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Recent Developments in Estate Planning

1. Estate Tax

Summary: Federal estate tax exemption increases again.

For persons dying in 2019, up to $11,400,000 may be transferred free of estate tax using the applicable estate tax exemption. The exemption is unified with the gift tax because the exemption amount is reduced by the total amount of taxable gifts made during the deceased person's lifetime. Thus, lifetime gifts of $1 million would reduce the applicable estate tax exemption to $10,400,000 million. The exemption amount adjusts annually for inflation.

The current law expires on December 31, 2025. If Congress fails to extend the current law, the applicable estate tax exemption would drop to approximately $6,000,000.

2. Testamentary Powers of Appointment

Summary: Increase in federal estate tax exemption affects testamentary powers of appointment.

If your estate plan includes an inheritance protection trust for a child or other beneficiary, the provision likely gives the beneficiary a testamentary power of appointment. This permits the beneficiary, effective upon the beneficiary's death, to redirect any remaining trust assets among individuals or charities of the beneficiary's choice. When avoiding estate tax is a major concern, it makes sense to limit the power of appointment in a manner that restricts the beneficiary from using trust assets to pay off personal debts. This allows trust assets to pass to the successor beneficiaries free of estate tax, which is important for large estates. But the limited power of appointment also prevents the successor beneficiary from getting a step-up in income tax basis, which can increase capital gains tax upon sale of trust assets.

The current estate tax exemption, now dramatically higher than it was in 2017, eliminates the estate tax as a planning issue for all but the very wealthy. This means it makes more sense to refrain from using limited powers of appointment in inheritance trusts. Why? The reason is because the value of *potentially* avoiding estate tax is outweighed by the more likely benefit of reducing income tax.

3. Inheritance Protection Trusts

Summary: Recent Arizona case exposes weakness in many inheritance protection trusts.

If your estate plan includes an inheritance protection trust for a child or other beneficiary, you may want to consider an amendment in response to a 2016 Arizona legal case.[1]

[1] Duckett v. Enomoto, U.S. District Court, D. Arizona; April 18, 2016.

The case involved an inheritance trust established for a child by his Mother's will upon her death. The IRS filed a tax lien against the trust because the beneficiary owed substantial personal income taxes from prior years. The beneficiary argued that the inheritance was a "purely discretionary trust" and therefore not a personal asset subject to the lien[2]. The judge ruled against the beneficiary based upon a careful review of the specific trust provision regarding distribution of income and principal.

The relevant provision stated, "The Trustee shall pay to [the beneficiary] so much or all of the net income and principal of the trust as in the sole discretion of the Trustee may be required for support in the beneficiary's accustomed manner of living, for medical, dental, hospital, and nursing expenses, or for reasonable expenses of education, including study at college and graduate levels."

The judge interpreted the phrase "shall pay" as a mandatory fiduciary duty owed to the beneficiary by the Trustee, although he also noted that specific calculations were left to the discretion of the Trustee. This approach is sometimes referred to as a "discretionary support" or "hybrid" trust. The combination of the Trustee's duty to make distributions ("Trustee shall pay to the beneficiary…") and the inclusion of guidelines regarding how to define support ("in the beneficiary's accustomed manner of living…") gives the beneficiary an underlying right to distributions from the trust – at least to the extent of the support guidelines. The judge applied this logic to permit the IRS to attach a lien to the beneficiary's interest in the trust.[3]

For maximum protection of inheritance you leave to others, it may be appropriate to amend your will or living trust to clarify your intent that a Trustee's power to make distributions is purely discretionary and not mandatory. Otherwise, a creditor could use the above-described case to establish a legal argument that diminishes, or worse, eliminates the protections you intended to create.

