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What's trending on NP Trusts & Estates

Michael Phelps can't avoid the income tax, getting educated about education credits, reviewing your estate plan, wealth planning for children with special needs, rollovers of retirement plan and IRA distributions and how the MA Supreme Court recently protected discretionary spendthrift trusts. Here's what's trending in estate planning and wealth management.

Income Tax

Even Michael Phelps can't out-swim Uncle Sam

Michael Phelps, the most decorated Olympian of all time, has won 23 gold medals in his career (and 28 medals altogether). But according to the IRS, alongside his Olympic glory, he's also racked up over $250,000 in federal income tax bills from these victories over the years (assuming the top tax rate, which is likely given all of his endorsement deals).

American Olympians are subject to a so-called "victory tax"—meaning an athlete must pay income tax on the prize money they receive from winning, along with the value of the medal itself.

The U.S. Olympic Committee awards cash bonuses of $25,000 for gold medals, $15,000 for silver and $10,000 for bronze. The value assigned to the actual medal is approximately $600 for gold, $300 for silver and a negligible amount for bronze (made mostly out of copper and zinc). Although most countries exempt their athletes from taxes on Olympic winnings (and even provide government funding for their expenses), American winnings are taxed as ordinary income, just like lottery winnings.

The existence of this "victory tax" may come as a surprise to some people, and the fairness of the tax has been debated for years among politicians and athletes. On the one hand, you have athletes sacrificing a huge amount of their time and energy to reach the pinnacle of their sport and ultimately represent the U.S.A. in a global competition. And on the other, ordinary citizens make sacrifices every day to support their families while paying their fair share of taxes. Shouldn't we all be held to the same standard?

Last month, the U.S. Senate passed legislation that would exempt American Olympic and Paralympic athletes from having to pay income taxes on medals and other prize money. The bill is

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currently being considered by the House. Keep in mind that bills like this have tried and failed to pass before, so we'll have to wait and see if this time is different.

— Thomas A. Stedman

Tax scammers: a personal encounter

At the start of the summer, I cautioned against a variety of scam artists posing as IRS agents and trying to bully innocent people into thinking they owed additional taxes. Typically there are threats of immediate arrest unless these bogus taxes are paid on the spot. How true this is!

The tax scammer and my mother

My own mother got a robo-call advising her to call a particular phone number if she wanted to avoid a lawsuit and jail time. In my mother's case, I decided to amuse myself by calling back to see how this scam goes down. The man answering had a thick accent and identified himself as "Bavid Smith" (yes, Bavid, with a "B") and gave me his IRS employee identification number. He also gave me a case number, even though I had given him a fake name and no social security number for my mother.

After learning that my mother is indeed elderly, Bavid advised that $5,500 in "federal taxes" were due from 2011 to 2014. I said, "Gee, this must be a mistake," and this was the first we had heard of this. He assured me that written notices had been sent to my mother last fall, but he could not verify the address to which those notices had been sent.

Bavid wanted to assure me that this situation was very serious and urged me to write down all the information he was giving me. He kept pushing the "guilt button," asking whether my mother had intentionally not paid or whether she had simply made a mistake.

I pressed Bavid on the type of "federal tax" due, whether it was federal sales tax (there is no such tax) or the estate tax (which is not applicable because my mother is still alive). He just kept reiterating that it was for the "federal tax" and again wanted to be sure I understood the seriousness of the situation.

Indeed, lawyers in Washington DC were standing by to file papers with the court to seize my mother's property and the local police would be at my mother's house in 25 minutes unless we could resolve the matter over the phone. Bavid demanded to know what I wanted to do. Sorry Mom, but I told Bavid to send the police to pick you up!

Tax scammers and the IRS

The IRS is aware that these scams continue and take on new twists. On August 2, another warning was issued noting an increase in automated calls in which the caller impersonates an IRS agent demanding tax payments on iTunes and other gift cards.

Remember, the IRS will never:

— call to demand immediate payment over the phone, nor will the agency call about taxes owed without first having mailed you several bills.

— call or e-mail you to verify your identity by asking for personal and financial information.

