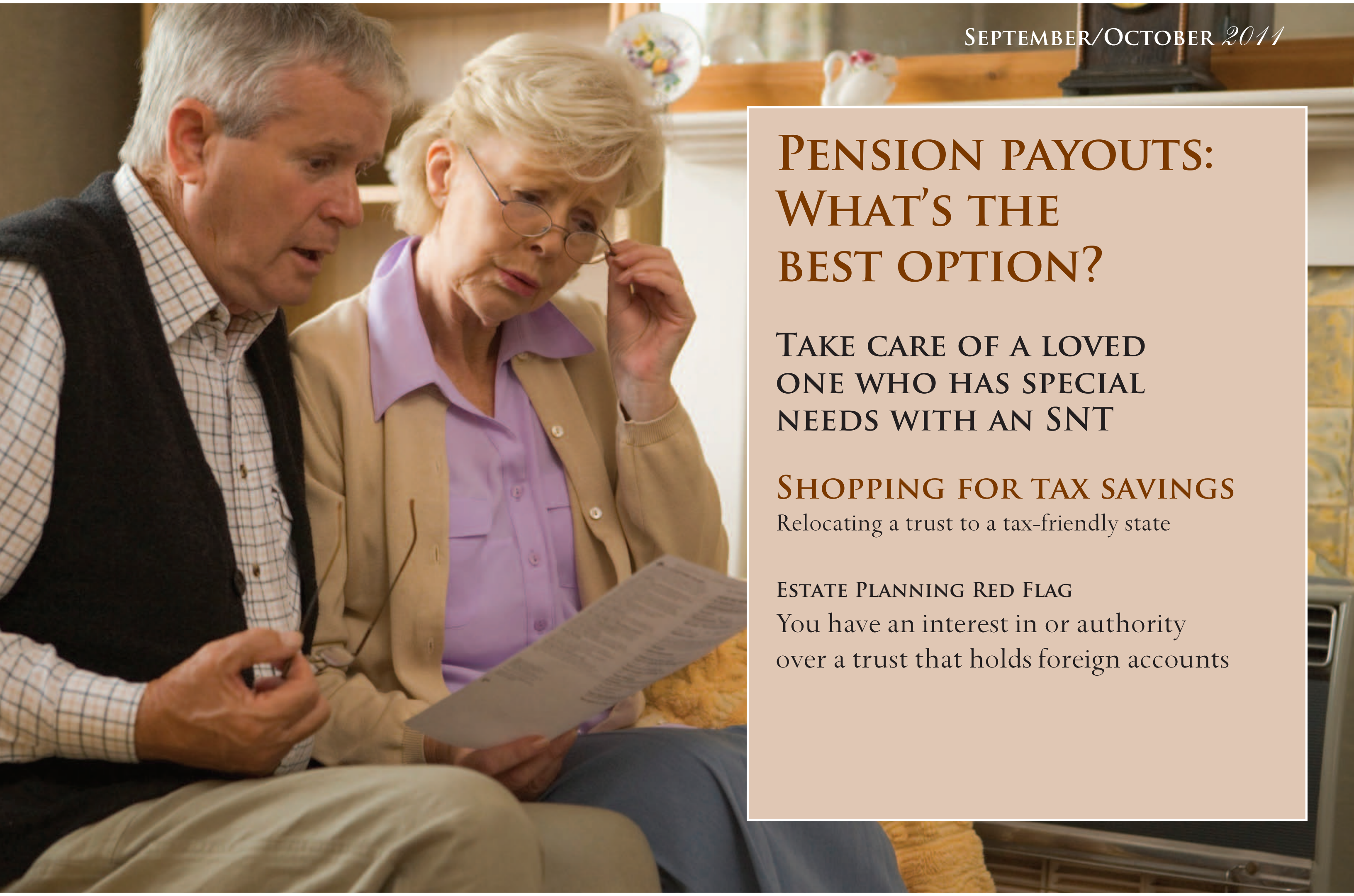
The Estate Planner



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Pension payouts: What's the best option?

