

Insight on Estate Planning

Year End 2010



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AP&S

ADLER POLLOCK & SHEEHAN P.C.

SOLUTIONS AT LAW®

**One Citizens Plaza, 8TH Floor
Providence, RI 02903
401.274.7200**

**175 Federal Street, 10TH Floor
Boston, MA 02110
617.482.0600**

www.apslaw.com

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Social Security: When's the right time to start?

Estate planning and retirement planning go hand in hand. After all, the amount of wealth you leave to your children and grandchildren will depend on the amount you need to continue your desired lifestyle during your retirement years.

Social Security is an important component of retirement income. Many people elect to begin receiving benefits as soon as they're eligible, but that's not always the best choice. There's no magic formula for deciding when to begin receiving Social Security benefits, but there are a few factors to consider.

What difference does it make?

You can begin receiving Social Security benefits as early as age 62 or as late as age 70. The longer you wait, the higher the monthly benefit. Why? Because the system is designed to provide you with roughly the same total benefit (based on government life expectancy tables) regardless of when you begin receiving payments.

If you start benefits before your "normal" retirement age (see "What's your retirement age?" on page 3), you'll receive a smaller check over a greater number of years. If you start later, you'll receive a larger check over a smaller number of years.

If you were born between 1943 and 1954, for example, your normal retirement age is 66. If you start receiving benefits at age 66, you're entitled to a full benefit based on a formula tied to your earnings history.

Let's say your monthly benefit at age 66 is \$2,000. If you elect to begin receiving benefits at age 62, the monthly amount is reduced by 25%, to \$1,500. (For ages between 62 and 66, benefits are reduced



on a sliding scale.) If you delay benefits past age 66, the amount is increased by 8% per year.

Many people can maximize wealth accumulation by delaying Social Security benefits to age 66 or even later. But there also are reasons to start Social Security early. For example, in many cases, tapping other investments — such as IRAs, 401(k) plans or mutual funds — comes at a higher cost in terms of lost future earnings or accelerated taxes.

What's your break-even point?

Assuming that you can live comfortably without Social Security benefits, when is the optimal time to begin receiving them? A useful tool for choosing the right starting age is to calculate your break-even point.

For example, Frank, who is retired, is about to turn 62. He's trying to decide between taking a reduced Social Security benefit right away or waiting until his normal retirement age of 66. His full monthly benefit at 66 would be \$2,000 and his reduced benefit at 62 would be \$1,500.

Frank's break-even point is just before his 78th birthday. At that point, his total benefits will be about the same whether he starts at age 62 (192 months \times \$1,500 = \$288,000) or at age 66 (144 months \times \$2,000 = \$288,000). If Frank expects to live to at least age 78, his lifetime benefits

will be greater if he waits until age 66 to start collecting. If he doesn't expect to reach that age, he's better off starting at age 62.

Suppose that Frank's father and grandfather both lived to be 90. If Frank follows suit, he'll receive an additional \$72,500 in Social Security benefits by waiting until his normal retirement age of 66.

After determining your break-even point, the right choice for you depends on several factors, including your actuarial life expectancy, health and family history. Also, keep in mind that the above example doesn't consider potential earnings on Social Security benefits. If you plan to invest your benefits, you may need to adjust your break-even point upward or downward, depending on your expected rate of return.

Do you plan to keep working?

If you plan to continue working after you become eligible for Social Security, you're likely better off delaying benefits at least until you reach your normal retirement age. If you start earlier, your benefits will be reduced by \$1 for every \$2 you earn above a certain threshold (\$14,160 in 2010).

So, for example, if your benefit amount is \$1,500 per month, or \$18,000 per year, your benefits will

be eliminated if you earn \$50,160 or more. After you reach your normal retirement age, you can continue working without reducing your Social Security benefits.

Are benefits taxable?

Whether you continue to work or not, a portion of your Social Security benefits may be taxable. To determine if any of your benefits are taxable, your tax advisor must add one-half of your benefits to *all* of your other income, including tax-exempt interest.

If the total exceeds a base amount (\$25,000 for single filers, \$32,000 for joint filers), up to 85% of your benefits will be taxable. (The taxable portion depends on your income level.)

Review your situation

Choosing the right time to begin receiving Social Security benefits can be a complex decision. In addition to the factors discussed here, you should consider whether your spouse is entitled to his or her own benefits or to survivor benefits after you die. Your estate planning advisor can help you evaluate your situation and select the option that maximizes the potential value of Social Security for your family. ■

What's your retirement age?