— demand that you pay taxes without giving you the opportunity to question or appeal the amount they say you owe.

— require you to use a specific payment method for your taxes, such as a prepaid debit card.

— ask for credit or debit card numbers over the phone or e-mail.

— threaten to immediately bring in local police or other law-enforcement groups to have you arrested for not paying.

— *John L. Garrett*

Getting educated about education credits

Higher education costs can be overwhelmingly expensive. However, there are two tax credits available that can help offset some of these costs by reducing your income tax liability. They are the American Opportunity Credit and the Lifetime Learning Credit. These credits are quite valuable because unlike a deduction, which reduces the amount of income subject to taxation, a credit directly reduces the tax liability itself.

These credits can generally be claimed if an individual pays qualified higher education expenses for themselves, their spouse or a dependent for who they claim an exemption on their tax return.

These credits are not available to you if your filing status is married filing separately or if you are claimed as a dependent on another person's tax return. There are also limits on the amount of modified adjusted gross income (MAGI) a taxpayer can have in order to claim these credits.

The following can help you decide which credit you qualify for:

American Opportunity Credit

- Up to $2,500 maximum credit per **eligible student**
- MAGI limit is $180,000 if married filing jointly. $90,000 if single, head of household or qualifying widow(er)
- 40% of credit may be refundable, meaning it can exceed your tax liability
- Available **ONLY** if the student has not completed the first four years of postsecondary education.
- Available **ONLY** for four tax years per eligible student
- Student must be pursuing a program leading to a degree or other recognized education credential
- Student must be enrolled at least half-time for at least one academic period

Lifetime Learning Credit

- Up to $2,000 maximum credit per **tax return**
- MAGI limit is $130,000 if married filing jointly and $65,000 if single, head of household or qualifying widow(er)
- Credit is nonrefundable, meaning it is limited to your tax liability
- Available for all years of postsecondary education and for courses to acquire or improve job skills
- Available for an unlimited number of tax years
- Student does not need to be pursuing a program leading to a degree or other recognized education credential

As you can see, there are significant differences between the two credits. However, both can provide significant tax savings and should not be overlooked when filing your personal income tax returns.

— Michael Ruschioni

Avoiding tax on sale of principal residence

If you sell (or exchange) your principal residence at a gain, up to $250,000 of the gain may be excluded from income if you owned and occupied it as a principal residence for an aggregate of at least two years in the five-year period ending on the date of sale and did not claim an exclusion on another sale within the prior two years. If you are married filing jointly, you may be able to exclude up to $500,000 of gain. Even if you do not meet the two-out-of-five year ownership and use tests, you are entitled to a reduced maximum exclusion limit if the primary reason for your sale was a change in your place of employment, health reasons or unforeseen circumstances.

Caution: If you use a residence as a vacation home or rental property after 2008, an allocable part of your gain may not qualify for the exclusion, even if you meet the two-out-of-five-year ownership test.

Frequency of exclusion. If you meet the ownership and use tests for a principal residence, you may claim the exclusion when you sell it although you previously claimed the exclusion for another residence, provided that the sales are more than two years apart. If you claim the exclusion on a sale and within two years of the first sale you sell another principal residence, an exclusion may not be claimed on the second sale even if you meet the ownership and use tests for the residence. There is an exception if the second sale was due to a change in employment, health reasons or unforeseen circumstances. In that case, a prorated exclusion limit is allowed.

Principal residence. A principal residence is not restricted to single-family homes but may include a mobile home, trailer, houseboat or condominium used as a principal residence.

If you have multiple homes. If you have more than one home, you may exclude gain only on the sale of your principal residence and only if you meet the ownership and use tests for that residence. Your “principal residence” is determined on a year-to-year basis, based primarily on where you live most of the time. However, the IRS may also consider such factors as the primary residence of your family members, your place of employment, mailing address, the address listed on your tax returns, driver’s license and automobile and voter registration and the location of your bank.

