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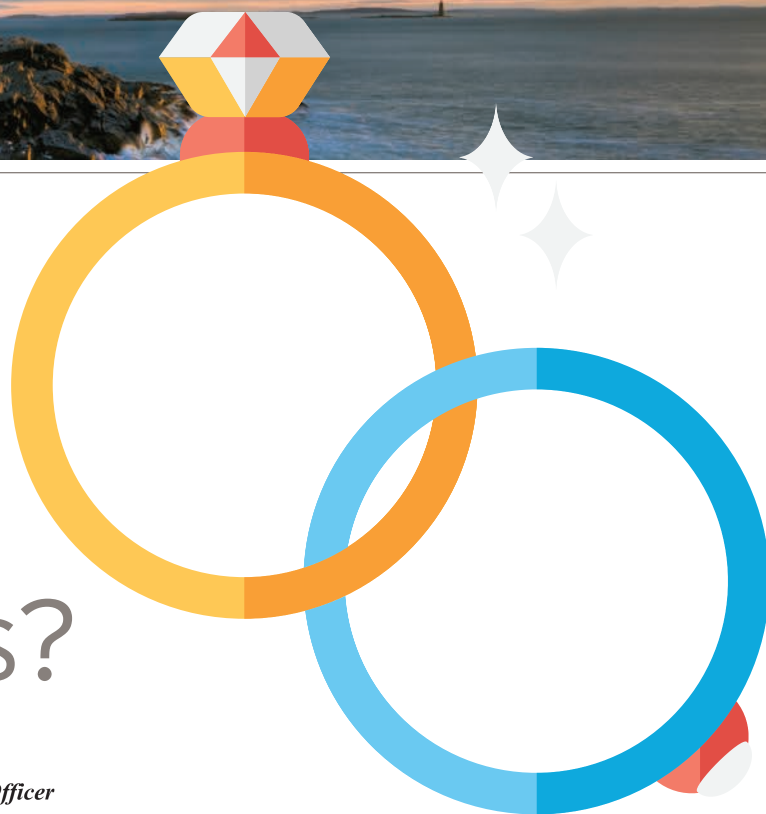

What's Yours is Yours, and What's Mine is...Yours?

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As their children begin dating seriously, parents ask us about pre-marital agreements, or pre-nups (for pre-nuptials) as they commonly are called. Although an excellent tool, it's not an automatic "yes" that every child approaching marriage must have one. There are many factors, financial and emotional, to consider.

Story continued inside.

In This Issue:

What's Yours is Yours, and What's Mine is ... Yours?

The Downside of UTMA Accounts

Cash as an Asset Class

Cover story continued.

A pre-nup can determine who is entitled to what property if the marriage ends either by divorce or death. But, state property and divorce law also are relevant in determining property rights, so it's important to understand some basic rules.

From a marital property rights standpoint, there are two primary types of laws in the U.S. - common law and community property law. Community property states and territories are Arizona, California, Idaho, Nevada, New Mexico, Puerto Rico, Texas, Washington and Wisconsin. (Regardless of where you live, it also can be possible to elect into community property treatment in Alaska.)

Share and Share Alike

So, what is community property? Essentially, it's a state-law policy position premised on the notion that "we built this together during our marriage," so we split things 50:50. Income earned and assets acquired or created during marriage are considered owned one-half by each spouse. The exception is a spouse's "separate" property, which stays with the spouse who owns it. Separate property includes assets:

- owned before the marriage;
- received during the marriage by inheritance or gift, including such property held in a trust; and
- bought with separate property funds or the proceeds from the sale of separate property.

The rest of the states follow common law principles, which essentially affirm that a spouse owns as separate property what he or she earns, creates, brings into the marriage, and receives by gift or inheritance.

What Happens when a Marriage Ends?

When a marriage ends by divorce or death in a community property state, half of the community property goes to each spouse. Separate property stays with the spouse who owns it.

Common law states start with the notion that each spouse is entitled to his or her separate property. However, in divorce, each spouse has a right to claim an "equitable portion" of the assets acquired during the marriage. Equitable means "fair," and that is determined by a variety of factors that may or may not result in a 50:50 split. If the marriage ends in death, the surviving spouse can chose to take under the will or an "elective share" (typically one-third to one-half) of the deceased spouse's property.

So, About that Pre-Nup…

After reading about 50/50 splits or "equitableness determined by a variety of factors," you might think that you should run, not walk, to your family counsel for a pre-marital agreement. Perhaps so, but slow down. There are alternatives that may be acceptable.

Other Options?

Good structural planning may protect many of your child's assets. For example, wealth that you (or other family members) have transferred in trust for the benefit of your child typically is protected in the event of divorce as long as it remains in the trust.

