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How the rich can legally avoid taxes

Boston College Professor of Law Ray Madoff is an advocate for reforming the taxation of the wealthiest Americans. In her most recent book, *The Second Estate: How the Tax Code Made an American Aristocracy*, Professor Madoff analyzes what she considers the defects in the current tax system, loopholes that have made taxes virtually optional for the very rich. She also offers a practical vision for reform—one that does not include direct taxation of wealth.

The interesting thing is that Professor Madoff's loophole inventory can also be read as a road map for those who are eager to lower their tax bills.

Recipes for tax avoidance

Avoid Salaries. Salaries are the most heavily taxed income, reaching a 37% marginal rate at \$640,600 for singles and \$768,700 for married couples filing jointly. In contrast, long-term capital gains and qualified dividend income are taxed at just 20%. Many billionaires keep their salaries at \$100,000 or less, relying instead on their lightly taxed investment income.

Work in private equity.

Managers of venture capital funds, hedge funds and

private equity funds are compensated by a share of the profits earned by the funds, typically 20%. This share is called *carried interest*, even though the fund manager has made no investment of capital. Carried interest is taxed at long-term capital gain rates rather than as ordinary income. Attempts to alter this tax treatment, which have been supported by Presidents Obama, Biden and Trump, have not been successful.

Professor Madoff reports that carried interest accounts for 84% of private equity partner compensation. On the *Forbes* "400 Richest People" list in 2023, more than sixty of the people listed had close ties to private equity, venture capital or hedge fund management.

Buy, Borrow, Die. One of the tax benefits of investing in property or equities is that taxation is deferred until the property is sold. Professor Madoff illustrates the value of such deferral by comparing two \$100,000 investments made for 20 years. Each grows at an assumed 10% per year. Investment A is a bank account, and so income taxes must be paid each year on the interest income. Investment B is a stock that pays no dividends, so all the growth is in the value of the shares, which is not currently taxable. After 20 years, the bank account will be worth \$340,000 because of the tax drag, while the stock

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But for many wealthy Americans, taxable income has become a matter of choice—a nonnecessity that can be avoided with little cost.

—Professor Ray Madoff

will be worth \$647,000. The untaxed growth of the stock is effectively reinvested in it each year. However, there will be a 20% tax when the stock is sold; even so, the net value will be \$537,000, almost \$200,000 more than the bank account with the same rate of return.

But why sell the stock? Appreciated property can be used as collateral for a loan, and loan proceeds are not subject to the income tax unless the loan is forgiven. This is why so many wealthy people continue to employ debt to make their major purchases—it works out better after taxes.

The final element of this strategy is to hold the capital asset until the owner's death, when it receives a basis step-up to fair market value. Tax on the capital gain is forgiven forever. Those who inherit the property may sell it without worrying about taxes on the capital gain from the sale, because there won't be any capital gain.

Inherit wealth. Gifts and inheritances have been excluded from income taxation since 1913. The theory has been that these transfers are subject to the separate estate and gift tax system. However, according to Professor Madoff, "The estate tax is effectively dead (and should be laid to rest)." There is an "alphabet soup" of estate and gift tax loopholes—from QTIPs to SLATs to CRUTs, and so on—and there is remarkably little public support for increasing taxes imposed at death.

Be sure to seek professional tax advice before embarking on any of these strategies yourself.

Recommendations

Professor Madoff does not advocate for a wealth tax, such as the proposal now collecting signatures in California for a November vote. There is a cloud of uncertainty over the constitutionality of taxes on unrealized capital gains. There is also the practical problem of accurately assessing the value of one's wealth, given that it may include hard-to-value investments in closely held companies, fine art and collectibles, and real estate. Putting a value on personal wealth now happens once in a lifetime—at death. Making this an annual exercise would be impractical for both taxpayers and tax collectors. Professor Madoff's prescription is less radical.

Repeal the estate tax. It's not working. It doesn't raise much revenue. It's effectively a tax on the failure to plan, the failure to take advantage of the many paths for legitimately avoiding it.

Repeal the income tax exclusion for inheritances and gifts. A major gift or inheritance is an accretion to wealth as much as a salary is. The gain should be reported to the IRS and taxed with the other income received in the year of receipt. The annual gift tax exclusion would be preserved for small gifts (\$19,000 per donee in 2026), as well as the exclusion for payments of educational or medical expenses and transfers between spouses. Professor

Madoff proposes a lifetime tax-free inheritance limitation of \$1 million, and additional exclusions for family farms and businesses.

Tax unrealized capital gains at death, or upon transfer by gift. This tax rule is already in effect in Canada. The estate of the person who earned the gain would pay the tax; the basis step-up would no longer be needed. But what about assets placed in a trust that lasts for a generation or longer? Professor Madoff's book does not address that possibility for dodging taxes on gains for long periods.

