TRUST ARTICLES

Ask a Trust Officer – Estate Settlement

DEAR TRUST OFFICER:

How long does it take to settle an estate?—PROSPECTIVE TESTATOR

DEAR PROSPECTIVE:

The short answer to your question might be, "It takes much longer to settle an estate than most beneficiaries think is reasonable."

To get to a more helpful and longer answer, we need to answer many more questions first, such as:

- Is there a will?
- If so, is there a chance the will could be challenged?
- Are there complicated assets?
- Are there hidden assets?
- Are any assets located out of state?
- Are the beneficiaries hostile?
- Must death taxes be paid (typically only larger estates)?

To make this even more complicated, the time and procedures for settling an estate vary from state to state. In the very best case scenario, estate settlement could take six to nine months. Here's an example of a worse case:

The estate of Prince Rogers Nelson (the artist formerly known as "Prince") is nowhere near settlement four years after his death in April 2016. He left no will. There were protracted controversies over who qualified as his heir under the Minnesota laws of intestacy (laws that kick in when there is no will). Prince owned very complicated assets (royalty rights). Estate taxes are due, and valuing those royalty rights is very complicated. The estate has been estimated at $200 million, which could mean estate taxes in the $80 million range. Those taxes have to be paid in cash, which is in short supply in the estate.

Three of Prince's heirs have sued the estate, saying that they have provided services for which they should be compensated. Their impatience at having no sign of their inheritance after four years of waiting is understandable.

However, the heirs need to understand the risks the executor faces. An executor who distributes assets to heirs before satisfying the IRS on estate taxes becomes personally liable for paying those taxes should the estate later run short of funds.

If you are concerned about how your heirs will fare during the probate process, you should definitely have a will. You should also consider employing a living trust, which may be able to provide a continuity of financial support to beneficiaries while the probate process unwinds.

Do you have a question concerning wealth management or trusts? Send your inquiry to trust@countryclubtrust.com.

Pro and Con on CARES Act Withdrawals

To help cope with the economic calamity resulting from the coronavirus pandemic, the CARES Act allows for the withdrawal of up to $100,000 from retirement accounts. One needs to have been infected or have a direct financial impact from the pandemic to be eligible. For example, being unable to work because daycare became unavailable is sufficient. Ordinary income taxes will have to be paid on the withdrawal, but the 10% penalty tax may be waived. Alternatively, the taxpayer may elect to repay the funds to the retirement account over three years.

The relief is welcome, but it is not without risks of its own. Quoted in the professional journal, *Tax Notes*, attorney Alan Gassman pointed out that in most states the money in retirement accounts is fully protected from the claims of creditors in a bankruptcy. Such protection is lost for any withdrawal. What's more, creditor claims could interfere with the possibility of repaying the money to the retirement account. The better course for many people, according to Gassman, will be to borrow against other assets, even at a higher interest rate.

On the other hand, for the wealthier taxpayer this could be a tax-saving opportunity. If asset prices are down when the withdrawal is made, the income tax liability will be reduced as well. What's more, the wealthy taxpayer could be in a lower tax bracket this year. The value at withdrawal becomes the tax basis for the holdings. When the assets are sold in the future, the taxpayer will owe tax on the capital gain, rather than an ordinary income tax. Presumably capital gains will continue to enjoy their preferential tax rate in the future.

Gassman concluded: "So while Joe Sixpack is probably going to make a mistake and this provision will cause more harm than good, the people he works for may want to take the [$100,000] out."

Your mileage may vary, as they say. The opportunity for penalty-free withdrawals is welcome, but the decision is not to made lightly. The advice of a financial professional is strongly recommended.

Turning Art into Cash Without Selling

Auction house Sotheby's reports a surge in customers who are borrowing using their fine art or jewelry as collateral [www.sothebys.com/en/articles/creating-liquidity-from-art-during-challenging-times]. Many auctions necessarily have been postponed due to the pandemic, although that has been offset to some extent by a record number of online auctions conducted by Sotheby's.

One major reason for such borrowing identified in the article is the need for funds to pay estate taxes, given the uncertainties of successfully liquidating a collection in such volatile times. At the other extreme are those who expect that there will be some relative bargains coming available in the art market, and who want to have ready access to cash to take advantage of them. The art market generally does not correlate precisely with the stock market, but it will lag. The art market dropped about 20% after the 2008-09 recession, for example, before coming back strongly.

Loans against fine art will have a loan-to-value ratio (or LTV) of 40% to 60%. Factors that go into determining the suitable ratio include the diversity of the collateral, the price points, the potential for blockage discounts if many items have to be sold at once, and the depth of the market demand for the pieces.

Borrowers need to be aware of how often the value of the collateral will be reappraised. A loan against art will work the same way as a loan against stocks. Should the value of the art fall, there will be a margin call. In that event, the borrower will have to provide a repayment or additional collateral to secure the loan.

A GRAT in Action

The Grantor-Retained Annuity Trust (GRAT) has emerged as a popular strategy in the estate planner's toolkit. The idea is that a grantor places assets in a trust while retaining the right to receive payments from the trust. When the term of the trust expires, any assets remaining in the trust pass to a beneficiary, typically a family member.

Here's an example of a GRAT that, unfortunately, failed. On February 1, 1998, Patricia Yoder created a Grantor-Retained Annuity Trust, keeping for herself a fixed annuity for 15 years. The annuity was set at 12.5% of the trust's initial value. The trust was funded with investment real estate, and the annuity came to $302,259 per year. Although the value of the trust's income varied from year to year, the annuity payments to Patricia did not change, and they were timely paid.

Patricia died November 2, 2012, three months shy of the expiration of the GRAT's term. Her estate tax return reported a total taxable value of $36.8 million, including the value of the GRAT. Some $11.1 million in estate taxes were paid. Someone then had second thoughts, and believed that including the GRAT in the taxable estate was a mistake. A refund of $3.8 million was sought, and when the IRS did not respond, the matter went to District Court.

The estate argued that a fixed annuity is not a "right to income" within the meaning of the tax code section that covers this area. An annuity is the right to receive payments from transferred property, regardless of the income earned by the property. The Court acknowledged that there is no case directly on point, but using a substance-over-form reasoning held that the estate tax does apply in this situation. The U.S. Supreme Court has held that the grantor's reservation of any interest, however remote, was sufficient to bring the conveyance within the code's "possession or enjoyment" language of the tax code.

With that much money at stake, an appeal was filed with the Ninth Circuit Court of Appeals. That Court has now affirmed the District Court decision.

Had Patricia chosen a 14-year trust term, or if she had lived just three more months, the $3.8 million tax would have been avoided.

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