Estate planning and retirement planning go hand in hand. After all, the more wealth you set aside for retirement — and the better job you do of managing your retirement funds — the more you'll have left to provide for your family after your death. One tough decision that retirees face is choosing the best option for receiving payouts from a pension plan.

Annuity vs. lump sum

Some defined benefit pension plans give retirees a choice between receiving payouts in the form of a lump sum or an annuity. If you have other sources of retirement income, taking a lump sum distribution allows you to spend the money as you please. Plus, if you manage and invest the funds wisely, you may be able to achieve better returns than those provided by an annuity.

Choosing between a single-life annuity and a joint and survivor annuity can be an uncomfortable decision — essentially, you and your spouse are gambling on each other's lives.

On the other hand, if you're concerned about the risks associated with investing your pension benefits — or don't want the responsibility — an annuity offers guaranteed income for life. (Bear in mind that guarantees are subject to the claims paying ability of the issuing company.)

Single life vs. joint life

If you choose to receive your pension benefits in the form of an annuity — or if your plan doesn't

offer a lump sum option — most plans require you to choose between a single-life or joint-life payout. A single-life annuity provides the plan participant with monthly benefits for life. The joint and survivor option provides a smaller monthly benefit, but the payments continue over the joint lifetimes of both spouses.

Deciding between the two monthly options requires some educated guesswork. To determine the option that will provide the greatest overall financial benefit, you'll need to consider several factors — including your and your spouse's actuarial life expectancies as well as factors that may affect your actual life expectancies, such as current health conditions and family medical histories.

One exercise that can help you make the decision is to perform some breakeven analysis. (See "Assessing the odds" on page 3.)

It's also important to consider your current financial needs — that is, your expenses and your other assets and income sources. Even if you expect a joint and survivor annuity to yield the greatest total benefit over time, you may want to consider a single-life annuity if you need additional liquidity in the short term.

Choosing between the single-life and joint and survivor options can be an uncomfortable decision — essentially, you and your spouse are gambling on each other's lives. And if you bet wrong, the losses can be significant.

Suppose, for example, that you have the pension plan, you expect your spouse to outlive you by 10 years and you select the joint and survivor option. If your spouse outlives you by 20 years, he or she will receive a windfall. But if your spouse dies before you — or if you exceed your life expectancy — it may turn out that you would have been better off with the larger monthly benefit offered by the single-life option.

Unfortunately, you can't change your decision retroactively: Once you select one or the other, you're stuck with it.

The single-life option can be a risk as well. You might choose this option, for example, if you and your spouse have comparable life expectancies or if you expect to live longer. Under those circumstances, the higher monthly payment will maximize your overall benefits. But if you die prematurely, the payments will stop.

Assessing the odds

Choosing a pension payout option involves a bit of risk, so it's a good idea to get a handle on the odds. Using breakeven analysis can help.

Suppose, for example, that your pension plan offers a choice between a single-life annuity that pays $3,000 per month or a joint and survivor annuity that pays $2,200 per month. Assume also that you expect to live another 20 years.

The breakeven point is the number of years your spouse would have to live for the two options to generate the same total benefit. For example, in this case, the single-life option would generate $720,000 over 20 years, and your spouse would have to live a little over 27 years for the joint and survivor option to produce a comparable benefit.

Working with your estate planning advisor to crunch the numbers for various scenarios can give you an idea of the risks and potential rewards associated with each strategy.

Eliminating the guesswork

If it's important to provide your spouse with a continuing source of current income, consider combining a single-life pension payout with an insurance policy on your life. Here's how it works: You select the single-life option, locking in a higher monthly payment for life. Next, you purchase a life insurance policy, using some of the higher monthly payment to finance the premiums.

If you die before your spouse, the death benefit provides your spouse with a source of income. If your spouse dies first, you can choose a new beneficiary (a child, for example) or simply cancel or cash in the policy.

Keep in mind that the viability of this strategy depends on whether you qualify for affordable life insurance coverage. So it's a good idea to wait until your application is approved and the policy is issued before you elect a pension payout option.