If your trust was drafted by a Wealth Counsel attorney using its industry-leading WealthDocx software[4], it probably does not include the type of extraneous wording ("in the beneficiary's accustomed standard of living") that contributed to the adverse ruling in this case. However, the software, by default, uses the phrase "shall pay" and that may be enough to give creditors a slight opening to argue that you actually intended to create a discretionary support trust. Thus, in response to this recent Arizona case, I recommend an amendment that does the following:

- Edits the phrase "shall pay" to "may pay."
- Adds a sentence, "The discretion to make distributions includes the discretion to distribute nothing."
- Adds a sentence with conservative guidelines of this nature, "Accordingly, I request that my Trustee always consider the other known resources available to the beneficiary before making discretionary distributions."

I believe that these changes will eliminate any ambiguity about your intent and strengthen the protection an inheritance trust is capable of providing.

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[2] A purely discretionary trust does not grant a property interest to the beneficiary because the Trustee is not legally obligated to make any distributions to the beneficiary. See A.R.S. §14-10504(E).

[3] Whether the IRS could immediately seize assets from the trust to pay the lien is a different matter and was not ruled upon in the case.

[4] Bouman Law Firm has used WealthDocx software exclusively since October 2006.

4. IRA Protection Trusts

Summary: Recent US Supreme Court case increases popularity of IRA Protection Trusts.

The IRA Protection Trust is a sophisticated estate planning technique intended to coordinate the administration and distribution of IRA assets after death. While generally reserved for persons with more than $100,000 in tax-deferred retirement accounts, the IRA Protection Trust has become an integral component of comprehensive estate planning. An IRA Protection Trust formalizes the availability of the income tax-saving “Stretch-out” rules and permits extensive post-death contingency planning and asset protection planning.

Although the IRA Protection Trust was originally created as an income-tax savings technique, its ability to offer inheritance protection for beneficiaries now provides a second major reason to consider adding the strategy to your estate plan.

During your lifetime your retirement accounts are protected from most creditors by a combination of federal and state laws. Federal law (known as “ERISA”) protects the assets in a qualified retirement plan. This includes all 401(k), 403(b), and TSP accounts. Arizona law goes further by protecting the assets in an Individual Retirement Arrangement (“IRA”) by statute.[5]

Arizona law goes even further yet by protecting IRA assets from a beneficiary’s creditors after the original account owner’s death, provided the account is treated as an inherited IRA. This result is supported by an important Arizona bankruptcy case,[6] but later the US Supreme Court overruled a portion of the case in *Clark v. Rameker* (June 12, 2014). The *Clark* case ruled that an inherited IRA is not protected in a bankruptcy proceeding, although the court did not specifically address whether a conflicting state statute might change the result. Therefore, the Arizona statute continues to protect an Arizona resident’s inherited IRA assets from seizure and attachment outside the bankruptcy context (from personal judgment creditors) and also in bankruptcy (although there is some minor uncertainty about this latter point). This makes Arizona one of only eight states that offers this protection. The others are Alaska, Florida, Idaho, Missouri, Ohio, North Carolina, and Texas.

However, any retirement account owner with beneficiaries living in other states – or who might become a resident of another state – should be aware that an inherited IRA may be exposed to the beneficiary’s bankruptcy creditors and to the beneficiary’s personal judgment creditors during a lawsuit. The IRA Protection Trust addresses this concern by incorporating powerful legal provisions including a spendthrift clause, purely discretionary distribution provisions, and optional use of an independent Trustee. In addition, most IRA Protection Trusts include trust protector provisions to adjust for law changes after the account owner’s death. All of these combine to provide significantly enhanced creditor protection for the beneficiaries no matter where they live.

If you have large amounts in retirement accounts (generally more than $100,000 per non-spouse beneficiary), you should consider naming a separate stand-alone retirement plan trust as beneficiary. This approach protects a beneficiary’s interest from creditors and in the event of a beneficiary’s divorce. It can also ensure that any remaining assets in the account at your child’s death go to your grandchildren and not to your in-law who may get remarried.

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[5] See A.R.S. 33-1126(B).

[6] See In re Thiem, Bktcy Ct AZ 1/19/2011, 107 AFTR 2d 2011-529.

5. Financial Power of Attorney

Summary: New provision added to financial power of attorney form regarding trusts.

