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Helping Clients Build and Manage Wealth

THE BACK BAY ADVISOR

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Getting Organized for Your Heirs

Even if you have a formal estate plan, organizing your personal paperwork and informing heirs of basic decisions will make it easier for heirs to handle your estate after your death.

Without an organized approach, your preferences for funeral arrangements may not be followed, friends or family may not be notified of your death, or items with sentimental value may not be properly passed on. Without organized financial records, your heirs may not locate all assets, with the possibility that stocks, bonds, bank accounts, real estate, or insurance policy benefits may go unclaimed.

One way to approach this task in a systematic manner is to prepare a personal letter of instruction, covering the following topics:

- **Your assets and rationale for distribution.** This is a good place to explain why you distributed your estate in the manner you did. You can go into specific detail, informing heirs how each asset will be distributed, or you can give a general overview of your estate plan. If you selected one heir as executor or trustee, explain why you chose that individual. List all assets and where important documents concerning those assets are located. Prepare a list of all checking and savings accounts, including the bank name, account numbers, and

individuals on the account. Detail all insurance policies, including policy numbers, effective dates, levels of coverage, and policy location. Also list all outstanding debts.

- **Individuals to contact.** List names, addresses, and telephone numbers of individuals your heirs may need to contact, including employers, attorneys, accountants, insurance agents, investment managers, and financial planners.
- **Personal papers.** Indicate where personal records are kept, including your birth certificate, mar-

riage certificate, divorce or separation agreements, diplomas, military records, and naturalization records.

- **Safe deposit box.** Indicate where the safe deposit box is located and what is contained in the box. Note where the key is kept and who has access to the box.
- **Disposition of personal items.** Detail how you would like personal items distributed, including jewelry, photographs, personal collections, pets, and furniture.
- **Funeral arrangements.** Indicate your preferences for funeral

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Tips to Consider for Your Estate Plan

Current tax laws have made estate planning more complicated. The estate tax is scheduled to phase out gradually until 2009, be repealed in 2010, and then reinstated in 2011 based on 2001 tax laws. That assumes there will be no future tax legislation during that time. But don't let these evolving tax laws prevent you from planning your estate. Instead, consider the following tips:

- **Plan your estate, even if it won't be subject to estate taxes.** The amount you can distribute to heirs other than your spouse without paying estate taxes will increase from the current \$1,500,000 to \$2,000,000 in 2006

and \$3,500,000 in 2009. Estate taxes will be repealed in 2010, but then reinstated again in 2011 based on 2001 tax laws. However, there are reasons other than minimizing estate taxes to plan your estate. For instance, parents with minor children should name guardians and provide for their children's support, while individuals in other than first marriages may want to protect children from prior marriages. You may also need a will, durable power of attorney, and health care proxy.

- **Leave written instructions for heirs.** You can provide heirs

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Your Estate Plan

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with important financial and personal information and clarify requests made in other legal documents. You can also explain your rationale for distributing assets, especially if they aren't split equally among heirs.

- **Decide whether to leave your entire estate to your spouse.** With the unlimited marital deduction, you can leave all your assets to your spouse without paying any estate taxes. However, if you have assets in excess of the estate tax exclusion amount (detailed above), your heirs will not be able to utilize that exclusion amount when all assets are left to your spouse. Thus, when your spouse dies, your heirs may pay more estate taxes than if you had left some assets to them, either outright or through trusts. If your spouse needs those assets after your death, you can set up a trust that allows your spouse to use income during his/her life, with the balance distributed to heirs after your spouse's death.
- **Name executors, trustees, and guardians carefully.** An executor (or personal representative) administers your estate through probate court, locates and values all assets, pays your estate's obligations, and distributes your estate to heirs. A trust manages your estate and distributes income and principal. A guardian takes physical care of your minor children and handles their finances. All three roles significantly impact your estate, so choose these individuals carefully and ensure they can handle the responsibilities.
- **Review the distribution of assets that bypass your will.** Jointly owned property will transfer directly to the co-owner, while assets with named beneficiaries will transfer directly to those beneficiaries. If you don't

keep this in mind, some heirs could receive a higher percentage of your estate than intended. Beneficiaries of assets such as life insurance policies, 401(k) plans, and individual retirement accounts should be reviewed after major personal changes, such as marriage, divorce, death, or birth.

- **Consider adding a disclaimer provision to your estate planning documents.** This provision details what happens if your heirs disclaim all or a portion of their inheritance. That way, heirs can decide after your death how much to place in various trusts. For instance, a husband can leave all assets to his wife with the condition that any disclaimed assets go into a trust paying her income for life and distributing the remaining assets to their children after her death. This gives the wife the opportunity to divide assets based on her needs and the estate tax laws at the time of her husband's death.
- **Implement an annual gifting program.** You can make annual gifts, up to \$11,000 in 2005 (\$22,000 if the gift is split with your spouse), to any number of individuals without paying federal gift taxes. Since estate tax repeal is only scheduled for one year, this strategy removes assets from your taxable estate as well as any future appreciation or income generated on those gifts. Over a number of years, an annual gifting program can remove substantial assets from your estate. You may also want to use your \$1,000,000 lifetime gift tax exclusion.
- **Skip a generation on a tax-free basis.** Leaving assets to children who already have sizable estates may mean the assets will be taxed again when they bequeath them to your grandchildren. A better strategy may be to transfer those assets directly to your grandchildren, although you can only transfer a lifetime amount of

\$1,500,000 in 2005 before triggering an additional tax called the generation-skipping transfer tax. This amount follows the estate tax exclusion.

