

**Tax planning**

Is too much of your money going up in taxes?  
Tax effects of choosing the right shares to sell

**Estate planning**

The trouble with secret clauses



Spring 2016

# Is too much of your money going up in taxes?

**April is the cruelest month . . . . T. S. Eliot, *The Waste Land***

T. S. Eliot probably was not thinking about Form 1040 when he wrote that line of poetry, sometime before 1922. The modern income tax was then still in its infancy, and it did not yet affect the majority of the population. Today, however, April brings the dreaded day of reckoning. Even those who expect refunds sometimes put off the chore of tax filing until the last minute.

There are steps that one can take to bring some control to tax obligations. Here are some ideas.

**First steps**

The tax code offers a wide array of choices for building capital on a tax-deferred or tax-free basis. These are focused on providing resources for retirement, education, and, for some taxpayers, medical expenses. If you are eligible, you may reduce current taxes through an IRA contribution. Otherwise, you can reduce or elimi-

nate future taxes on your savings by maximizing your deferrals to:

- an employer's 401(k) or 403(b) plan;
- a Roth IRA;
- a 529 plan for education savings; or
- a Health Savings Account if you meet eligibility requirements.

A portion of your taxable portfolio may be dedicated to investments that are generally tax free—more on this below. The balance of your portfolio may be managed in a tax-efficient manner.

Tax efficiencies arise when choices are made with the 20% tax rate on long-term capital gains and qualified dividends in mind. See page 3, "Tax effects of choosing the right shares to sell," for one example.

**Advanced planning**

Your individual circumstances will dictate whether any of these strategies might be of benefit.

**Serial home sales.** Up to \$250,000 of gain is tax free upon the sale of a principal residence, or \$500,000 for married couples filing jointly. That sounds like a lot, but for those who have owned their homes for a long period of time, it may not be enough to reduce taxes on the sale to zero.

The full exclusion is available every two years. Some people who have been required to relocate frequently may be able to build a rather nice nest egg along the way.

**Like-kind exchanges.** When property that is held for productive use in a trade or business is exchanged for property of a "like kind," for use for a similar purpose, no gain or loss is rec-

*Continued on next page*



ognized on the exchange. (However, if cash is involved, that part of the exchange will be taxed.) The most common form of like-kind exchange is the real estate swap, which may allow a property owner to “trade up” to larger property on a more tax-efficient basis.

**Philanthropy.** There are many incentives in the tax code for making charitable gifts. One of the best is the tax treatment of appreciated securities. For example, a person who makes a gift of stock valued at \$10,000 to a qualified charity will get a \$10,000 tax deduction, even if he or she paid only \$1,000 to buy the stock initially. No tax is imposed on the increase in value. (Other restrictions may apply to the deduction, however.)

Capital may be redeployed for private and charitable purposes through a thoughtfully designed trust. The charitable interest may be at the trust’s termination, or the income may go to charity and the assets stay in the family. The income, gift and estate tax benefits of charitable trusts can make them an ideal strategy for the philanthropy-minded family.

### **On the “tax freedom” of munis**

Municipal bonds have long been prominent in the portfolios of high-income persons. Because their interest payments are not normally subject to federal taxation, they provide less pre-tax income than taxable bonds. That also means less interest expense for the states and localities that issue the bonds, and less burden on taxpayers. On an after-tax basis, munis may provide more spendable cash than their taxable counterparts, and they are usually backed by the taxing power of the issuer.

However, there are times when municipal bonds generate direct or indirect tax liabilities.

**Social Security interactions.** A portion of one’s Social Security benefits may be subject to federal income tax. How big a portion? That depends upon how much “provisional income” one has, and that number includes interest payments from tax-free munis. However, investing in fully taxable bonds would likely boost the taxable portion of Social Security even higher.

**Private activity bonds.** Municipal bonds that are sold for private pur-

poses, such as stadiums or industrial parks, generate interest payments that are tax free for ordinary income tax calculations but fully taxable for purposes of the Alternative Minimum Tax. As a result, the interest rates on these bonds is generally a bit higher than it is for fully tax-free bonds. If you know that you will be AMT free, it may be worthwhile to seek out these bonds. But you will likely be disappointed by your after-tax returns from these instruments in the years when you do pay the AMT.

**Capital gains and losses.** If you sell a municipal bond for more than you paid for it, you’ve generated a fully taxable gain. Fortunately, if you’ve held the bond for at least 12 months, you’ll be eligible for the lower tax rate on long-term gains.

**Original issue discounts.** If you have purchased municipal bonds after April 30, 1993, at a discount from their face value and later sell for a higher price, a portion of your gain may be taxed as ordinary income.

**Estate taxes.** The estate tax applies in full to the full fair market value of all municipal bonds held by an estate.

**State income tax.** The general rule is that for state income tax purposes, the interest payments from in-state bonds is tax free, while the interest from out-of-state bonds is taxable.

