Lakin Spears LLP

TRUSTS AND ESTATES GROUP

2018

PLANNING UPDATE

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Tax Reform

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law. The new law makes sweeping changes to the income tax rules and the transfer tax rules. The transfer tax rules govern the taxation of estates, gifts and generation-skipping transfers and are the subject of this article.

The lifetime exemption for gifts and estates is doubled from $5,000,000 to $10,000,000 per person, adjusted for inflation since 2011. For gifts made and deaths occurring in 2018, the inflation-adjusted exemption is expected to be in the range of $11,200,000 per person. The generation-skipping transfer tax exemption is similarly increased. If a transfer exceeds the applicable exemption, the tax rate remains unchanged at 40%.

It is important to note that these exemption increases are temporary. On January 1, 2026, the exemption amounts revert back to $5,000,000 per person, adjusted for inflation since 2011 (projected to be in the range of $6,000,000 to $6,500,000 per person).

The very beneficial "basis step-up" regime, under which the income tax basis of an inherited asset is adjusted to the asset's fair market value on the date of death, remains in place. This allows heirs to sell appreciated assets without incurring a capital gains tax.

There are no changes in the rules for the gift tax annual exclusion. Each year a person may make annual exclusion gifts without eroding the lifetime exemption as long as the gifts are considered to be of present interests. For 2018, the annual exclusion amount is increased from $14,000 to $15,000.

The other gift tax exclusion we deal with in estate planning is the exclusion for a lifetime gift to a spouse who is not a citizen of the United States. For 2018, this exclusion is increased from $149,000 to $152,000.

For most families, the primary tax goal in estate planning will be maximizing income tax basis benefits and, while additional estate tax planning may not be necessary, an estate plan update may allow for reduced capital gains tax in the future. For some families, minimizing estate tax will still be the primary goal; these families should consider additional planning to utilize the increased exemptions before they expire.

Either way, if your estate plan has not been reviewed within the last few years, we recommend that you have your estate plan reviewed in 2018.

New Rules for Modification or Termination of Trusts

With the increase in the estate tax exemption to $11.2 million per person (see related article on tax reform), you should consider whether an existing irrevocable trust originally put in place for estate tax avoidance purposes still makes sense. Because the irrevocable trust assets likely will not receive a basis adjustment for

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income tax purposes upon the termination of the trust, it is possible that, under the new law, the irrevocable trust may actually increase taxes (i.e., capital gains taxes) rather than serve to reduce taxes (i.e., estate taxes).

Under new California law effective in 2018, the procedures for modifying or terminating an irrevocable trust have been relaxed to some degree. Before 2018, the court had limited authority to modify or terminate an irrevocable trust which contained a spendthrift clause (see related article on a creditor's access to a beneficiary's trust), even when all of the trust beneficiaries consented. Now, with the consent of all of the trust beneficiaries, if the court finds good cause to do so, it may approve a modification or termination of an irrevocable trust, regardless of a spendthrift clause, so long as the court determines that the reason for modifying or terminating the irrevocable trust outweighs the interest in accomplishing the material purpose of the trust. The new law also authorizes the court to limit the class of beneficiaries whose consent is necessary to modify or terminate the trust.

Also, if the person who established the irrevocable trust (i.e., the settlor) is still living, the new law clarifies that the modification or termination of the trust may be done without court approval as long as the settlor and all beneficiaries agree in writing.

Under continuing law, the court retains its authority to terminate an irrevocable trust with uneconomically low principal, and the court may modify or terminate an irrevocable trust if there are unanticipated changed circumstances that would defeat or substantially impair the accomplishment of the purposes of the trust.
If you are the settlor, trustee or beneficiary of an irrevocable trust that you believe may no longer be serving its original purpose, please contact us to discuss the potential modification or termination of the trust. Please note that it is always important to consider the income and other tax consequences, and any non-tax objectives, before an irrevocable trust is modified or terminated.

The Art of Choosing a Fiduciary

In making potentially life-changing decisions for you or your family, the trustee of your trust, the executor of your estate or the agent under your power of attorney is acting in a fiduciary capacity. That is, she is acting not for her own benefit but rather for the benefit of another person. The fiduciary must always abide by the various duties imposed under the law and under the governing document (loyalty, impartiality, prudence and avoiding self-dealing and personal enrichment, for example).

Given the broad powers and duties, selecting a fiduciary is one of the most important decisions to be made in estate planning. While there are times when appointing a family member or friend may be the best choice, there are other times when a professional fiduciary might be a better choice. Sadly, we have seen how a bad fiduciary choice can result in improper conduct, family conflict and excessive legal costs.