If a child owns family business stock or a limited interest in a family partnership before marriage, that asset is separate property, potentially protecting from divorce both the assets within the entity and the income accumulated within it.

Commingling separate property with community property can "taint" the separate property, turning it into community property. Therefore, careful bookkeeping, monitoring of cash flows, and proper titling of assets can be critical. For example, in some community property states, income from separate property is community. Periodically "sweeping" the income out of the separate property account can help to maintain the separate character of the account.

The Conversation

Still, it makes sense to consider a pre-nup. Some families have a long history of open discussion and there is an accepted philosophy, "This is how we do it in our family when we get married." If so, the conversation can be similar to discussing how the holidays work at your house. In any event, the matter can be presented dispassionately and, hopefully, is not taken by the future in-law as a personal affront.

If, however, this is the first time the issue has been raised, it can be trickier. Either or both of the happy couple might perceive that you are questioning the future in-law's fitness to become part of the family. The conversation gets harder as the wedding date approaches.

Talking about money and finances is not always easy. Pre-marital agreements can make this even more challenging. When two people are just about to embark on the most hopeful of endeavors, this discussion raises the possibility that the marriage will end.

Make the discussion about finances in general. Your child can demonstrate respect for the future spouse by fully disclosing all assets (which is required for the legal enforceability of the pre-nup) and discussing and agreeing to future financial plans and budget concepts. The marital agreement can be a small part of a much larger discussion of the couple's financial future.

Both parties will need their own counsel. Some marital lawyers are practical, while others can be obstructionist, so the couple can discuss their objectives first and, hopefully, agree to find attorneys who will look out for their respective client's interests while working constructively to accomplish the couple's objectives.

The Family and the Business

If your child is or may become a co-owner of a family business or other treasured assets, the conversation also should address the potential impact of divorce or death on the other family members. Your child selects the person to be his or her spouse. Hopefully, the family welcomes the newlywed into the family. But your child should recognize that it is unfair to the family to impose the spouse (and, potentially, the spouse's family) into the business or co-ownership relationship. The future in-law typically will understand this if explained with love and compassion.

Understanding the benefits of pre-marital agreements and alternatives can help you and your child decide what is most appropriate. It is never too soon to start the discussions, with the best time being long before your child develops a serious relationship.

CASH AS AN ASSET CLASS

For an investor focused on long-term growth, a high cash balance might be the last thing you want to see, especially when money market yields hover around 0.15% (thank you, Federal Reserve Board Chairs Bernanke and Yellen). In a world of persistent monetary easing and subsequent healthy returns in U.S. equity markets, seeing the drag on returns from a higher cash balance can be quite frustrating, particularly for a risk seeking investor – one who is more concerned with gains than potential losses.

Given these uncertain times, with imminent U.S. elections; unknowns in China and potential effects on other emerging economies; instability of the European Union; and all-time highs in U.S. equity markets despite static growth in our gross domestic product, one must address this all-important question: how much cash should I really be holding? Is cash really king?

The Downsides of Cash

First, let's get the bad news out of the way. There are risks to holding a high percentage of cash in your portfolio:

> **Lack of capital appreciation** – Short-term money market funds offer virtually no appreciation potential.

> **Income risk** - As interest rates fall, the opportunity to generate yield from cash held in a money market fund falls as well. We've all experienced this over the last eight years.

> **Inflation risk** – Short-term interest rates typically do not offset the impact of inflation on the value of cash.

Despite the multiple downside risks, there are times when holding a large cash component outweighs the risks.

Potential Need for Liquidity

At the most basic level, a material cash position provides quickly accessible liquidity for an emergency or sudden large cash need. The proper amount of liquidity to maintain for this purpose depends on a multitude of variables, including the type of entity holding the investments (generation skipping exempt trust, personal account, foundation, etc.), other cash sources (e.g., employment), insurance coverage (life, liability, fire, etc.), and personal spending habits.

Cash serves as a buffer to downside market as well as a stabilizer for a portfolio, particularly in a market correction environment. For a family or individual looking to preserve capital to pass on to future generations, or for the funding of a charitable foundation, downside protection can be critical to the overall success of a portfolio. Furthermore, when faced with an environment of little perceived upside in bond and equity markets, cash could be the deciding factor between a good and bad year of overall portfolio performance.

Dry Powder

"Keeping some powder dry," meaning holding some cash in reserve, allows an investor to take advantage of tactical opportunities. Market corrections give investors an opportunity to purchase stocks or other assets at heavily discounted prices. Having cash available allows you to take advantage of these opportunities and to do so without having to sell other assets potentially triggering gains and resulting in tax liabilities.