### **We have more ideas**

Our job as a corporate fiduciary is to develop investment and financial management plans for people in a great range of circumstances. We think creatively; we don’t approach our clients with preconceived notions of the best way to achieve their unique goals.

Everyone should explore the options and opportunities presented by our trust and investment services. If you have not done so already, we invite you to contact one of our officers soon to learn more. □



## Tax effects of choosing the right shares to sell

Selling stock isn't typically a tax-driven decision, but tax consequences do need to be taken into consideration. If you've purchased shares of a company over a number of years and have decided to lighten your holdings, your choice of which lot to sell could make a big difference on your tax bill. Here's a simplified example.

Sam and Janet own 40,000 shares of a hypothetical company we'll call XYZ Corp. They purchased the shares at various times over the past ten years, in four transactions of 10,000 shares each. Here is a summary of their position:

XYZ stock	Held for	Cost/share	Purchase price
Block 1	10 years	\$5	\$50,000
Block 2	5 years	\$10	\$100,000
Block 3	3 years	\$15	\$150,000
Block 4	6 months	\$10	\$100,000

Now let's assume that Sam and Janet need to sell one block of 10,000 and the current price is \$12. They can have a gain or a loss, depending upon which block they choose to sell, and the gain can be long term or short term. This table summarizes their potential tax liability if they are in the 35% tax bracket:

XYZ stock	Gain (loss)	Tax rate	Tax due (tax savings)
Block 1	\$70,000	20%	\$14,000
Block 2	\$20,000	20%	\$4,000
Block 3	(\$30,000)	20%	(\$6,000)
Block 4	\$20,000	35%	\$7,000

Should the couple choose to sell Block 3, they will realize a long-term capital loss of \$30,000, which may be netted against long-term gains for a potential tax savings of \$6,000. The worst result would be first in, first out, selling Block 1 and triggering a large tax bill, but that is the approach required by IRS Regulations if the taxpayer fails to identify the proper lot to be sold.

Tax planning for real portfolios is more complicated than this simplified example. As you can see, excellent records are an essential prerequisite for informed decision making. □



## The trouble with secret clauses

When Dimitri remarried in 1989, he created a revocable trust for his wife and two sons from his first marriage, his only descendants. The sons were to receive a distribution from the trust at Dimitri's death, but most of the assets were to remain in trust for the life of the surviving spouse. At the survivor's death, the trust would terminate in favor of the sons or their descendants. The sons were named the trustees of this trust.

Some 23 years later, Dimitri had a change of heart. In August 2012 he had the revocable trust restated, removing the sons as trustees, and he also removed the distribution to them at his death. The sons were very unhappy with this development, and they let their father know about it. They were particularly displeased with the choice of Celia Rafalko as successor trustee, as they believed that she was a close confidant of their stepmother. Dimitri took umbrage at their communications, which, he felt, impugned the character of his wife and showed a lack of confidence in his judgment.

Dimitri died in December 2012. In January 2013 one brother wrote to his stepmother proposing that they all agree to terminate the trust, splitting the principal equally among the brothers and the stepmother. He also asked that all records of trust administration be preserved carefully.

Unbeknownst to the brothers, Dimitri had a second restatement of the trust done in September 2012, after the disagreement with the sons. This time the trust included an *in terrorem* clause, which disinherited any beneficiary who interfered with the administration of the trust. When they learned of the secret clause, the first son backed off on his suggestion, and the second son disavowed any knowledge of the suggestion to terminate the trust.

In accordance with the September trust, Rafalko sent the sons releases to be signed, in which they promised never to contest any aspect of the trust's administration. They signed. Nevertheless, Rafalko warned the sons that she was going to consider whether they had violated the *in terrorem* clause. In May 2013 she told the sons that they were disinherited. This would have no effect on the stepmother's trust interest, but it did result in Rafalko having the power to direct the trust assets to charities at the stepmother's death.

The sons challenged their disinheritance, and the Virginia courts found that the trustee had acted in bad faith. Communication regarding a change in the trust's administration is not the same thing as mounting a legal challenge to it, and the brothers instantly backed off when they learned of the *in terrorem* clause. As the purposes of that clause were fully achieved, the trustee's further "punishment" of the sons was an abuse of discretion. The sons also were awarded some \$45,000 in attorney's fees, to be paid out of the trust. □

A wealth of knowledge for your financial future.

- Investment management
- Estate planning and trust services
- Financial advice
- Banking and credit services



The Norway Savings Asset Management Group

Standing: Mary Leavitt, Jake Ouellette, Kurt Garascia & Brittany Robidoux  
Sitting: Jen Schumacher & Brian Bernier



**Norway Savings**  
**Asset Management Group**  
*return on integrity*

1200 Congress Street, P.O. Box 8550 Portland, ME 04102  
207.482.7920 • [www.norwaysavingsbank.com](http://www.norwaysavingsbank.com)

Norway Savings Asset Management Group is a division of Norway Savings Bank offering Investment Management, Estate and Trust Services, and Financial Advice.

- Not FDIC Insured
- No Bank Guarantee
- May Lose Value