If your estate plan includes a revocable living trust, it may be appropriate to include a new provision in your financial power of attorney that permits your agent to amend the trust for limited purposes:

- To alter administrative and investment powers upon request of a financial institution
- To reflect tax or other legal changes that affect trust administration
- To correct ambiguities or typos.

6. Planning for Digital Assets

Summary: Estate planning for digital assets is a trending area of law development.

The Arizona Legislature enacted a new law in 2016 entitled, "Uniform Fiduciary Access to Digital Assets Act." The Act extends the rights a fiduciary (Personal Representative, Trustee, Agent et. al.) already has to manage tangible property to also include digital assets like computer files, access to Internet sites, and online digital media, but restricts a fiduciary's access to electronic communications unless the original user consented in a will, trust, power of attorney, or other record.

7. Advance Health Care Directive Registry

Summary: State of Arizona provides free registry service for health care directives.

The office of the Arizona Secretary of State continues to provide a free registry service to electronically store and access for health care directives. Your participation in the registry service is voluntary, but may be valuable if you are concerned about the accessibility of your documents in an emergency. For more information, visit https://www.azsos.gov/services/advance-directives.

8. Certifications of Trust

Summary: Arizona amends law encouraging acceptance of a Certification of Trust.

The Arizona legislature recently amended the law on Certification of Trusts (A.R.S. 14-11013). When a Trustee provides a Certification of Trust to a financial institution, it may not require the Trustee to provide copies of excerpts from the trust document that contain dispositive provisions (i.e., who gets what) or successor Trustee names (i.e., who will manage the trust upon death of Trustor) unless the financial institution also provides a verified statement that states a reasonable basis for the request.

A financial institution is now liable for damages, costs, expenses, and attorney fees if a court determines that it did not act in good faith or did not comply with the need for a verified statement in demanding a copy of the trust document.

In summary, the law change reinforces the legislature's intent to simplify the process of doing business with a trust. When buying or selling property using a trust, or opening or re-titling an account into a trust, a Trustee should only have to provide a copy of the Certification of Trust and

not the entire document. Financial institutions that still request a copy of the entire trust document are acting unreasonably and, in some cases, against the law.

See Arizona SB 1204, signed March 29, 2018 by Governor Ducey.

9. Asset Protection Trusts

Summary: Arizona does not permit self-settled asset protection trusts, but an alternative exists.

An asset protection trust is created when a person called a trustor transfers ownership of an asset into an irrevocable trust, which is managed by a trustee for benefit of one or more beneficiaries. The assets you contribute to an irrevocable trust are generally protected from your future or unknown creditors. The catch is that you cannot name yourself as both trustee and beneficiary like you would normally in a revocable living trust for probate avoidance. In other words, you cannot self-settle your own irrevocable asset protection trust and retain the ability to make distributions back to yourself. This arrangement does not provide any asset protection and is against public policy in all 50 states.

However, approximately 16 states now permit self-settled asset protection trusts in some variation. The most well-known are Alaska, Nevada, Wyoming, South Dakota, and Delaware. Unfortunately, the full faith and credit clause of the U.S. Constitution makes it unlikely an Arizona court would respect the governing law of a self-settled asset protection trust established in one of these states for an Arizona resident. Foreign asset protection trusts avoid this problem in theory, but if the full protection of the trust is triggered by an actual threat, case law has shown the beneficiary also loses access to the trust assets unless willing to move permanently outside of the United States. This is an unintended consequence most people are not willing to accept.

Although Arizona law does not permit self-settled asset protection trusts, an Arizona trustor may still obtain the desired creditor protection by establishing the trust in Arizona, excluding the trustor as an eligible beneficiary, and relying on spendthrift provisions to protect the trust assets from creditors of the eligible beneficiaries.

This type of irrevocable trust may be referred to as a *hybrid* asset protection trust because it may be drafted to include a provision giving an independent person or company called a trust protector the power to move the trust to another state or country that permits self-settled asset protection trusts. This change of governing law might permit the trust protector to add you as an eligible beneficiary later.