— *Masha Rabkin*

Estate Planning

The times, they are a-changin': reviewing your estate plan

Even the ageless Bob Dylan, who turned 75 in May, cannot avoid getting older. Yet a recent survey concluded that more than 70% of Americans do not have an up-to-date will, and even in the "over 65" cohort, one of every two have out-of-date estate plans. But life is not a static event, and both family dynamics and family resources change over time. Periodically taking stock of those changes can avoid potential problems for your family down the line.

Most wills and estate plans, given the passage of time, become obsolete. Marriages, divorces, births of children and grandchildren, the passing of loved ones and other major family events will occur. Family dynamics and interpersonal relationships will ebb and flow. Incomes, assets and personal financial situations will change. Does a will drafted a decade ago, or an estate plan developed in conjunction with that will, take into account those changes? If not, last decade's will may not adequately reflect today's circumstances and preferences.

Many who have not yet developed a plan or created a will that is currently outdated think that is something they will eventually "get to." But people who wait may lose the necessary mental capacity to create or amend a will, or pass away before they get the opportunity to do so. In these all too familiar cases, the individual is "stuck" with the state law that controls the disposition of a person's assets when they are intestate (meaning they die without a will) or with a document that does not truly convey their wishes as to the distribution of their assets and valued personal items.

Moving from Dylan, a sage of the 60s, to Ferris Bueller, a sage of the 80s, "Life comes at you fast." By being proactive and creating or updating your will and estate plan today, you can stay one step ahead and ensure that your bequests to family members and valued colleagues truly reflect your wishes and preferences.

— *Thomas J. D'Antonio*

Estate planning considerations with frozen genetic material

Millions of couples in the United States suffer from infertility or are otherwise unable to have a child without the assistance of assisted reproductive technology. Thankfully, modern medicine has made huge advances in this field and utilizing this technology has become more common than ever.

As this technology becomes more common, individuals and their estate planning advisors should be having discussions about what should happen to stored genetic material upon death or in the event of divorce.

For instance, through the in vitro fertilization process many couples will create multiple fertilized embryos at one time, storing unused embryos for later reproduction attempts. Couples who must hire surrogates for reproductive purposes are likely to do the same. If, prior to utilizing all of these embryos through attempts at reproduction, the couple divorces, or one of them dies, this brings to light potential issues related to the ownership of the genetic material and the inheritance rights of posthumously born children.

An agreement between couples with regard to such genetic material can control who retains ownership of those embryos in the event of a divorce. Without such an agreement, couples would be relying on state law if a dispute as to the ownership of the genetic material occurred (which may be scant). A recent case involving Sofia Vergara and her ex-fiancé, Nick Loeb, shows us the importance of agreements with regard to genetic material. Although Loeb and Vergara are no longer together, Loeb is currently suing Vergera over the right to have a child using embryos they created while they were together. The case must now be decided in the California courts.

Estate planning documents should also take into account clients' wishes for the disposition of genetic material in the event of their deaths, and should address issues such as (i) if one member of a couple dies, should the surviving member be entitled to use frozen embryos after his or her death to have a child; (ii) if that child is born several years after the deceased individual's death, should that child still be entitled to inherit from the deceased individual; and (iii) if that child is allowed to inherit, for how long after a person's death should the estate wait to take into account posthumously born heirs?

Again, there is some case and statutory law on these issues in some states, but, as these issues are of such a personal nature, most clients would probably like to make these determinations for themselves.

Although discussing assisted reproductive issues may be a more intimate discussion than most estate planning advisors generally have with their clients, it is an important and necessary discussion to ensure that the client's wishes are fulfilled.

— Annette K. Eaton

Wealth Management

Wealth planning for children with special needs

Life expectancy for special needs children has risen steadily in recent years. Education, therapy and general life supervision services over many years can be overwhelming for special needs clients and their families. Almost two-thirds of caregivers of a special-needs child report concern about outliving their retirement income and their ability to provide lifetime care for their dependent.

Though public benefits are vital, a common challenge is helping the disabled individual find care without sacrificing any of their benefits. For example, to qualify for Supplemental Security Income and Medicaid, disabled individuals generally must not have more than $2,000 in assets.