Choose wisely

To choose the option that's right for you, examine the alternatives in light of your family's overall financial situation. This includes your and your spouse's current and future income needs, the needs of your children and other family members, and the availability of liquid assets to meet those needs. ✤

Take care of a loved one who has special needs with an SNT

When creating or revising your estate plan, it's important to take into account all of your loved ones. Because each family has its own unique set of circumstances, there are a variety of trusts and other vehicles to specifically address most families' estate planning objectives.

Special needs trusts (SNTs), also called "supplemental needs trusts," benefit children or other family members with a disability that requires extended-term care or that prevents them from being able to support themselves. This trust type can provide peace of mind that your loved one's quality of life will be enhanced while not disqualifying him or her for Medicaid or Supplemental Security Income (SSI) benefits.

Preserve government benefits

The costs of extended-term care for a family member with special needs can be enormous and aren't always predictable, and these costs can endanger your family's financial security. An SNT preserves your loved one's access to government benefits that cover health care and other basic needs.

Medicaid and SSI pay for basic medical care, food, clothing and shelter. To qualify for these benefits, however, a person's resources must be limited to no more than $2,000 in "countable assets."

Generally, every asset is countable with just a few exceptions. The exceptions include a principal residence, regardless of value (but if the recipient is in a nursing home or similar facility, he or she must intend and be expected to return to the home); a car; a small amount of life insurance; burial plots or prepaid burial contracts; and furniture, clothing, jewelry and certain other personal belongings.

An SNT is an irrevocable trust designed to supplement, rather than replace, government assistance. To preserve eligibility for government benefits, the beneficiary can't have access to the funds, and the trust must be prohibited from providing for the beneficiary's "support." That means it can't be used to pay for medical care, food, clothing, shelter or anything else covered by Medicaid or SSI, such as the basic medical care provided by those programs.

Pay for supplemental expenses

With those limitations in mind, an SNT can be used to pay for virtually anything government benefits don't cover, such as unreimbursed medical expenses, education and training, transportation (including wheelchair-accessible vehicles), insurance, computers, and modifications to the beneficiary's home. It can also pay for "quality-of-life" needs, such as travel, entertainment, recreation and hobbies.

Keep in mind that the trust must not pay any money directly to the beneficiary. Rather, the funds should be distributed directly — on behalf of the beneficiary — to the third parties that provide goods and services to him or her.

Consider the trust's language

To ensure that an SNT doesn't disqualify the beneficiary from government benefits, it should prohibit distributions directly to the beneficiary and prohibit the trustee from paying for any support items covered by Medicaid or SSI. Some

SNTs specify the types of supplemental expenses the trust should pay; others give the trustee sole discretion over nonsupport items.

To ensure that an SNT doesn't disqualify the beneficiary from government benefits, it should prohibit distributions directly to the beneficiary and prohibit the trustee from paying for any support items covered by Medicaid or SSI.

Like many trusts, most SNTs contain spendthrift language to protect the trust assets against creditors' claims. Also, in some states, it may be necessary to include specific language providing that the trust is an SNT, that the funds are intended for only nonsupport purposes and that your intention is to preserve the beneficiary's eligibility for government benefits. In other states, simply designing the trust as a discretionary trust may be sufficient, but it can't hurt to include SNT spendthrift language just to be safe.

Above the countable assets limit?

If your family member with special needs owns more than $2,000 in countable assets, thus making him or her ineligible for government assistance, an SNT is useless.

One solution is a Medicaid payback trust — an irrevocable trust established by the person with special needs (or by court order) to pay for permitted supplemental needs during his or her lifetime. When he or she dies, any remaining trust assets are used to reimburse the government for Medicaid benefits provided to the beneficiary, with any excess assets going to the trust's remainder beneficiaries.

Alert family and friends

After creating or revising your estate plan, it's wise to discuss with your family your intentions. This is especially important if your plan includes an SNT. To ensure an SNT's terms aren't broken, notify family members and friends to make gifts or donations directly to the *trust* and not to the loved one with special needs. ✤

Shopping for tax savings

Relocating a trust to a tax-friendly state

People who live in states with high income taxes sometimes relocate to a state with a more favorable tax climate. A similar strategy can be available for trusts. If a trust is subject to high state income taxes, you may be able to change its residence — or "situs" — to a state with low or no income taxes.

