IN THIS ISSUE

Trust UPDATE

Stillman BANK

June 2019

Second marriages estate planning

According to a study from the Pew Research Center, about 40% of new marriages include one person who has previously been married. In some 20% of weddings, both partners have been married before. This has led to an increase in the number of "blended families," with stepbrothers, stepsisters, and stepparents.

Blended families present a variety of unique challenges, but one that is sometimes overlooked is that of estate planning. Here's one true example.

Can the ranch be kept in the family?

Spencer Willey grew up on a ranch in Wyoming with his father and grandparents. He expected to take over the family ranching operation eventually. In 2001 Spencer's father, Allen, created a revocable trust to manage his property, including the ranch. Allen was the trustee, Spencer the successor trustee, and Spencer's wife another successor trustee should Spencer be unavailable. Spencer's children were to become co-trustees when they reached age 21, and they were the ultimate beneficiaries of the trust. At that time Allen was living with Bertha, and the trust also provided her with a life estate in the home that they shared. Allen later married Bertha.

In 2006 Allen amended the trust. He granted a life estate in another home on the ranch to Bertha's daughter and granddaughter from her earlier marriage, and he

removed Spencer's wife as a possible successor trustee. In a 2009 amendment, Bertha's daughter was named a successor trustee.

A major revision of the trust occurred in 2010, when Spencer and his wife were removed as beneficiaries and successor trustees, and the grandchildren would no longer become co-trustees. In fact, the trust then stipulated that none of Allen's descendants could ever serve as trustee. The beneficial interests of Bertha and her children were expanded, and they were expanded again in a 2011 amendment. The record does not indicate the reasons for these changes, whether Allen had a falling out with Spencer, or even if Spencer were kept informed of the amendments when they were made.

In 2012 Allen began suffering from memory and speech problems. He was diagnosed as having "frontal temporal dementia." In October 2013 Allen put the ranch up for sale. In March 2014 more trust amendments were executed, further enlarging Bertha's interests. A confidentiality clause was added, forbidding the trustee from telling Spencer's children about the terms of the trust. Finally, an *in terrorem* clause was added to disinherit anyone *and their descendants* who challenged the trust terms.

Reaction

Spencer filed a lawsuit in May 2014 to stop the sale of the ranch, to remove his father as trustee of the trust due to incapacity, and alleging that Bertha had exercised undue influence over Allen in persuading him to sell the ranch instead of leaving it in trust for his grandchildren. Allen resigned as trustee in October 2014. In May 2015 Spencer amended his complaint to allege Bertha's undue influence in persuading Allen to remove Spencer and his wife as trust beneficiaries. Allen died a month later.

A trial was held on the issue of undue influence and whether there was an oral contract for the inheritance, but Spencer lost. When the grandchildren went to court to stop the sale of the ranch, the lower court held that they were no longer trust beneficiaries as a result of their father's lawsuit in defiance of the *in terrorem* clause. The Supreme Court of Wyoming eventually affirmed that ruling, holding that the forfeiture of the interests of minors resulting from the actions of their parents does not violate public policy.

An alternative

In situations such as this, we've seen a lot of interest in the *Qualified Terminable Interest Property Trust,* or more commonly, *QTIP Trust*. The trust is "qualified" for the marital deduction from the federal estate tax, provided the surviving spouse is a U.S. citizen. The trust is "terminable" because it ends at the spouse's death, and the spouse usually doesn't have the right to change who gets the property at that point. In other words, the inheritance for the children is secure.

However, the father in the Willey case did use a trust. The inheritance for his grandchildren failed for two reasons. First, the trust was revocable (QTIP trusts normally are irrevocable), which meant that the terms could be changed at a later time. Second, family members were used as trustees instead of naming an independent outsider, such as a bank trust department or a trust company.

We don't have all the facts in the case—perhaps there was an estrangement between the father and his descendants that led to the changing of the trust terms in favor of the children of his second wife. The lesson for all concerned is that estate plans should not be taken for granted.

We are a resource

If remarriage is on the horizon, we welcome the opportunity to assist you with your estate and trust planning. We will be glad to work with your other advisors to contribute to a smooth blending of your new family now and a secure financial future for you, your new spouse, and your children in the years to come. ☐

Choices for marital trusts

Source: Internal Revenue Code; M.A. Co.

Trust type	Estate tax exposure at spouse's death	All income to spouse?	Spouse can direct remainder?	Comment
Traditional marital deduction trust	Yes	Yes	Yes	Best for larger estates, paired with a credit shelter trust
Qualified Terminable Interest Property (QTIP) Trust	Elective	Yes	No	Best for multiple-marriage situations
Credit shelter trust	No	Elective	No	Appropriate by itself for smaller estates, but may be paired with traditional or QTIP trust
Qualified Domestic Trust (QDOT)	Yes	Yes	Elective	For a spouse who is not a U.S. citizen

Q&A: The Kiddie tax

What is the kiddie tax?

