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Can You Trust Your Kid With $5.25 Million?

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Wealthy families got a holiday gift on Jan. 1, when Congress agreed on permanent estate-tax rules that are much more generous than many financial planners had expected.

Some aren't celebrating, however. Instead, they are grappling with new questions about how best to set up trusts for their heirs—while keeping a measure of control over their wealth.

Under the new rules, a taxpayer may shield up to $5.25 million from estate taxes ($10.5 million for couples), and must pay 40% on amounts over the exemption, up from 35% last year. Had Congress done nothing, the exemption would have fallen to $1 million ($2 million for couples), and the rate would have jumped to 55%.

On top of that, the estate and gift tax remain unified, meaning an individual can use his entire exemption to make gifts while alive.

Now that the uncertainty has been lifted, some ultrawealthy families are wondering whether they want to leave heirs that much tax-free money after all. Can their children handle a payday of as much as $10.5 million without losing their motivation to work hard and be productive?

Wealth transfer to younger generations is the biggest concern among clients of U.S. Trust, Bank of America's private wealth-management unit, says Keith Banks, its president. And when U.S. Trust surveys people with at least $3 million in assets who aren't clients, "they say, 'My children are not ready yet to inherit the wealth they will receive.'"

There is a solution for such situations: the "quiet," or "silent," trust, which keeps the children in the dark about their wealth until later.

Michael Puzo, chair of the private client group at Boston trust specialist Hemenway & Barnes, says he set one up for a Massachusetts couple late last year after they expressed worries that a child getting the money too soon might just "hang out on the beach," Mr. Puzo says. Instead, the child will learn about the multimillion-dollar inheritance at age 30.

What about families that already have set up their estate plans? There was a burst of activity late last year in particular, when people rushed to lock in favorable tax rules before the possible change on Jan. 1. U.S. Trust created six times as many trusts in December 2012 as in December 2011, Mr. Banks says. Adds Carol Harrington, a partner at law firm McDermott Will & Emery in Chicago: "I've been doing this since 1977, and I've never seen anything like this."

For families that rushed to capture last year's tax breaks without thinking through all of the emotional consequences, there is good news: A few simple techniques can help you get back some control over when your heirs can collect money and how.

To be sure, the law isn't yet set in stone. Certain types of trusts, methods to value property and other tools used by families to reduce their taxes are on lists of potential loopholes that could be closed later this year. Still, experts say there are moves that can be made now to address the thorniest estate-planning issues.

Here's what you can do.

Keep It Quiet

First, some basics. Most people making big financial gifts choose to set up trusts, which can shield assets from divorce or other legal actions. The trust must have a "trustee"—a banker, lawyer, family member or friend responsible for managing its finances and making decisions about funding heirs' needs, from college to weddings and mortgages.

During last year's estate-planning bonanza, demand spiked for quiet trusts in particular, experts say. While only about 13 states explicitly allow them, some 19 others have rules implying they are permitted—and more states are pushing to make them legal, including New Jersey and Maryland.

Even if you live in a state that frowns on quiet trusts, you could open one in a state that allows them, such as Alaska, says Richard Greenberg, a tax attorney in Woodbridge, N.J.

Hemenway & Barnes, the Boston firm, even opened a trust company in Salem, N.H., to take advantage of that state's favorable treatment of quiet trusts and other estate-planning options.

Quiet trusts are controversial among estate planners, in part because they make it harder for trustees to do their job of keeping heirs informed about their investments.

With a traditional trust, the trustee generally reports directly to beneficiaries, or their parents if the beneficiaries are children. With quiet trusts, the donor specifies who the trustee reports to and when.

That means someone who manages a quiet trust can't get the heirs' feedback about investment goals. And heirs might end up with mixed feelings after learning they went for years without knowing they someday would inherit a tidy sum.

"If I were going to set up a trust for my kids, I would tell them about it and why I don't want them to rely on it," Ms. Harrington says. "If I don't feel comfortable doing that, then I should just keep my money."

Alan Moore, a financial adviser in Milwaukee, says he generally recommends against parents and children keeping such secrets, and always asks why a client wants to hide inheritance plans. "This tells me there is something more going on psychologically that we need to address," he says, such as anger or a need for control.

Mr. Moore recalls working with one set of siblings who didn't learn until their 50s that their parents had left them millions—and, rather than being delighted, were disturbed their mom and dad had kept the secret from them.