Here are some things to think about as you consider whether a friend or family member should take on the important role of a fiduciary:

• *Impeccable character.* Your fiduciary may take over the management of your assets and may make critical decisions affecting the lives of you and your family. You must have complete confidence that he will never inappropriately apply your assets for his own needs or make a decision based on his personal benefit. If the person you have in mind for a fiduciary has already shown you in his personal life that he is capable of self-dealing or secrecy, manipulation or irresponsibility around financial or personal issues, he likely is not right for the job.

• *Good judgment and organization skills.* As noted below, a fiduciary can hire professionals to assist with investments, taxes, legal matters and business issues; she need not be an expert in these matters. But she must also have a good sense for decision-making, be attentive to the needs of those she is acting for, dedicate the time required to carry out the necessary tasks and keep careful records of her actions and expenditures.

• *Willingness to work with advisors.* Being held to a high standard of care, your fiduciary should be open to working with legal, tax and investment professionals to ensure that he is following all appropriate fiduciary protocols. This is an area where a fiduciary can be penny-wise and pound-foolish. If he fails to get proper counsel early on, it could create serious legal and financial problems, and increased costs, later.

• *Communication and flexibility.* Your fiduciary will likely have to have at least one difficult conversation with, or make at least one difficult decision affecting, a beneficiary, co-fiduciary or other person involved in your affairs; she should not be a communication or decision-making "avoider." She should sincerely listen to the thoughts of those she serves. If there is an honest disagreement, she should be open to a reasonable compromise. Of course, ultimately your fiduciary will have to exercise her discretion as she sees fit (and in accordance with her fiduciary duties), but if she does so after an open and honest process, your trust in her will not be misplaced. A person who tends to think "it's my way or the highway" is usually not an ideal fiduciary.

• *Time constraints.* Acting as a fiduciary is very time-consuming and can be stressful. It also creates exposure to personal liability. The person you wish to appoint should have the time to willingly commit to doing this important job properly. Forcing the job on a person you think is obligated to act under familial duty is often a recipe for failure. If the person you have in mind is already intellectually, emotionally and physically maxed-out with his own family, work, social and charitable obligations, or if he is dealing with health issues, think carefully about whether he is right for the job.

So what do you do if you do not have anybody in your family or friend circle to act as your fiduciary? Perhaps you have two candidates who can work together, each bringing different skills? A co-fiduciary arrangement is not uncommon, but it creates its own set of issues that warrant further consideration.

Another option may be the use of a professional trustee (an individual private professional fiduciary or a corporate trust department). Fortunately, in the San Francisco Bay Area we have access to many experienced and excellent professional fiduciaries. A discussion of the benefits these professional fiduciaries can provide is beyond the scope of this article, but if you think this may be the solution for you, please contact our office and we will be happy guide you further.

To wrap up this discussion, here are several common pitfalls in choosing a fiduciary:

• *Choosing your children based solely on birth order:* Falling back on the default "oldest child acts first" is convenient, but it ignores a thoughtful consideration of the points discussed above. Also, sibling relationships must always be taken into account. Even with the most loving of siblings, putting one in the position of making important decisions for the other may cause an end to their friendship.

• *Choosing all of your children together so there are no hurt feelings.* As noted above, a co-fiduciary arrangement is possible, but if your children do not have a history of cooperation, trust and harmony, these bonds will not magically be created on your incapacity or death. In fact, our experience shows the opposite to be true – frayed relationships often do not survive the incapacity or death of the parents, as bad feelings from childhood rivalries and perceived injustices are revived.

• *Choosing your caregiver.* You may trust the person who comes into your house every day to help with your most intimate needs. However, due to the frequency of financial elder abuse by caregivers, California law now limits the ability of caregivers to act as a fiduciary for those they care for.

• *Choosing a "cheap" fiduciary.* While California law entitles all fiduciaries to be compensated for their time, often a family member or friend who acts will waive the right to compensation. However, this is no guarantee that cost savings will result when compared to the appointment of a professional fiduciary. For example, an inexperienced family member or friend acting as your fiduciary will likely need far more attorney and accountant hand-holding than a professional fiduciary. Also, a family member or friend who fails to get and follow proper guidance, or who does not possess the character traits described above, is more likely to make misjudgments and mistakes that require costly remediation down the road.

Do not hesitate to contact our office if you would like to review your fiduciary appointments.

Creditor Access to a Beneficiary's Trust

Many clients ask us about leaving assets to a child (or other beneficiary) in a way that protects the assets from creditor and spousal access. This may be because a child is not financially responsible, is in an unstable marriage or is in a high-liability profession. Generally, leaving assets to a child in a so-called irrevocable "spendthrift" trust, rather than outright, makes those assets harder for a third party to access. A spendthrift trust includes a clause that prohibits the beneficiary from assigning away his or her inheritance, and it also protects against a creditor accessing the inheritance to satisfy a judgment against the beneficiary. Without a spendthrift clause, a beneficiary's interest in a trust can be voluntarily or involuntarily transferred. Most irrevocable trusts include a boilerplate spendthrift clause.