The kiddie tax is a special tax on the net unearned income of a child. A child's wages are taxed as other taxpayers' wages are, starting at the bottom of the rate scale, but the unearned income is not.

What do you mean by "unearned income"?

Unearned income includes taxable interest, dividends, capital gains, Social Security payments, pension payments, certain trust distributions, and unemployment compensation. Salaries and wages received for work are not included.

Why is there a special tax rate for unearned income?

Congress was concerned that adults would give income-producing assets to their children to save on taxes on the investment returns. The idea was to eliminate any tax benefit from making such a gift.

What about a child who has built savings from his or her earned income. Are the investment returns from those savings also considered "unearned"?

Yes, those returns also will be subject to the higher tax rates, even though the underlying assets were not received by gift.

What tax rate is that?

Until 2017 the unearned income of children was taxed at the marginal tax rate of their parents. However, this led to complications and confusion, because children often don't know their parents' tax situation. Even the parent may not know their marginal tax rate if an extension to file has been requested.

The Tax Cuts and Jobs Act simplified the kiddie tax by eliminating the reference to the marginal tax rate of the parents. Instead, the children use the rate table for trusts and estates. The brackets in this table are far more compressed than for individuals. The top tax rate of 37% kicks in at $12,750 of unearned income. Contrast that with a threshold of $510,300 for singles and $612,350 for married filing jointly for hitting the 37% tax bracket. Accordingly, this simplification came at a significant cost for all but the very wealthiest of families (those already in the 37% tax bracket).

Why am I hearing about the kiddie tax now?

The new version of the kiddie tax apparently has hit some unintended targets. In particular, the young dependents in "gold star" families (families of veterans who died in active-duty service) and college students with scholarships that cover room and board are being hit with unexpectedly higher taxes than in the past.

Who needs to pay the kiddie tax?

These are the conditions requiring the paying of the kiddie tax:

- the child is required to file a tax return and does not file jointly;
- unearned income is greater than $2,200;
- either parent is alive; and
- the child is under 18, or is 18 but does not provide more than half of his or her support with earned income, or is age 19 through 23 and a full-time student and does not provide half of his or her support from earned income.

So, is this change in taxes for children permanent?

No, the new kiddie tax is scheduled to expire in 2026, along with the rest of the personal income tax changes made by the Tax Cuts and Jobs Act.

Also, discussions are under way in Congress about making modifications earlier than that to provide relief for some young taxpayers.

What do you recommend?

For those who wish to transfer assets to children, consider gifts of stocks that don't pay dividends. Capital appreciation will not be taxed until the child sells the shares. If that sale can be delayed until after the child reaches age 24 or is no longer a student, the kiddie tax will be avoided. ☐

Divorce, Florida style

Florida law provides that a will made by a married person benefitting a spouse is automatically revoked upon a later divorce. How about this situation?

Ron made a will naming his fiancée, Sylvia, as his beneficiary. The couple married about two years later. The marriage lasted some six years, but ended in divorce. Ron died two years after that.

Ron's father was incapacitated, under the care of a guardian. The guardian petitioned for Ron's estate to be settled as if Ron had died without a will. That would have made the father the sole heir. Sylvia objected, presenting the will executed before the marriage. The guardian pointed out that that will was revoked by the divorce, and the trial court agreed.

On appeal, Sylvia won when the court took a very literal look at the statutory language. When Ron executed his will, he was not a "married person" yet, so the revocation statute did not apply. The court invited the legislature to change the language of the statute to provide a more just result in such circumstances.

Heirship, New Jersey style

New Jersey law provides the presumption that a child born to a married woman is the child of her spouse. How about this situation?

Elisa ended a two-year relationship with Douglas, though she was then pregnant with Douglas' child. She married Gregory, who knew of the pregnancy and knew that the child was not his. Nevertheless, Gregory's name appeared as the father on the birth certificate, and the son was named Gregory Jr.

Three years later, Gregory and Elisa separated and eventually divorced. Gregory remarried, had two children with his new wife, and saw very little of his namesake. Elisa did not remarry, and she raised Gregory Jr. on her own.

After the divorce, Elisa rekindled the relationship with Douglas for a time. Years later, when Gregory Jr. was in his 20s, Elisa revealed to him the truth that Douglas was more than her friend, he was Gregory Jr.'s biological father. A casual relationship ensued between the two, but something that fell short of parent and child.

Then Douglas was murdered. A blood test proved that he was Gregory Jr.'s actual father. Douglas had no will, no wife, and no other descendents. Douglas' siblings sought letters of administration, expecting to inherit his estate. Gregory filed an objection, stating that he was a possible heir.

The trial court ruled, based upon the blood test, that Gregory Jr. was the sole heir to Douglas' estate. The siblings appealed, arguing that the boy had been equitably adopted by Gregory Sr. The appellate court rejected that argument, holding that equitable adoption has only been used to create inheritance rights, not destroy them. ☐