Special needs trusts

Special needs trusts are a way for individuals and families to manage their assets while not compromising access to government benefits. The most common special needs trusts are first-party and third-party special needs trusts. The reason for the different options is due to regulations surrounding government benefits.

A first-party special needs trust is useful for individuals who are already receiving SSI but have come into a large sum of money. This option enables the beneficiary to retain his or her benefits while also utilizing his or her own funds when necessary. However, the downside to this plan is any assets remaining after the individual dies are distributed to the government to reimburse for the cost of his or her medical care.

The option most often used by families is a third-party special needs trust, which functions like a first-party special needs trust but does not contain the payback provision.

529 ABLE accounts

In recent years, another option, 529 ABLE accounts, which are modeled after the 529 college savings plans have become available for families to set aside money for short- and long-term needs. 529 ABLE accounts can hold up to $100,000 in assets without impacting eligibility for government benefits, and families can contribute up to the maximum gift exclusion each year.

ABLE accounts are currently offered by only a handful of states, although you need not live in the state to be able to open an ABLE account in that state. Consult with your estate or financial planner to determine your best options.

Now, more than ever, it is important to understand your options and utilize plans that can create peace of mind for the disabled individual and their family. The increased longevity of special needs people may mean that more resources are needed and it is important to work with a team of legal, tax and financial professionals to ensure the right plan is in place for each client's circumstances.

— *Steve McCabe*

The band's all here: a primer on "nontraditional" trust office holders

Historically, a trust was a relationship between ***only*** a trustee and beneficiaries. However, recently, several new "office holders" have become commonplace in trusts, so much so that many states have passed laws expressly recognizing new roles. These roles vary as much as the mind can imagine.

Trust advisers and special purpose trustees. Trust advisers and special purpose trustees allow investment or distribution decisions to be made by a third party (or sometimes the settlor or a beneficiary) without the involvement of the general trustee. Simply put, the trustee does not make the decisions until directed by the relevant adviser or special purpose trustee. These roles have become particularly prevalent where a trust holds a concentrated position in stock or a closely held business because the settlor can name someone with specific investment skills for those assets, and the trustee wants to avoid liability for decisions it does not make.

Trust protectors. Trust protectors are frequently given powers typically not granted to trustees for purposes of flexibility. These powers include amending a trust, moving a trust to a new jurisdiction or removing/replacing a trustee. Some states have statutes that provide a default list or an illustration of powers that a trust protector can exercise.

Designated representatives. A designated representative frequently serves as a watchdog for trust beneficiaries. For example, a designated representative can receive information regarding a trust or make distribution requests to a trustee, in either case on behalf of a beneficiary. This may be valuable if a settlor does not want information regarding a trust to be given to a minor beneficiary or a beneficiary with substance abuse or spendthrift issues.

Drafting considerations: When you are creating your trust, you have a large degree of flexibility in creating and structuring the offices described above (or even other roles if you are so inclined). A number of considerations are vital in structuring the role:

1) Clearly delineate the role of the office holder by listing the powers he or she can exercise. Do not rely on default state laws.

2) Describe the standard of liability of the office holder and trustee and whether the office holder is a fiduciary. A fiduciary is held to a higher standard of liability and, consequently, advisers and special purpose trustees are often fiduciaries, since they exercise traditional trustee powers.

3) Determine how the office holder should be compensated, how he exercises his powers and how you expect the trustee and office holder to interact.

— *Kenneth F. Hunt*

Rollovers of retirement plan and IRA distributions

In most cases, distributions received from a retirement plan or IRA prior to retirement can be "rolled over" by depositing the payment in another retirement plan or IRA within 60 days. You can achieve the same result by having your financial institution or plan transfer the payment directly to another plan or IRA.

When you roll over a retirement plan distribution, you generally don't pay tax on it until you withdraw it from the new plan. This allows your account to continue to grow tax-deferred without interruption.

Other than qualified Roth IRA distributions and any amounts already taxed, distributions not rolled over will be taxable currently. You may also be subject to additional tax unless you're eligible for one of the exceptions to the 10% additional tax on early distributions.