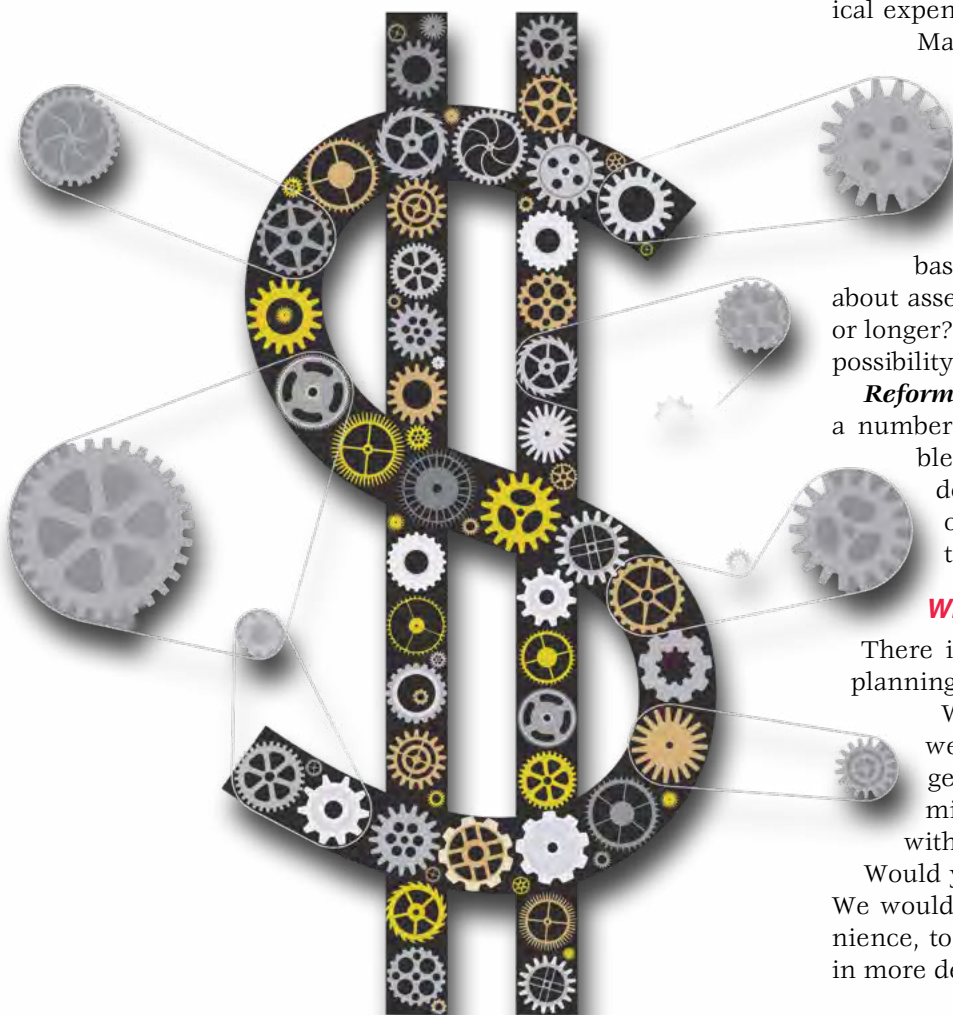
Reform philanthropy. Professor Madoff identifies a number of problems in the tax benefits for charitable giving. She wants stricter payout rules for donor-advised funds, as well as limits on the charitable giving tax benefits for estate and gift tax purposes.

What about your planning?

There is more to family financial security than tax planning.

We provide objective investment advice, and we manage investment portfolios. Our fees are geared to our responsibilities. We help to optimize portfolios for risk and reward, consistent with our clients' investment goals and objectives.

Would you like to know more about our capabilities? We would be pleased to meet with you at your convenience, to lay out our credentials and offer our insights in more detail.



Probate roundup

Don't forget to fund the trust

Robert created a revocable trust in 2014 that named his wife, Jacqueline, his daughter Karey, and certain others as beneficiaries after his death. In 2021, Robert had a change of heart, and had an estate planning attorney draft a new trust, this time with Jacqueline as the sole trust beneficiary. Unfortunately, Robert never transferred the assets from the 2014 trust to the 2021 trust. In fact, the 2021 trust was never funded at all.

Jacqueline asked the trial court to reform the 2021 trust, making it instead a restatement of the 2014 trust. Satisfied by the evidence that this did reflect Robert's wishes, that Jacqueline had met her burden of proof, the trial court ordered the reformation.

This was an error, the District Court of Appeals held. Recourse to that remedy is appropriate when there has been a mistake of law or fact. Here there was no such mistake; the 2021 trust perfectly reflected Robert's desires. The fact that his desires were not achieved was due to the mistake of not funding the trust, not an error in drafting.