- **Consider making charitable contributions during your lifetime.** While charitable contributions made after death are free of estate taxes, that may not provide any benefit due to higher exemption amounts. Charitable contributions made during your life will still lower your taxable estate and provide a current income tax deduction.
- **Understand when a revocable living trust is appropriate.** Living trusts can provide substantial estate planning benefits, such as removing assets from probate and preserving the use of your estate tax exclusion. However, these trusts do not reduce estate taxes unless used in conjunction with other trusts.
- **Shelter life insurance proceeds from estate taxes.** While life insurance proceeds are always free from federal income taxes, owning the policy yourself will cause the proceeds to be included in your taxable estate. Instead, you may want another individual or trust to own the policy, so the proceeds are excluded from your taxable estate.
- **Realize a wide variety of trusts exist to meet specific estate planning needs.** Trusts can be established to meet a variety of objectives — to reduce estate taxes, to control asset distribution, to make gifts to charities, to provide for the possible incapacity of the creator, to protect heirs from themselves or others, to avoid probate, to allow a professional to manage assets, or to ensure provisions are made for minors.

Even with the changing tax laws, you should take time to plan your estate. Please call if you'd like to discuss your estate planning situation in more detail. ■■■

Thinking Through a QTIP Trust

A common estate plan for married couples is to set up two different trusts:

- The first trust, commonly referred to as a credit shelter or bypass trust, holds assets to preserve the estate tax exclusion amount. That amount is currently \$1,500,000, but is scheduled to increase to \$2,000,000 in 2006 and \$3,500,000 in 2009. The deceased's spouse can then use the income and even some of the principal from the trust, with the remaining assets distributed to heirs after the spouse's death.
- If the spouse wants to control the remainder of his/her estate not placed in the bypass trust, a qualified terminable interest property trust (commonly referred to as a QTIP trust) is typically used. Any assets not placed in the bypass trust are placed in the QTIP trust, with income distributed to the spouse during his/her life-

time. This qualifies for the unlimited marital deduction, so estate taxes won't be assessed at the first spouse's death. After the surviving spouse's death, the principal is distributed to heirs designated by the first spouse.

The main objective of the QTIP trust is to allow use of assets by your spouse while you still determine the distribution of those assets after your spouse's death. That way, should your spouse remarry after your death, his/her new spouse won't inherit any of your assets. Or, if you have children from a previous marriage, this trust will ensure those children receive part of your estate. But if you do decide to use a QTIP trust, think through all provisions so you don't impose unnecessary hardship on your spouse. Some items to consider include:

- **Decide how much discretion to give your spouse in making withdrawals.** A spouse can be-

come resentful if an outside trustee places too many restrictions on withdrawals or requires extensive documentation for withdrawals. You may want to discuss these items beforehand and give your spouse broad discretion in this area.

- **Consider allowing your spouse to change trustees.** If your spouse has difficulty dealing with the trustee, you may want to give him/her the ability to change trustees or select investment managers.
- **Review the trust's ultimate beneficiaries with your spouse.** Make sure your spouse understands the trust's purpose and why you have chosen its ultimate beneficiaries. No matter what happens to his/her personal or financial situation after your death, your spouse won't be able to change the trust's beneficia-

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arrangements, including whether you want a religious or secular service, whether you want flowers or donations to charity, whether you want to donate your organs or body to medical institutions, and where you would like to be buried or how your remains should be disposed of. These are items your heirs may feel uncomfortable asking about, but will be grateful your wishes are known so they can carry them out. Also list any friends or family you would like contacted after your death.

Your thoughts on these subjects can change over time, so review and update the letter periodically. Keep it in a place where heirs can find it

What Is an Intentionally Defective Grantor Trust?

An intentionally defective grantor trust is an irrevocable trust designed to trigger the grantor trust rules, thus allowing the grantor, rather than the trust, to pay income taxes on trust income. Assets can be moved to the trust through gifts or sales, thus removing the assets and any future appreciation from the grantor's estate. Larger gifts may trigger use of your lifetime gift exclusion or the payment of gift taxes. Selling the assets to the trust and paying interest income on an installment sale are not taxable events. Since the defective trust is considered an extension of the grantor, these events are considered transactions with the grantor.

Any outside income generated by the trust is taxable to the grantor. Since the grantor is required to pay

the tax on this income, it is considered a legal obligation and not a gift. Thus, all trust earnings can accumulate inside the trust for the beneficiaries' benefit.

There is no step-up in basis when the assets are transferred or sold to the trust. Thus, while the grantor uses this trust to reduce estate taxes, heirs may find themselves faced with high capital gains. However, the capital gains taxes aren't owed until the asset is actually sold. Also, if the asset is real estate, heirs may be able to perform a Section 1031 like-kind exchange to defer gains.

To use this type of trust, the trust document must be drafted to invoke the grantor trust rules. Several conditions can accomplish this. ■■■