Year of birth*	Normal retirement age	Reduced benefit at age 62 (as % of full benefit at normal retirement age)	Increased benefit at age 70 (as % of full benefit)
1943–1954	66	75.00%	132.00%
1955	66 and 2 mos.	74.17%	130.67%
1956	66 and 4 mos.	73.33%	129.33%
1957	66 and 6 mos.	72.50%	128.00%
1958	66 and 8 mos.	71.67%	126.67%
1959	66 and 10 mos.	70.83%	125.33%
1960 and later	67	70.00%	124.00%

Source: U.S. Social Security Administration

*If you were born on Jan. 1, refer to the previous year's numbers.

The next steps ...

Putting to rest your deceased loved one's affairs

Losing a spouse, parent or other close loved one can throw your life for a loop, what with having to take care of your family and make funeral arrangements all while dealing with your own grief. And after the memorial service, you'll likely need to turn your attention to the deceased's estate and related legal and financial matters. Breaking the job into steps can help ease the stress.

Step 1: Locate important documents

Your first step should be to locate your loved one's will or living trust document. Places to look include safe deposit boxes, safes or strong boxes, or filing cabinets. Contact the attorney who drafted your loved one's will or living trust and make an appointment. If the attorney can't be identified or the deceased didn't have one, the personal representative named in the will or the trustee of the living trust should retain one.

If the deceased had a living trust, the trustee can begin managing his or her affairs immediately, without the need for court proceedings.

If assets pass under a will, the deceased's personal representative should consult legal counsel about initiating probate proceedings. If you're named as the personal representative, remember that you have no authority to act on behalf of the estate until a court accepts the will as valid and appoints you to act in that capacity.

If the deceased had a living trust, the trustee can begin managing his or her affairs immediately, without the need for court proceedings.

If your loved one died without a will or living trust, consult legal counsel about steps you should take to initiate court administration of the estate.



Other important documents to locate include life and other insurance policies, bank records, retirement plan and other employee benefit documents, deeds and other real estate documents, automobile registrations, income tax returns, W-2 forms and other tax records, and notes receivable and payable.

Step 2: Inventory assets and liabilities

Assuming you're the personal representative or trustee, you'll need to conduct an inventory of your loved one's assets and liabilities, paying particular attention to assets that may require immediate attention, such as life insurance policies, stock options and retirement plans. If probate is required, be sure your attorney moves quickly so the court can address the disposition of stock options and other time-sensitive assets.

Don't pay any outstanding bills until you've inventoried all of the deceased's assets and debts and compiled a complete list of his or her creditors.

Step 3: File life insurance and Social Security claims

To file a life insurance claim, contact the deceased's insurance agent. You'll likely need to furnish the following to the life insurance company: a death certificate; insurance policy numbers and amounts; the deceased's full name, address and date and place of birth; the deceased's occupation and last place of employment; and the beneficiary's name, address, age and Social Security number.

To apply for spousal and dependent benefits, contact your local Social Security office. You'll need to furnish a certified copy of the death certificate; the deceased's Social Security number, proof of age and marriage certificate; the deceased's employer information, approximate

Taking care of business arrangements

If your loved one was employed at the time of death, be sure to contact his or her employer or business associates. Inquire about the deceased's group life, accidental death or disability insurance policies; pension funds or other retirement plans; accrued vacation and sick pay; unpaid commissions; and health insurance covering you or other dependents.

If the deceased was a business owner, determine the obligations of the trustee or personal representative to continue the business's operations. Consult legal counsel to review any succession planning documents prepared by the business and arrange for a qualified appraisal if necessary.

earnings in the year of death and earnings records for the previous year; and Social Security numbers and proof of age for the deceased's spouse and dependents.

If assets pass under a will, the deceased's personal representative should consult legal counsel about initiating probate proceedings.

One step at a time

The loss of a loved one is never easy, and while dealing with your grief you may be called on to settle his or her estate. Bear in mind that the steps described aren't exhaustive, so work with your estate planning advisor to ensure you don't miss any. ■

How much is your life worth?

Conduct a “valuation” before buying life insurance

Life insurance can serve a variety of purposes, such as creating wealth, paying estate taxes, or replacing a family member’s income or other financial contributions to the family. How much coverage is needed depends in part on the purpose. Unfortunately, people tend to underestimate the amount of insurance they’ll need to provide for the financial security of their families, particularly when one spouse contributes significant nonwage value to the family.

To determine the right amount of insurance to replace a person’s financial contribution to the family, conduct a “valuation” of each family member’s life. The valuations may be higher than you think.

