The COMPASS Chronicle

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Highlighting important wealth management issues

A Primer On Setting Up a Trust Fund

Trust funds used to be the realm of the wealthy, providing a tool to pass money to heirs and charities. Nowadays, though, they are becoming a means for more people to engage in smart estate planning.

Trusts are legal arrangements allowing you to put assets into accounts that benefit another person or an organization, like a charity or college. They are often complicated and require a lawyer to put together — although there are online alternatives that you should typically avoid.

The basic idea is to control who gets your assets, either when you're alive or afterward. A trust can help you lower estate taxes and avoid probate, the often-arduous legal procedure that proves a will is valid.

First Steps. As you set up a trust, you need to settle a few key questions:

1. What assets go into the trust: stocks, bonds, mutual funds, cash or property?

2. Who are the beneficiaries, meaning the people who receive the trust's benefits?

3. Who will be the trustee, the person who manages the assets and oversees the trust? Often it is best to appoint someone you know, who also is familiar with your financial situation and your beneficiaries. Plus, this person should be financially astute, and knowledgeable about taxes and investing.

4. How will assets be invested and managed, and when will they be paid out? For instance, you might not want your children to receive the benefits until they're 35, as an established adult.

5. What is the duration of the trust, and under what conditions will it end operations? Is it paid out over time, or all at once?

6. Can its conditions be changed? Some trusts are irrevocable, meaning they are chiseled in stone. Others are revocable, meaning for instance you can shift the beneficiary to be your daughter instead of your younger brother.

7. What stipulations do you want? Maybe the money will go to your son for everything except paying off his creditors. Or your daughter, but not your son-in-law if she should die.

Beyond these considerations, it's wise to find a good, experienced estate attorney. The lawyer will craft a document called a declaration of trust, which will set up the trust fund and establish its conditions.

Timing. Next, the trust fund is registered with the IRS, allowing it to file its own tax returns and legally open financial accounts at banks or other institutions. Then, you transfer the assets

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COMPASS Corner

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Subsequent to robust returns during the first half of 2019, the third quarter experienced relatively muted returns, with the bond market performing best as interest rates continued their decline. Following above-trend economic growth in 2018 primarily due to the effect of tax cuts, growth this year has understandably decelerated with the trade war and resulting tariffs. The capital markets have begun to respond to concerns that the economic deceleration may be greater than expected.

Among stocks during the third quarter, U.S. stocks performed best, especially the stocks of the largest companies, particularly technology and defensive names (e.g., utilities and consumer goods). The Russell 3000 Index, a proxy for U.S. stocks, generated a total return of 1.2% for the three months ended September 30, whereas the MSCI EAFE Index, a representative index of other developed markets, actually declined 1.1% during the quarter. Emerging market stocks continued to falter, falling 4.3% for the third quarter.

Bonds benefitted from the decline in interest rates that began during the fourth quarter of 2018 on economic growth concerns. The yield on the 10-year U.S. Treasury ended the quarter at 1.67% after closing the previous quarter at 2.00%. The yield actually fell as low as 1.46% in early September. Such a decline in interest rates led to a rally in bonds, with the Bloomberg Barclays U.S. Aggregate Bond Index gaining 2.3% during the quarter.

Europe's Growth Problem And Your Portfolio

Aging populations are reshaping the world's largest economies; it's caused a global savings glut and is driving current U.S. financial economic conditions.

The demographic trends are behind the U.S. yield curve inversion and stock market volatility, but rarely make headlines in the financial press.

Here are the facts.

Germany's working age population is shrinking, as is all of Europe's, Japan's and China's, too.

In contrast, the U.S. working age population is expected to grow in the years ahead.

With the world's largest economies home to a growing population of retirees, demand for secure retirement income is driving prices for sovereign bonds higher.

The glut of savings from income-starved retirees is chasing the certainty of government guaranteed bonds, driving prices higher and yields down.

Exacerbating the bond market problem, Germany, the world's second largest supplier of sovereign bonds after the U.S., has been issuing *fewer* bonds to avoid burdening its growing population of retirees with paying down government debt.

Shrinking the supply adds to the upward pressure on sovereign debt prices and depresses yields.

In addition, the rising likelihood of a recession in Germany has forced its central bank to keep interest rates low to stimulate growth.

Demand for secure retirement income is driving prices for sovereign bonds higher.

This confluence of demographic factors and an economic slowdown has boosted demand for U.S. Treasury bonds, driving prices on long-term bonds higher and yields lower.

With the yield on a three-month T-bill at 1.99%, higher than the yield on a 10-year Treasury bond at 1.5%, the yield curve is inverted — as it has been for much of 2019.

For the past several decades, yield curve inversions were rare and usually were followed within 18 months by a recession.

So, the current inversion has spread fears of a U.S. recession and caused increased volatility in the stock market in recent months.

Retirement income investors may want to consider how lower yields on fixed income allocations in their portfolios might affect them in the years ahead, because the change in supply and demand for sovereign debt is being driven by long term demographics.

Significantly, the yield curve inversion is caused by bond market supply and demand and not so much U.S. economic fundamentals.