A recent California Supreme Court case (Carmack v. Reynolds) provides further planning guidance. The Court concluded that if a creditor has a legal judgment against a beneficiary, the creditor can reach trust assets that are "due and payable," but not yet distributed, to the beneficiary, except for trust assets that are specifically earmarked and actually needed for the beneficiary's support or education. Trust assets that are "due and payable" are those that the trustee is required to distribute to the beneficiary. If the assets that are due and payable are not sufficient to satisfy the creditor's judgment, the creditor can levy up to 25 percent of the distributions expected to be made to the beneficiary in the future, subject to certain offsets, including anticipated support needs for the beneficiary.

By way of illustration, if the beneficiary of an irrevocable spendthrift trust is entitled to receive an automatic distribution of $10,000 on March 1, 2018, and on each March 1 thereafter for 10 years, and if a creditor has a legal judgment under which the beneficiary owes the creditor $50,000, on March 1, 2018, the court may require the trustee to pay the $10,000 distribution directly to the creditor. The court could approve an additional future payment to the creditor of $22,500 (25% of each of the remaining nine $10,000 distributions as they come due). To collect the remaining amount due under the judgment, on each subsequent March 1, the court can further require the trustee to pay the balance of that year's $10,000 distribution (or $7,500) until the judgment is fully paid.

The Court's ruling provides valuable guidance in drafting the distribution requirements of an irrevocable spendthrift trust where creditor access is of a particular concern. For example, a fully discretionary trust (that is, it provides for no mandatory distributions), or a trust limiting mandatory distributions to those needed for support and education only, may be appropriate. In addition, it may be appropriate to limit a beneficiary's broad (or "general") lifetime or testamentary power of appointment over trust assets.

Of course, these restrictions must be balanced with the other tax and non-tax costs and benefits of the trust. They may not make sense in every situation. Also, it is important to note that a judgment for child support or spousal support, or a lien for unpaid taxes, is subject to more generous access rules.

Attorney-Client Privilege

Generally, the attorney-client privilege allows a client to communicate freely with her attorney and receive candid advice in return, knowing that such communication will never be disclosed to a third-party. This privilege is a powerful, bedrock legal principle that is as important in civil law matters, such as estate planning and estate litigation, as it is in criminal law matters. The privilege enables individuals to communicate with their attorneys in confidence, which encourages individuals to obtain advice to conform their conduct to the law.

In California, communications between a client and her attorney remain confidential so long as the communication is necessary to accomplish the purpose for which the client consulted the attorney and so long as the attorney provides some legal advice to the client as a result. One important caveat to this rule is that a communication is not confidential if it is disclosed by the client to a person other than the attorney, unless that person's involvement in the communication is required "to further the interest of the client" or "is reasonably necessary for the transmission of the information or the accomplishment of the purpose for which the [attorney] is consulted." (Cal. Evid. Code, sec. 952.)

This means that a client may speak with her attorney's assistants, paralegals, and other staff about her matter, as well as other "reasonably necessary" individuals. "Reasonably necessary" individuals may also include interpreters, physicians, spouses, and parents. For example, an elderly and infirm client may require a trusted family member to participate in communications in order to convey the attorney's recommendations. That said, if a client discloses an attorney-client communication to a third party, the client may have waived her privilege. For example, if a client forwards her attorney's e-mail to a friend or family member, she may have waived her privilege. Likewise, if a client copies a friend or family member on an e-mail, the client may have waived her privilege.

The best practice is to not share your confidential attorney communications with anyone, or seek your attorney's advice before doing so. It is natural for a client to want to share their attorney's advice with friends and family, or to ask a friend or family member to attend an attorney meeting. Clients often rely on the input and support of friends and family when dealing with legal matters. However, if the friend or family member is not necessary for the protection of the client's interests, the attorney-client privilege may be waived.

The rules summarized here apply while the client is living. Different rules apply after the client's death.

Founded in 1914 in Palo Alto, LAKIN SPEARS, LLP is a law firm built on a long tradition of prompt, efficient and value-added legal service to our clients throughout the Bay Area. The firm specializes in handling trusts and estates, family law, real estate and business matters.

The Trusts & Estates Group provides the full range of legal services in the areas of estate planning, estate and trust administration, gift and philanthropic planning, incapacity planning, guardianships, conservatorships, estate, trust and conservatorship litigation, and estate and gift tax return preparation.

This publication is for general information only and is not specific legal advice or a substitute for advice from qualified counsel.

Please contact us if you have any questions about the information in this newsletter.

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