IN THIS ISSUE

Trust UPDATE

Stillman BANK

February 2019

Five Reasons for a Trust

You might think that the doubling of the amount exempt from federal estate and gift tax ($11.4 million per person in 2019) would reduce the need for estate planning, given that so few families will now need to worry about this tax. But you would be mistaken in that thought, because controlling estate taxes was never the primary object of a sound estate plan. Family financial protection has always been the real goal, and tax efficiency simply supports that goal.

Just as the need is undiminished, so is the demand for estate planning counsel. Perhaps the premier venue for idea exchange in this area is the Heckerling Institute on Estate Planning, held each January in Orlando. This year an attendance record was set, as more than 3,400 lawyers, accountants, life insurance agents, and financial advisors gathered for a full week of lectures from experts in the field.

Here are five examples (names fictitious, of course) of non-tax objectives that may be addressed through thoughtful estate planning. For each, a trust plays a crucial role in the solution.

Wayward child

Tony has had trouble “finding himself.” He dropped out of college, has never had a stable relationship, and has been working at a series of menial jobs. He had some drug problems as a student, but the rehab stay seems to have done him some good. Still, Tony has never been good at managing money.

Providing Tony’s inheritance in trust, instead of outright, will protect that money for Tony’s life. A trust turns what could have been a windfall into a long-term financial resource. The assets will also be shielded in the event Tony marries and subsequently divorces. The trustee may be provided with discretion in making trust distributions, and standards of support may be identified. There will be resources if Tony requires another round of rehab.

Special needs child

Alice is near the high-functioning end of the autism scale. Her education has gone well, and she’s hopeful about getting a job. Still, Alice is not likely to achieve financial independence. She’s likely to need government benefits, such as Medicaid and Supplemental Security Income all of her life.

A special needs trust could improve Alice's financial life without impairing her access to need-tested benefits. A variety of restrictions apply to these trusts, but they can make a real difference in the quality of life for a special needs person.

Successful child

Dorothy's successful ob-gyn practice is a source of great pride for the family—she was the first child to go to college, and the first to become a doctor. But even the most successful doctors have to be concerned about the threat of malpractice lawsuits.

An inheritance in a discretionary trust for Dorothy, and perhaps for her children, will protect those assets from any future claims that might be made against her. The trustee should be an independent third party.

Blended family

Sam and Janet had two kids when Janet was diagnosed with the breast cancer that ultimately took her life. A few years later Sam remarried, and he and Liz have had two children together.

This sort of "blended" family structure has become increasingly common. Balancing the financial needs of multiple generations can be quite challenging. One approach to securing an inheritance for both a surviving spouse and children is the Qualified Terminable Interest Trust, known as a QTIP trust. The spouse will receive all the trust income, paid at least annually, for life. When the spouse dies, the remaining trust assets are divided among younger beneficiaries, as specified in the trust document.

Financial privacy

The Smiths are local celebrities. What started as a local dairy store has blossomed into a small chain of popular grocery stores, named for the grandfather-founder, Jim Smith. The Smiths have become big supporters of the local arts community.

It's no surprise, given their prominence, that members of the Smith family are often approached for making donations of one sort or another. They have a convenient response in this situation—"Our trustee handles those inquiries." The family wealth is managed in a collection of trusts, which allows them to deflect uncomfortable questions. What's more, the trusts keep all the details of the family wealth structure private, out of the public eye.

May we tell you more?

Have these brief examples stimulated your thinking? Could a trust-based wealth management plan be beneficial for you and your family? We have just skimmed the surface of the possibilities. Perhaps the most important aspect of trust planning is that there are no cookie-cutter solutions; every trust plan is crafted for its specific creator and beneficiaries.

Trust administration is our business. We will be pleased to put our expertise at your service. Please call upon us at your earliest convenience. ☐

Reflections on who should settle your estate—or be your trustee

One of the most important questions to be addressed in an estate plan is the choice of executor to supervise the settlement of the estate. If a trust is part of the plan, the choice of trustee is equally crucial. The first thought that many parents may have is to nominate a child for these responsibilities.

Attorney Stuart Bear explored this question in a presentation to the Heckerling Institute. He explores with his clients what will be required for the jobs, and asks them to think through the consequences of their choice. A series of questions are used to guide the conversation, such as:

- Do your children get along?
- Do your children get along with each other's spouses?
- Are your children able to work together?
- How would one child react to his or her sibling managing and distributing the assets?
- Are your children financially stable?
- Are your children in similar financial situations?
- Is there a child you foresee demanding his or her inheritance immediately?
- How would one child react to his or her sibling having a position of power over him or her?
- Do your children have time to fulfill fiduciary responsibilities?
- Do your children have the financial and personal skills to administer the estate?

Very often this conversation will lead the client to realize that a neutral party with experience in estate settlement is likely to be a better choice for promoting family harmony. We can be that neutral third party.

