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Trust UPDATE

Stillman BANK

October 2021

Permanent tax-saving steps to consider at yearend

Tax deferral is a good thing. Making deductible IRA contributions, delaying income, accelerating deductions—these are ways to pay less in tax now. Eventually the piper will have to be paid.

But there are a few tax-planning strategies in which the tax savings are permanent. Perhaps the best one of these is the step-up in tax basis at death. (Perhaps that is why President Biden proposed killing this tax break, but he has been rebuffed by Congress.). The tax basis of an inherited asset is its fair market value at the date of death of the original owner. That means that the tax on all the unrealized gain is forgiven and never will be collected. The theoretical offset to that savings is that the asset will be subject to the federal estate tax, which applies at a 40% rate. Given that the federal estate tax exemption is now $10 million (plus inflation adjustments), that tax exposure is very theoretical indeed for the majority of families. (Note, however, that the estate tax exemption will fall in half in 2026, and Congress has proposed accelerating that change to next January.)

Still, holding appreciated assets until death is not much of an active strategy. Here are other ideas to consider as the year concludes.

Avoid short-term gains

The tax rate on a capital gain from the sale of an asset held for more than a year is generally about half of that on the sale of something held for a year or less. This can create a quandary. Should an investor lock-in a gain by selling while the price is high, or risk a market downturn by waiting until the longer holding period is satisfied? No doubt, in today's volatile financial markets, this call is often not an easy one to make. Still, a bias toward longer-term holding periods will lead to better overall tax results.

Use tax-deferred accounts wisely

There is a temptation to hold appreciating assets, such as stocks, in a tax-deferred account, such as a traditional IRA. Years of tax-free compounding are certainly attractive. On the other hand, all distributions from the traditional IRA will be taxed as ordinary income. There is no preferential tax rate for long-term holdings. What's more, the basis step-up at death doesn't apply to assets in retirement accounts. Accordingly, the better result for some investors will come from owning their appreciating assets in a taxable account, and investing their IRAs in bonds and other income-oriented choices.

The zero tax on some capital gains

Taxpayers in the 15% tax bracket and lower pay no tax at all on their capital gains (up to the end of the 15% bracket). Should the taxpayer experience a year of falling into that low bracket, it's a great time to harvest gains at no tax cost. The more likely scenario for an affluent family is in the realm of gifts. A grandparent who would like to give $15,000 to a grandchild, perhaps to help with higher-education expenses, would be well-advised to instead give the grandchild appreciated securities. Assuming that the grandchild has only nominal income, the stocks may be sold without any tax drag on the proceeds.

Convert to a Roth IRA

Conversion of a traditional IRA to a Roth IRA is a taxable event, and the tax can be substantial. However, with the Roth IRA all future income and capital appreciation have the potential of being fully tax free. Should a taxpayer find himself or herself in a lower bracket than usual, it well may be a good time to consider such a conversion.

See your tax advisors before making any final decision. ☐

Year-end estate planning

Estate planning moves this year have been complicated by tax changes that were included in the Build Back Better Act, reported by the Ways and Means Committee in September. The most significant of these is the rough halving of the amount exempt from federal estate and gift tax, from the current $10 million to $5 million (plus inflation adjustments—this year the exempt amount is $11.7 million). The move was already on the books, but scheduled for 2026; the legislation would advance that drop to the first of next year.

This has some estate planners suggesting to their clients that major gifts made this year could "lock in" the larger exempt amount. The fate of the legislation remains unclear, and historically a reduction in the amount exempt from federal estate taxes has never occurred, only been threatened. To completely lock in the larger exemption a taxpayer's lifetime taxable transfers would have to exceed $11.7 million.

The legislation also takes aim at "intentionally defective grantor trusts" and "grantor retained annuity trusts" (GRATs), which have been used by the wealthy to minimize estate and gift taxes. For example, according to a report from ProPublica, Laurene Powell Jobs, the widow of Steve Jobs, used a series of GRATS after the death of her husband to transfer some $500 million to children, friends and family while avoiding an estimated $200 million in federal gift tax. The changes to trust taxation are not delayed to next year, but could take effect upon the enactment of the legislation. Some observers have suggested that they may have a retroactive effect.

Changes from some wish lists that did not appear in the Ways and Means release, include:

- taxing capital gains at death or upon a transfer to a trust;
- increasing the estate tax rate from the current 40% to 65%; and
- changes to the taxation of dynasty trusts.

See your estate planning advisors to learn more.

Large IRAs are targeted

According to a report in *ProPublica* last June, the co-founder of PayPal, Peter Thiel, has a Roth IRA worth some $5 billion. No details were provided on how this personal information was obtained, which was surprising given that tax and financial information has privacy protections. Reportedly Thiel funded his Roth IRA with PayPal shares worth $1,700, well within the contribution limits at the time. When PayPal was sold to eBay three years later, that investment ballooned in value to $28.5 million. Those funds were used, in turn, to invest in other rising companies, such as Facebook.