Types of rollovers:

1. **Direct rollover**—If you are to receive a distribution from a retirement plan, you can ask your plan administrator to make the payment directly to another retirement plan or to an IRA. The administrator may issue your distribution in the form of a check made payable to your new

account. No taxes will be withheld from your transfer amount.

2. **Trustee-to-trustee transfer**—If you are to receive a distribution from an IRA, you can ask the financial institution holding your IRA to make the payment directly from your IRA to another IRA or to a qualified retirement plan. No taxes will be withheld from your transfer amount.

3. **60-day rollover**—If a distribution from an IRA or a retirement plan is paid directly to you, you may roll over all or a portion of it by depositing it in an IRA or a retirement plan within 60 days. If the distribution is from a retirement plan taxes will be withheld, so you will have to use other funds in order to roll over the full amount of the distribution.

IRA one-rollover-per-year rule:

Although there are exceptions for rollovers to or from qualified plans and for Roth IRA conversions, you generally cannot make more than one rollover between your IRAs within a 1-year period.

Beginning after January 1, 2015, you can now make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs you own.
If you intend to make more than one rollover in any 12-month period be certain that one of the exceptions apply before doing so.

Types of distributions that cannot be rolled over:

IRAs:

1. Required minimum distributions
2. Distribution of excess contributions and related earnings

Retirement plans:

1. Required minimum distributions
2. Loans treated as a distribution
3. Hardship distributions
4. Distributions of excess contributions and related earnings
5. A distribution that is one of a series of substantially equal payments
6. Withdrawals electing out of automatic contribution arrangements
7. Distributions to pay for accident, health or life insurance
8. Dividends on employer securities
9. S corporation allocations treated as deemed distributions

— *Jo-Ann Silva Martin*

Keep that trust out of the kitchen sink: how the MA Supreme Judicial Court recently protected discretionary spendthrift trusts

In August 2015, the Massachusetts Appeals Court ("Appeals Court") caused quite a stir when it issued the unprecedented decision *Pfannenstiehl v. Pfannenstiehl*, which not only allowed a divorcing husband’s beneficial interest in a discretionary spray spendthrift trust established by his father for multiple family members to be included in his marital estate and divisible in the divorce proceeding, but purported to value his interest in the trust by a simplistic computation. The fate of discretionary spray spendthrift trusts seemed shaky until the Massachusetts Supreme Judicial Court (“SJC”) reversed the Appeals Court’s decision on August 4, 2016.

Massachusetts employs the “kitchen sink” approach to dividing assets in a divorce: all personal assets of either spouse can be pooled into the “marital estate” and judges have unfettered discretion to distribute those assets between the divorcing spouses. However, historically a spouse’s interest in a discretionary spray spendthrift trust is typically excluded from the marital estate because the interest is considered to be too remote and speculative to be deemed a concrete personal asset. This is because the trustee has duties to multiple beneficiaries and distributions to beneficiaries are generally within the trustee’s complete discretion. However, when it considered the *Pfannenstiehl* case, the Appeals Court instead upheld a lower court ruling that determined that the husband had a definable, 1/11th interest in a discretionary spray spendthrift trust established by his father for all of his children and grandchildren, and treated that purported interest as a marital asset for the divorce proceedings. Based on this purported interest, the lower court ordered the husband to transfer over $1.168 million to the wife.

This decision sent shockwaves throughout the trust industry in Massachusetts because it threatened the very essence of discretionary spray spendthrift trusts—to allow the trustee to make discretionary distributions among a class of beneficiaries, and to protect each beneficiary’s interest in the trust from being directly reachable by the beneficiary’s creditors.

The SJC disagreed with the Appeals Court and held that the husband’s right to receive distributions from the trust was “speculative” and did not render his right to future distributions from the trust to be “sufficiently certain such that it may be included in the marital estate.” So, discretionary spray spendthrift trusts appear to be protected for now as long as the beneficiary’s right to receive distributions from the trust is within the trustee’s discretion.

— *Tarae Howell*

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NP TRUST & ESTATES BLOG

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