The baby-boom spawned an "echo" baby-boom generation and that makes the growth path of the U.S. comparatively favorable to the other major world economies. ●

Prepare For A Sweeping New Law On Retirement Account Taxes

A sweeping new law changing retirement investing tax rules was passed by the House of Representatives on May 29th. It's expected to be passed by the Senate and has the support of President Donald J. Trump. Although the legislation may not be signed into law until late this year, individuals with retirement accounts should consider how its enactment will affect them and their beneficiaries. Here's what you need to know now:

Secure Act Misnomer. The legislation is referred to as the Secure Act. Often buried or unmentioned in coverage is the full name of the legislation, "Setting Every Community Up for Retirement Enhancement Act of 2019."

Kills Stretch IRAs. A popular strategy for stretching tax deferral would be eliminated by the proposed law. The legislation's sweeping changes would kill stretch IRAs and represents a move to higher taxes on IRA beneficiaries. Non-spouse beneficiaries of Individual Retirement Accounts (IRAs) would no longer be permitted to defer taxes on payouts of inherited IRA over their expected lifetime after 2019. Under current rules, you could leave an IRA to your children and your heirs who can take distributions from that IRA based on their life expectancy. This allows those inheriting IRAs to stretch deferral of taxes over many decades, and the IRA account compounds without being taxed in this period. Under the proposed change, heirs would be required to distribute an inherited IRA over 10 years.

Exceptions. The proposal carves out an exception for minors — 18 or 21 in most states — until they reach the age of majority, and then they would be required to distribute the assets in the IRA over 10 years. A surviving spouse, those who are chronically ill or disabled are among those not affected by the new 10-year payout rule.

Beginning Date Of Required

How To Swap Real Estate And Defer Taxes, Maybe Forever

A tax-savvy way to improve your real estate situation is to swap one property for a new one. Called a 1031 exchange, referring to its section of the tax code, this works so long as you are switching business properties. Personal residences aren't eligible.

While 1031 exchanges are often used by big commercial real estate operators, there's nothing stopping you from using the strategy for much smaller-scale holdings. The maneuver defers capital gains taxes, perhaps forever.

This takes some planning. For instance, say you have a vacation house and would like to exchange it for a property in a location that is closer to your residence. You must rent the original vacation place out for at least 14 days per year for two successive years, and in the eyes of the IRS, you have a business asset. The only caveat is that you must continue to rent out the new vacation house for 14 days over the next two back-to-back years.

A couple of more requirements: First, you must identify the substitute property within 45 days of selling the old real estate. Second, you need to buy the new property within 180 days of your sale.

The nice thing about 1031 exchanges is that you aren't confined to the exact same type of property. So, you can swap a condominium for a farm, or a house for a marina — as long as it's a business or investment property. You'll need expert advice on this issue.

The December 2017 tax-code rewrite barred applying Section 1031 to make tax-free exchanges of collectibles but left intact tax-free exchanges for business- or investment-purpose real estate.

Federal capital gains taxes now are 15% (for single income of $39,476 to $434,550) or 20% (for $434,551 or more). You can postpone paying taxes for the rest of your life. And your heirs benefit, too. When they inherit the property, they get a "stepped-up basis." This means the property is valued at the market rate at the time of your death. So, the cost basis adjusts upward. If your heirs turn around and sell it right away, they will owe little or nothing. The tax liability on the property is erased.

Of course, the swap must be a sensible business deal. Getting a tax-free sale of a profitable strip mall to buy an apartment building that has trouble keeping tenants, for example, would be a bad outcome.

Accounting for the value of a property properly is another important consideration, separating a capital investment in new appliances, for instance, from the fair value of the property.

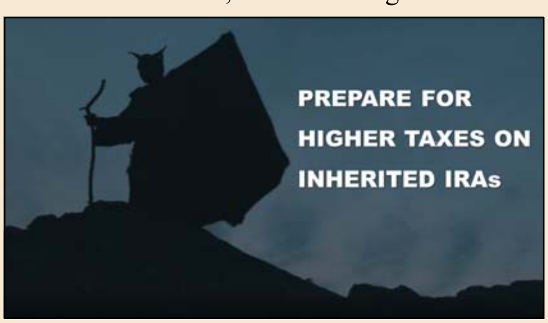
Keeping Uncle Sam's hands off the proceeds of a sale of real estate is an essential part of financial planning for owners of real estate for business, investment, or rental purposes, as well as those who rent out a vacation home as required under federal rules.

Strict timing limitations are required in a 1031 exchange. If a 1031 exchange is not properly constructed and executed in a timely manner, then an investor could lose all tax benefits of the transaction, including depreciation recapture. In addition, the property you sell must be a replaced with a like-kind property, and a Qualified Intermediary, as an independent third party, is needed to facilitate a 1031 exchange transaction and hold the funds on behalf of the investor.

Investors must also be leery of investments in private offerings created to sell 1031 exchange transactions. These are often illiquid investments, and do not offer guarantees of income or that your investment objectives will be met. They may be speculative, and you could lose some, or all, of your principal investment.

