is recalculated each year to provide an inflation hedge for your annual payments. Use rolling GRATs so you can regularly monitor your need for removing assets from your estate and put the brakes on each year if you need to. Favor simple annual gifts over larger transactions.**

√<u>**Take Precautions When Planning at an Advanced Age**</u>**. Issues of competency become more common when planning at an advanced age. Even if you're competent you should tae steps to corroborate that competency at the time of executing any trusts or**

RECENT DEVELOPMENTS

Summary: Don't die in New Jersey. New Jersey, as many states, has decoupled from the federal estate tax system. While the Federal exclusion is $2M in 2008 and is to increase to $3.5M in 2009, it remains a paltry $675,000 for the NJ estate tax. Now NJ is seeking to backstop the revenue from this lower exclusion in a manner that is complex, unfair, and troubling.

The NJ Division of Taxation adopted new regulations regarding commonly used marital trusts, Qualified Terminable Interest Property trusts, "QTIPs. NJAC 18:26-3A.8. If an estate makes a tax election for Federal estate tax purposes a similar election must be made for NJ estate tax purposes. If a QTIP election does not reduce the Federal estate tax liability, it will no longer be given effect for NJ estate tax purposes. This means that unless the estate exceeds the federal exclusion, $2M in 2008 and $3.5M in 2009, you cannot make a NJ QTIP. Therefore, the estate is forced to pay NJ estate tax if it is below the federal exclusion amount. This precludes avoiding tax by only funding a by pass to $675,000, the NJ exemption amount, which is a common approach in many wills. Example: You die in 2008 with a $2.5M estate. Your will bequeaths $675,000 to a by pass trust and the balance to a marital trust (QTIP) which qualifies for the estate tax marital deduction. There is no federal tax and should be no NJ estate tax. But this new reg means that NJ won't recognize the difference between $2M and $675,000 as a marital deduction so that your estate will owe tax on this amount! Does this mean that you have to make an outright marital above the $675,000 for estates under the federal exclusion amount? Will another type of marital deduction other than QTIP qualify? Will the tax allocation clause of the will allocate taxes against the by pass trust undermining your intended dispositive scheme? If children from a prior marriage are beneficiaries of the by pass, their interests could be decimated? Sub-