Mr. Puzo, who says he has set up increasing numbers of quiet trusts in the past two years, notes that it is important not to leave heirs in the dark too long: The beneficiary needs to know his financial situation, and the family needs to make sure someone is keeping tabs on the trustee, he says.

The key to making a quiet trust work, he says, is to see from the start that the trustee reports regularly to someone, such as a relative or close family friend, who is sharp, will ask questions and is aware of the beneficiary's situation.

Mr. Puzo also advises against making the beneficiary wait too long to see the whole picture. Instead, pick a reasonable age to end the quiet phase. Without direct contact with the beneficiary, the trustee won't know how best to serve, he says.

Tweak for Control

Families can build in ways to revise their estate-planning vehicles down the road. One common tweak to trusts holding big, new gifts: adding spouses as potential beneficiaries, so they can tap into the trust if need be.

A similar tool is the "nonreciprocal" spousal lifetime-access trust, in which the surviving spouse has continued access to the deceased spouse's trust. The key is to make sure the rights, interests and powers that each spouse grants to the other aren't identical, or even similar enough for the Internal Revenue Service to challenge.

This strategy became popular last year among "people who cut their teeth in the Depression and never feel comfortable that they have enough," says Joe McDonald, an estate-planning lawyer at McDonald & Kanyuk in Concord, N.H.

Families also are seeking ways to have a say later in how the money is doled out to their children, when they can better anticipate their needs and how well they handle it.

There are some technical ways to create this power in a trust. For example, a husband could set up one with gifts for his children, but give the wife the power to direct distributions of property among a defined class of eligible beneficiaries, typically descendants, other trusts or charities, Mr. McDonald says.

Another popular technique is called "decanting," which allows the trustee to move assets among various trusts. Generally, "you can't add beneficiaries, but you can subtract them and change the nature of their interests," he says. One note: Not all states allow the practice, and only certain types of trusts can use this strategy.

Decanting also can be used to move a trust to a different state with more advantageous trust accounting or administration rules or tax rates. "I think a lot of drafters built in so-called decanting provisions because there was a lot of work being done in a hurry at year-end," says Shari Levitan, an estate-planning lawyer and partner at Holland & Knight in Boston.

She says she also is seeing some families re-examining their decision to fund trusts with real estate. The problem: If you have given away your beach house, you can't use it freely, or it will end up back in your taxable estate. Instead, you have to hand the keys to your kids and rent the house back at a fair-market price. Not only might that feel strange—your kids are your landlord—but it also could prove costlier than you expected.

Rather than simply changing the names on the title, Ms. Levitan's firm is advising clients to get vacation-home appraisals and calculate how much cash should stay in the trust to cover expenses, then figure out fair-market rent and the regular carrying charges for real estate and maintenance, she says. In the end, she says, putting a beach house into a trust "may not be economically feasible."

Liquidate the Trust?

With the estate-tax exemption made permanent, families with less than $10.5 million who had set up trusts to hold annual gifts to kids and grandkids might be tempted to cancel them and distribute the money under the new lifetime gift-tax exemption of $5.25 million ($10.5 million for couples). That way, they wouldn't have to pay the fees involved in maintaining a trust, file separate income-tax returns for it or deal with administrative hassles.

But there are some big caveats to liquidating a trust. If your heir gets divorced, an ex-spouse could get part of the money. And the kids would get the money while you are alive, meaning you might see them spend it in ways you consider financially irresponsible, says Martin Shenkman, an estate-planning lawyer in Paramus, N.J.

Another change: The new law makes the "portability" of the federal exemption permanent, meaning that after the second spouse dies, the heirs generally would owe estate tax only on assets above the combined exemption for both parents. (Note: A tax return has to be filed after the first spouse dies to secure this benefit.)

In the past, married couples would create special "bypass" trusts that allowed them to double each spouse's estate-tax exemption. Now those trusts are unnecessary, Mr. Shenkman says, except possibly for people in states that still have their own estate tax with lower exemptions, such as New York, which has a $1 million exemption.

Instead of bypass trusts, wealthier families now should consider setting up a spousal-lifetime-access trust and making gifts to it incrementally during the first spouse's lifetime, with a dual purpose: avoiding state estate tax while also protecting assets from creditors in the couple's lifetime.

The trust also could hold tax-free life insurance for heirs, which could prove an increasingly attractive investment if income-tax rates climb, since such policies provide an income-tax-free benefit, Mr. Shenkman says.