An adult adoptee can be a "descendant"

Verl Eldon DeGood's will, drafted in 1989, created a testamentary trust. All trust income was to be paid to his wife, Ourdria. At her death, the trust was divided into two trusts for their children, Thomas and Melissa. Verl had adopted Thomas and hadn't adopted Melissa, but his will made it plain that he considered both of them to be his children.

The trust provided each child with a life estate, with

the remainder to their issue per stirpes. Verl died in 1990.

In 2008, Ourdria and the children petitioned a court to amend the trust to make clear how the trust income would be distributed after Ourdria's death. Specifically, if Melissa survived Thomas, his share would be held in further trust for "his descendants, per stirpes" until Melissa's death, when the trust would terminate. Ourdria died in 2013. In May 2021, when he was 58 years old, Thomas adopted Michael, who was then an adult. Thomas died less than two months later.

The corporate trustee of Verl's trust turned to the court to determine what to do with Thomas' share. Melissa argued that Michael was not "issue" as that word was used in the original trust, nor a descendant of Thomas as in the trust restatement. The lower court rejected that argument, holding that it was not reasonable to think that Verl wanted to disinherit an adopted grandchild when he went out of his way to provide for his own adopted children. "There was no evidence presented in this case that the adoption was for a nefarious purpose, or that it was other than the true relationship of parent and child."

On appeal, the Arkansas Court of Appeals confirmed the result. Michael's claim was upheld.

Spousal abandonment?

Gary and Emily married in 2007. In 2010, when Gary retired, Emily relocated to Chicago for work, returning home for weekends. After Emily retired in 2014, she went to live with her son from a prior marriage for a year in Alabama, then with her daughter in Indiana for four years. The couple never

divorced, and began "dating" again in 2018 while living in separate residences.

In January 2020, Gary's car was struck by a truck, causing very serious injuries to him. After Gary spent some time in the hospital and in rehabilitation, Emily agreed to move into Gary's home to take care of him. In May 2020, Gary's daughter from a prior marriage, Tonya, took him to see a lawyer, where he signed a will that specifically disinherited Emily. About that time, Gary also executed a transfer-on-death deed for his home and adjoining property to Tonya.

Emily continued to care for Gary for the next three years, including after he was diagnosed with dementia, until he died of COVID-19. After his death, Emily petitioned to open a supervised estate, naming herself as personal representative, declaring that Gary died intestate. Tonya then appeared with the will she had facilitated to be probated. Emily was removed as personal representative, and Tonya took over. Emily then filed for her spousal share of the estate and \$25,000.

Tonya argued that Emily had abandoned the marriage and forfeited her interest in the estate. The Probate Court ruled that, even though the couple were legally married at Gary's death, "the presence of a marital relationship between Emily and Gary was absent."

On appeal, the Court of Appeals holds that "abandonment," as that term is used in the statute, requires physical separation. Because Emily lived with Gary for the final three years of his life, the disinheritance statute does not apply to her.

Special circumstances for professionals

Estate planning generally provides for the family, perhaps friends, and a plan for the distribution of real and personal property. For professionals who have patients or clients, another issue in estate planning concerns meeting the needs of those people. This is achieved with a “professional will.”

Lawyers or doctors may have privileged and intimate information from their clients/patients—information that is important to the delivery of legal or medical services. In particular, those under the care of a psychologist could be in a difficult spot, should the professional die or become incapacitated unexpectedly. The American Psychological Association (APA) states that “psychologists make reasonable efforts to plan for facilitating services in the event that psychological services are interrupted by factors such as the psychologist’s illness, death, unavailability, relocation, or retirement.” A professional will is one way to address that, by appointing a person to handle that transition and putting all the information together for them to do so.

Similarities between a traditional will and a professional will include that they should be updated regularly as circumstances change. Both types of wills take an emotional toll and a lot of time to implement properly. No one wants to think about them. A recent survey elaborated on some of these points for professional wills for psychotherapists, and it indicated that 68% of respondents didn’t have a professional will and 40% reported feeling dread about creating one.

There are many specific hurdles when it comes to professional wills for a psychotherapist and finding professional executors who would handle it. They need to maintain the patient’s confidentiality, which decreases the pool of people who could be appointed to the job. They’ll need to figure out how their patients should be informed of the professional’s death—both active and prior patients. The professional executor may need to create the appropriate referrals, should there be a need for further care. Then there are all the general business things that have to do with collecting unpaid invoices, making sure the insurance reimbursements and leases are taken care of, and retaining medical records, which is a legal requirement in many states. This is not a job to be taken lightly, just as being an executor for a traditional will can be much more time consuming than anyone expects.

The first step is gathering information and finding someone to trust as a professional executor. Although an attorney or administrator can handle logistics, a fellow clinician is needed to maintain patient confidentiality and provide clinical judgment. In order to get a sense of the information needed, a sample professional will template from the APA is available at https://cdn.ymaws.com/www.gapsychology.org/resource/resmgr/latest_news/professional-will-template_&.pdf.

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