Beware of rules of thumb

Some people use rules of thumb — such as a multiple of earnings — to estimate the amount

of life insurance they need. For example, a person who earns \$100,000 per year might purchase coverage equal to some multiple of his or her earnings, such as 12 times earnings, or \$1.2 million.

The problem with rules of thumb is that often the multiples are unrealistically low. But even if the multiples are high enough, they’re based on averages, so whether they’ll yield the right amount for you can be hit or miss. A better approach is to determine an accurate amount based on your particular situation, taking into account factors such as fringe benefits, nonwage value and personal consumption.

A better method

An effective method for determining the amount of life insurance needed by you or your spouse is the one courts use to calculate damages in wrongful death cases. The goal is to arrive at an amount that will replace the financial value the person provides to the family. That value includes not only his or her salary, but also the value of fringe benefits — such as health insurance and pension benefits — and uncompensated work in the home. It should also take into account expected future wage increases.

Let’s look at an example. Randy wants to determine the right amount of life insurance coverage for his 45-year-old wife, Janet, who earns \$60,000 per year. She spends about \$12,000 of that amount on personal living expenses, leaving \$48,000 to benefit the family. She also provides significant nonwage value by taking care of the couple’s two children and the family’s home. Randy estimates this value at \$20,000 per year, based on what it would cost to hire a nanny/ housekeeper. Therefore, Janet provides a total value to her family of \$68,000 per year.



Assuming that Janet plans to retire at age 65, her annual value should be adjusted to reflect cost-of-living and expected future wage increases during the next 20 years. Assume for simplicity's sake that, once the children are older, Janet will take on other household duties so that her non-wage contribution remains the same throughout the 20-year period.

The total projected amount is then discounted to present value to arrive at the amount of insurance coverage needed to replace Janet's financial value to the family. Assuming, again for simplicity's

sake, that the inflation rate and the discount rate are equal — and therefore cancel each other out — Janet's value is $20 \times \$68,000$, or \$1.36 million. In this case, the appropriate amount of insurance coverage is nearly 23 times Janet's current salary.

No cookie-cutter formulas

Every family is different, so there's no one formula you can use to determine the right amount of life insurance. To avoid buying too little or too much insurance, ask your estate planning advisor to help you calculate the real value of each insured life. ■

Estate Planning Pitfall

You haven't considered IRS rules when making a family loan

Lending money to family members can be a great way to help them out without worrying about gift and estate tax liability. But before you get out your checkbook, do a little planning to avoid some potentially significant tax pitfalls.

If your loan is \$10,000 or more, you must charge interest at a rate that's at least as high as the applicable federal rate. If you don't, interest may be imputed to you — and treated as taxable income to you and as a taxable gift to the borrower.

Be sure to document the loan in writing and to follow the terms of the agreement. Otherwise, the IRS may argue that the loan amount was nothing more than a disguised gift, which could trigger gift tax liability. Even if you expect to forgive a portion of the loan in the future, it's best for the borrower to make at least a few payments to help demonstrate that the loan was legitimate and avoid an IRS challenge.

If the borrower defaults, make an effort to collect. This will help support your argument that the loan was legitimate and, if you can't collect, may allow you to take a bad debt deduction. If you decide to forgive some or all of the loan, try to do it in increments no greater than the annual gift tax exclusion (\$13,000 for 2010 and 2011).

There's a common misconception that you can avoid these issues simply by guaranteeing a loan to a family member rather than lending the money directly. But tread carefully because, though it's somewhat unsettled, the IRS might view a loan guarantee as a transfer of value subject to gift tax.



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DAVID T. RIEDEL
Estate Planning Practice Group Chair
driedel@apslaw.com

- Author, Wills, Trusts and Gifts
- Chairman, R.I. Bar Association's Committee on Probate and Trust since 1983
- Past President, Estate Planning Council of Rhode Island
- Named to *The Best Lawyers in America* since 1991, *Super Lawyer* (R.I.), *Martindale Hubbell AV* rated



E. HANS LUNDSTEN
Tax Practice Group Chair
hlundsten@apslaw.com

- Chair, R.I. Bar Association Lawyer-Accountant Liaison Committee
- Frequent lecturer and author of numerous articles on Rhode Island tax law
- Named to *Chambers USA America's Leading Business Lawyers*, *The Best Lawyers in America* in Tax Law and Corporate Law, *Super Lawyer* (R.I.), *Martindale Hubbell AV* rated

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