Even if the story is true, Mr. Thiel did nothing illegal. Nevertheless, the story sparked outrage in Congress, and the Build Back Better Act includes some major changes for IRAs that seem responsive to that story.

New rules

The change that has received the most publicity is also the least consequential. Taxpayers who have aggregate vested accounts in defined contribution plans, including IRAs, 401(k)s, and 403(b)s, of $10 million or more would be prohibited from making a contribution to an IRA or a Roth IRA in years in which the taxpayer's income exceeds $400,000 (for married filing jointly, $450,000). Rollovers, inherited IRAs, and transfers incident to divorce would not be considered contributions for this purpose. Note that the taxpayer would still be allowed to contribute to a 401(k) plan if available.

Changes to permitted IRA investments are much more important. Under current law, an IRA may not invest in a company in which the IRA owner has a 50% or greater ownership interest. This threshold would be lowered to 10%. The IRA also could not invest in securities available only to "qualified investors" who have a specified minimum income or assets—in other words, securities not available to the general public.

New RMDs

A new provision that seems specifically to target Mr. Thiel is an expansion of the required minimum distribution calculation for large IRAs and Roth IRAs. The general rule would be that half the account value in excess of $10 million would have to be distributed. A special rule would apply to Roth IRAs, for which 100% of the amounts greater than $20 million would have to be disgorged. The interaction of the two rules will be complicated. The 10% penalty for early withdrawals would not apply, but if the account owner is not yet 59 ½ the income tax would apply to the distribution of earnings from a Roth IRA. Mr. Thiel does not yet meet the age requirement.

Why it matters

Some may remember that one of the promises made by Bill Clinton when he campaigned for President was a 10% surtax on the incomes of millionaires. The tax was adopted after his election. Because the top tax rate was then 36%, the 10% surtax came to 3.6%, yielding a new top tax rate of 39.6%. We continue to have that tax bracket, the only bracket not expressed as a whole percentage. Interestingly, the definition of "millionaire" was brought down to those with an income of $250,000 or more.

The retirement plan changes contemplated by Congress have high thresholds today, accounts aggregating $10 million or more. The Joint Committee on Taxation scored the proposed changes to retirement plans as raising only some $4.3 billion over the ten-year budget window. Those high thresholds could be easily lowered should there be a need for more tax revenue in future years. According to the Investment Company Institute's 2021 Fact Book, IRAs and defined contribution plans hold some *$22 trillion* in assets. That is serious money. ☐

Find the beneficiary

Sometimes determining who is a proper beneficiary can be a challenge, as two recent cases illustrate.

Case one. Dale Ackers' 1993 will left half of his estate to his son, Gary, outright, and the balance to a trust for the benefit of his son, Larry. Larry was the sole lifetime trust beneficiary, and at his death the corpus would pass to Larry's then-living descendants per stirpes and not per capita.

Although this may sound like a routine trust provision, Larry's life circumstances turned out to be anything but routine. He had three children, but he gave up his parental rights as to two of them, and they were adopted into other families. One of those has since had two children of her own.

Larry wanted to enter into negotiations with the trust remaindermen with an eye toward terminating the trust. The problem is, who are the remainder beneficiaries? Larry wanted to exclude the children adopted by other families and any of their descendants. He filed a petition for declaratory relief to determine the remaindermen, and the trustee resisted. The question is not ripe for review, the lower court held, and the appellate court later affirmed. Members of the class gift cannot be determined until Larry's death.

Case Two. Theodore's June 2012 will left his multimillion-dollar estate to his life partner, Velma, if she survived him, or to the St. Jude Research Hospital if she predeceased him, which she did. The estate planning attorney kept the original of that will. An October 2012 will was executed changing only the nominee for executor of the estate. Theodore kept this original himself, as well as a copy of it.

Both wills explicitly disinherited Chip, Theodore's long-estranged son. He specifically asked his estate planner to not get in touch with Chip.

As Theodore's health declined, he was eventually moved into a nursing home, and a guardian was appointed for him. His papers were boxed up and followed him. After Theodore died, the guardian was unable to locate the original October 2012 will. She speculated that Theodore had destroyed it and recommended to the probate court that the estate pass to Chip. When the estate planning attorney learned of this development, she contacted the probate court and St. Jude's to inform them of the existence of the earlier wills. The probate and appellate courts held that the statutory requirements for proving a lost will had not been met.

The Supreme Court of Nevada reversed. Although the original October 2012 will could not be found, it continued to have legal existence until there was proof of its destruction by the testator, which was not here provided. The statute requires that two witnesses have knowledge of the terms of the will, and in this case one witness only could confirm the testator's signature, not the terms. Because the terms of the will were uncontested, failing to probate the lost will in this situation "would create an absurd result of putting an unnecessary and onerous burden on the second witness." ☐