Is a move right for you?

The taxation of a trust depends on the type of trust. Revocable trusts and irrevocable "grantor" trusts — those over which the grantor retains enough control to be considered the owner for tax purposes — aren't taxed at the trust level. Rather, trust income is included on the grantor's tax return and taxed at the grantor's personal income tax rate.

Irrevocable, nongrantor trusts generally are subject to federal and state tax at the trust level on any *undistributed* ordinary income or capital gains, often at higher rates than personal income taxes. Income distributed to beneficiaries is deductible by the trust and taxable to beneficiaries.

For an irrevocable trust, the ability to change its situs depends on several factors, including the language of the trust document and the laws of the current and destination states.

Relocating a trust may offer a tax advantage, therefore, if the trust:

- Is an irrevocable, nongrantor trust,
- Accumulates (rather than distributes) substantial amounts of ordinary income or capital gains, and
- Can be moved to a state with low or no taxes on accumulated trust income.

There may also be other advantages to moving a trust. For example, the laws in some states allow you or the trustee to obtain greater protection against creditor claims, reduce the trust's administrative expenses or create a "dynasty" trust that lasts for decades or even centuries.

Is your trust movable?

For an irrevocable trust, the ability to change its situs depends on several factors, including the language of the trust document (does it authorize a change in situs?) and the laws of the current and destination states. In determining a trust's state of "residence" for tax purposes, states generally consider one or more of the following factors:

- The trust creator's state of residence or domicile,
- The state in which the trust is administered (for example, the state where the trustees reside or where the trust's records are maintained), and
- The state or states in which the trust's beneficiaries reside.

Some states apply a formula based on these factors to tax a portion of the trust's income. Also, some states tax all income derived from sources within their borders — such as businesses, real estate or other assets located in the state — even if those assets are owned by a trust in another state.

Depending on state law and the language of the trust document, moving a trust may involve appointing a replacement trustee in the new state and moving the trust's assets and records to that state. In some cases it may be necessary to amend the trust document or to transfer the trust assets to a new trust in the destination state. A situs change may also require the consent of the trust's beneficiaries or court approval.

For tax purposes, a final return should be filed in the current jurisdiction. The return should explain the reasons that the trust is no longer taxable in that state.

Know the risks

Before you move a trust, be sure you understand the potential consequences. For example, if there's a conflict between the laws in the current and destination states, or if a state interprets the law differently than you do, the trust's income may end up being taxed in *both* states. Also, it's important to examine nontax factors, such as trust duration and asset protection.

Discuss the positives and negatives of moving your trust with your estate planning advisor. He or she can help you determine whether it's worth your while. ✤

Estate Planning Red Flag

You have an interest in or authority over a trust that holds foreign accounts

During the last few years, the IRS has stepped up its enforcement of the Report of Foreign Bank and Financial Accounts (FBAR) rules. To discourage taxpayers from hiding foreign accounts, these rules require U.S. citizens, residents and entities to file annual returns disclosing financial interests in, or signature authority over, foreign bank and investment accounts with an aggregate value of more than $10,000. Failure to comply can result in substantial penalties.

In addition to disclosing *direct* interests in foreign accounts, you're required to report certain *indirect* interests. For example, you may be required to disclose certain interests in family limited partnerships or other entities that hold foreign accounts.

You may have to report an interest in a *trust* that holds foreign accounts if you:

- Have signature authority, as trustee, over the trust's foreign accounts,
- Are treated as the trust's owner under the grantor trust rules,
- Receive more than 50% of the trust's income, or
- Have a beneficial interest in more than 50% of the trust assets.

If you're a trust beneficiary, recently finalized regulations clarify that you're required to file an FBAR only if you have an interest in *current* trust income or hold a *present* beneficial interest in the trust. In other words, if you're a beneficiary of a discretionary trust or hold a remainder interest, you're not subject to FBAR reporting requirements.

The regulations also provide that beneficiaries otherwise required to file FBARs need not report a trust's foreign accounts if the trust or trustee has already filed an FBAR for those accounts.