This is neither an offer to sell nor a solicitation to buy any security, which may be made only in an official offering memorandum. Investors should read any offering memorandum and review any risks associated. This article does not include all material information to determine whether to conduct a 1031 exchange. 1031 exchange opportunities are available only to accredited investors. Investors must be qualified prior to any discussion of a current or contemplated offering. ●

Minimum Distributions (RMDs). The new law would push back the age at which you must begin withdrawing money from an IRA. Under current law, you are required to begin taking distributions by the 1st of April following the year you turn age 70½. Under this new statute, that's going to be pushed back to age 72.



Stay Tuned. Waiting till the legislation is signed into law may not leave enough time to adjust your plans and minimize taxes for yourself and loved ones, and the legislation makes changes so sweeping and so new that its effects on long-term financial plans are still being researched. Please watch for an e-mail from COMPASS later this year should this legislation be signed into law. Tax planning requires a qualified tax professional and personal attention. This is an early warning about an important issue affecting strategic long-term tax planning and not intended as tax or legal advice. ●

Opportunity Zone Investment Frenzy Requires Caution

A new provision in the tax law for the first time in 2018 is leading to a frenzy of tax-driven investment products to be promoted to affluent investors, but caution is wise.

Investors can defer paying tax on large capital gains or eliminate gains taxes entirely by investing in one of more than 8,000 places across the country designated under federal law as Opportunity Zones (OZ). The lucrative new tax-driven investments are being promoted by Wall Street firms, which already has prompted warnings in the press about the sudden investment fascination.

With an OZ investment, a reinvested capital gain is tax-deferred, putting an additional 15% or 20% more into your OZ investment. You don't have to pay the gains tax until you sell your interest in the opportunity zone investment. If you stay in the fund for five years, you pay tax on only 90% of your delayed capital gains. Hold for seven years, and you pay tax on 85% of the gains. And if you hold it for 10 years, the appreciation on the OZ investment is tax-free when you exit the fund — assuming the investment has increased in value.

Since January 2018, more than 80 OZ funds have sprung up, even though the Trump administration has not finalized regulations governing them, according to a front-page story in *The New York Times* on February 20th, 2019. "Managers of the funds are seeking to raise huge sums of money by pitching investors on a combination of outsize returns and a feel-good role in fighting poverty."

Some of these OZ areas are more down-and-out than others. Perhaps the most prominent OZ is Long Island City, a waterfront section of the New York borough of Queens. Amazon was set to build a new headquarters there but backed out after its large tax breaks stirred controversy. Other gentrifying OZs include Oakland, Calif.; East Austin, Texas; and South Norwalk, Conn, but thousands are located in seedy parts of downtowns across the country.


The New York Times

Wall Street, Seeking Big Tax Breaks, Sets Sights on Distressed Main Streets

- Hedge funds and other wealthy investors are plowing money into so-called opportunity zone funds.
- The funds are a creation of the 2017 tax law that provides incentives for spending on projects in poor areas.

The frenzy of activity is reminiscent of tax scams peddled after the enactment of major federal tax reforms in the 1980s and 1990s, which resulted in huge losses for investors and a plethora of class-action lawsuits against Wall Street firms and other promoters.

OZ investing can be expensive, and you must be comfortable with the risk as well as the social objectives of a fund before investing, and it requires personal tax planning and investment research from a professional. Please let us know if you have questions about this new type of investment that must be considered cautiously. ●

Setting Up A Trust Fund

(Continued from page 1)

into the trust, a process called retitling.

Do you want the trust to take effect now or at your death? And should it be revocable or irrevocable? The argument for revocable is that your beneficiary, perhaps a young person, may not grow into someone who deserves your generosity. The case for irrevocable is if you want to earmark the assets to support an activity whose necessity won't likely change, such as educating a child or supporting a charity.

The question of how long the trust will stay around, before its last assets are paid out, is a tricky one. Common law is structured against letting trusts persist indefinitely. But many states let you get around that by setting up a so-called dynasty trust, which permits the wealth to grow for a long time without being taxed.

Types of Trusts. Aside from whether the trust is revocable or not, its structure can be very complex and carry advantages and disadvantages. Some examples:

- Generation-skipping trust, aka a dynasty trust. This lets you transfer money tax-free to beneficiaries who are two generations younger than you. The goal is to avoid the assets being taxed twice: once when they go to your grown children, and again when that generation passes the assets along to their own kids — namely, your grandchildren.
- Bypass trust. Here, you bequeath an amount up to the estate tax exemption (in 2019, that's up to $11.4 million from a single giver or double that from a couple). The rest goes to your spouse tax-free. After your spouse dies, you can stipulate that what's left goes to the kids.
- Qualified terminal interest property (QTIP) trust. This is best at singling out which particular relatives to direct your largesse to. A QTIP is often helpful in families where there are divorces, remarriages and stepchildren. Your surviving spouse can receive income from it, and once that spouse dies, the remaining principal goes to specific younger relatives.

For you, the donor, creating a trust fund gives you peace of mind that the legacy you want to leave is well-constructed and wisely directed. This article is not intended as personal advice, but rather as an educational resource about planning techniques available when working with a financial professional. ●

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