Q & A on Opportunity Zones

What are "Opportunity Zones"?

From the IRS: "An Opportunity Zone is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Secretary of the U.S. Treasury via his delegation of authority to the Internal Revenue Service."

Opportunity Zones were authorized by the Tax Cuts and Jobs Act in 2017. Over 8,700 Opportunity Zones were identified last year. The hope is that new investment will jump-start economic growth, distributing prosperity more broadly through the country.

What is the opportunity for investors?

There are two distinct tax breaks: tax deferral and tax forgiveness.

When an investor has a substantial capital gain, the gain may be rolled over to an investment in an opportunity fund. The new investment must be made within 180 days, but all gains harvested during that period may be rolled together. With the rollover, the tax on the capital gain may be deferred until December 31, 2026. That means the entire amount of the gain is available for reinvestment, not just the after-tax proceeds.

If the new investment is sold early, the deferral of tax ends and the capital gain tax must be paid. However, if the investment is held for at least five years, the basis is increased by 10%; and if it is held for seven years, the basis is increased by 15%. However, only investments made this year will reach the seven-year mark before the December 31, 2026, expiration of the deferral period.

What about the investment in the Zone?

If the taxpayer holds an Opportunity Zone investment for ten years or more, there will be no tax at all on any capital gain.

How about an example?

Irene sells stock worth $1.4 million that has a tax basis of $400,000, realizing a long-term capital gain of $1 million. She will owe federal taxes of $238,000 on the gain, including the Medicare taxes on net investment income. That means Irene will have $762,000 left for a new investment. Gains on the new investment will also be fully taxable.

Irene chooses instead to invest the entire $1 million in an Opportunity Zone fund. She won't have to pay the $238,000 until she sells the new investment. If she holds the new investment for five years, the tax falls to $214,200. If she makes the investment this year and holds it until the end of 2026, the tax falls to $202,300. That's when the deferral period ends, and she will have to pay the deferred capital gain tax with her 2026 tax return in the spring of 2027.

Meanwhile, the investment in the opportunity fund has its own performance record. Assuming average growth of 7.2% annually, the investment will be worth $2 million after ten years. Should she sell it then or thereafter, there will be no tax on the capital gain, a potential tax savings of an additional $238,000.

Of course, there is no guarantee that an investment in an Opportunity Zone fund will pay off. The point of providing the tax subsidy is to offset the perceived risks associated with investments in the distressed zones. Those risks don't disappear just because a tax benefit is made available.

Perhaps the most famous example to date of an Opportunity Zone investment is Amazon's new headquarters in New York City. Whether the deal may be structured to take advantage of this tax benefit is unknown at this time. ☐

Wrong avenue

In the course of an embezzlement investigation of Bobby Willis, the IRS executed a search warrant of his grandfather's home. There they found and seized $340,000 worth of $1 presidential coins, in mint condition, in 340 sealed packages of 1,000 each.

Willis was ultimately convicted of embezzlement. However, the collectible coins were not related to that crime, nor were they the fruit of that crime. Willis and his wife want the coins back. Unfortunately, two days after the seizure, the IRS arranged for the entire lot to be put into circulation. The IRS instead wired $340,000 to the Willis' attorney.

The couple doesn't want the money. They want the coins, which they allege were worth some $33 million. They filed suit under the Administrative Procedures Act (APA). That avenue might have worked if the IRS still possessed the coins, but it does not. The APA also does not permit an award of money damages against the government. Although the court acknowledges possible IRS malfeasance, "the APA is not a legally viable avenue" to find a remedy.

Book sale

Robert Connell was a successful stockbroker, first at Bache and later Smith Barney. In 2009 he joined Merrill Lynch, bringing his five-person team and some $350 million worth of assets under management along with him.

The employment contract called for paying Connell $42,980 per month. In a move that was routine in these circumstances, Merrill Lynch then loaned Connell some $3.6 million, to be repaid by Connell at $42,980 per month, deducted from his pay. This gave Connell access to his entire signing bonus while spreading the tax liability out over the term of the loan.

Just short of his one-year anniversary with Merrill Lynch, Connell was told he had to resign, or he would be fired. The reasons for the falling out are not clear, but Connell resigned in an attempt to preserve his reputation in the industry. Merrill Lynch then demanded repayment of the loan. Connell took the matter to arbitration at FINRA, where he won a judgment. Merrill Lynch was ordered to forgive the balance of the loan.

Loan forgiveness is taxable ordinary income to the borrower. Connell instead treated the payment as the sale of his book of business to Merrill Lynch, which could merit capital gains treatment.

The Tax Court looked to the FINRA proceedings to determine the character of the damage award. To be thorough, Connell's lawyer had argued both the sale-of-the-book theory and breach of the employment contract. Unfortunately for Connell, FINRA did not explain its rationale for the award. The Tax Court held that he did not meet his burden of proof, so the forgiveness was ordinary income. ☐