From a shorter-term standpoint, if you aren't able to find an investment opportunity that you believe offers a healthy amount of upside, but does present significant downside risk, does it make sense to buy it just so that you don't have too much cash? We don't think so. This notion is rather simplistic, but many investors don't believe it. Some argue that you must be 100% invested at all times in order to take advantage of any potential appreciation in the markets. I call this the "Fear of Missing Out" bias. But, returns have been harder to come by at today's rich valuation levels. This yield-chasing strategy could be detrimental to the long-term performance when there is a market correction and when the investor doesn't have cash to take advantage of the resulting opportunities.

Balancing Act

Even in an upward market environment, it can make sense to maintain a certain level of cash to offset the addition of riskier assets like emerging market equities or private equity. This balance of risk in a sort of barbell approach might allow an investor to take on riskier assets or investment strategies at one end while holding higher cash levels at the other end as a risk offset.

Cash can seem quite boring and worthless from an asset allocation perspective, particularly when it seems to be dragging down returns in an upward trending market. But the risks of holding higher amounts of cash can be more than offset when used appropriately in both a long-term and tactical short-term manner to reduce portfolio risk and take advantage of market opportunities.

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The Downside of UTMA Accounts

In most states, minors cannot legally own investment accounts or other assets outright. So, if your minor child is to own assets, it must be through a trust. Many people use a form of trust called a "custodial account" created under their state's Uniform Transfer to Minor's Act (UTMA). These accounts are simple and cheap to create (no attorney needed). Unfortunately, in our experience, they can be a disaster in the making.

First, why transfer wealth to your minor children?

Historically, one objective was to tax the income generated by that wealth at the child's tax rates, which typically were lower than the parents' rates. In 1986, Congress enacted the "kiddie tax," which all but eliminated that benefit by taxing most of children's income at their parents' top tax brackets. In 1986, Congress extended that regime to "kiddies" up to age 24.

Estate Tax Savings

The primary remaining benefit of transferring wealth to your children is to save estate and gift taxes. So, most wealthy couples take advantage of their $14,000 annual gift exclusions by transferring $28,000 annually to each of their children (and, later, grandchildren). Moderately wealthy families accomplish this by making their annual exclusion gifts to Section 529 education accounts, which can earn income tax-free if the accounts are used for qualifying educational expenses.

More wealthy families eschew the modest income tax savings potential of 529 plans in favor of directly paying educational expenses and using their annual exclusions for additional wealth transfer planning. (The ultimate estate tax savings from paying educational expenses AND making annual exclusion gifts likely far exceeds the income tax savings of "wasting" the annual exclusion gifts on the Sec. 529 plan.) It is these families who tend to get burned by UTMAs.

The UTMA Disasters

Years ago, one of our consultants received a panicky sounding call from a client. The client's oldest son was about to turn 21, the age at which an UTMA account terminates and distributes outright to the child. The client and his wife had dutifully made annual exclusion gifts to the account for many years. They had invested the account successfully and grown it to about $1.25 million. The problem? The son was a party animal at SMU in Dallas and the parents were concerned about what he'd do with the money when he got his hands on it.

Crazy story? Not really. Put aside $28,000 per year for 21 years. Compound it at 5% per year and your kid will have a million dollars. The good news is that you have saved $400,000 estate tax (at today's 40% rate). The bad news is that your kid might get a million dollar hangover.

An additional little-known problem with UTMAs can arise if the donor-parent is the custodian of the account. If that parent dies, the UTMA account will be subject to estate taxation, thereby negating the primary reason for creating and funding it in the first place!

A Better (albeit "Crummey") Alternative

Although more expensive to create and administer, the better approach to annual exclusion gifting is to use a trust. We typically recommend against the use of a so-called "minor's trust" (also called a "Section 2503(c) trust" after the tax law section that authorizes it). The reason is the tax law requires that the 21-year-old party animal must be given the right (for a limited period of time) to take the assets out of the trust at age 21.

Instead, we recommend the use of a longer-term trust that incorporates a so-called "Crummey power." This power gives the child a right to withdraw each gift for 30 days. If she doesn't exercise the withdrawal right, the property is locked in the trust. Until the child reaches adulthood, the withdrawal right is exercisable by the parent (not the child). After reaching adulthood, if you fear that the kid might withdraw the next gift that you plan to make, you just don't make it. Either way, the prior years' gifts (and the earnings on them) remain locked in the trust.

So, while we applaud the estate tax planning benefit of annual exclusion gifts, we encourage thinking ahead about the potential impact when your little darlings grow up. Better to be safe than sorry – use a trust rather than a UTMA account.

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