Trust Company *of* Vermont

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Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester ◆ St. Albans

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Keep Calm and Carry On

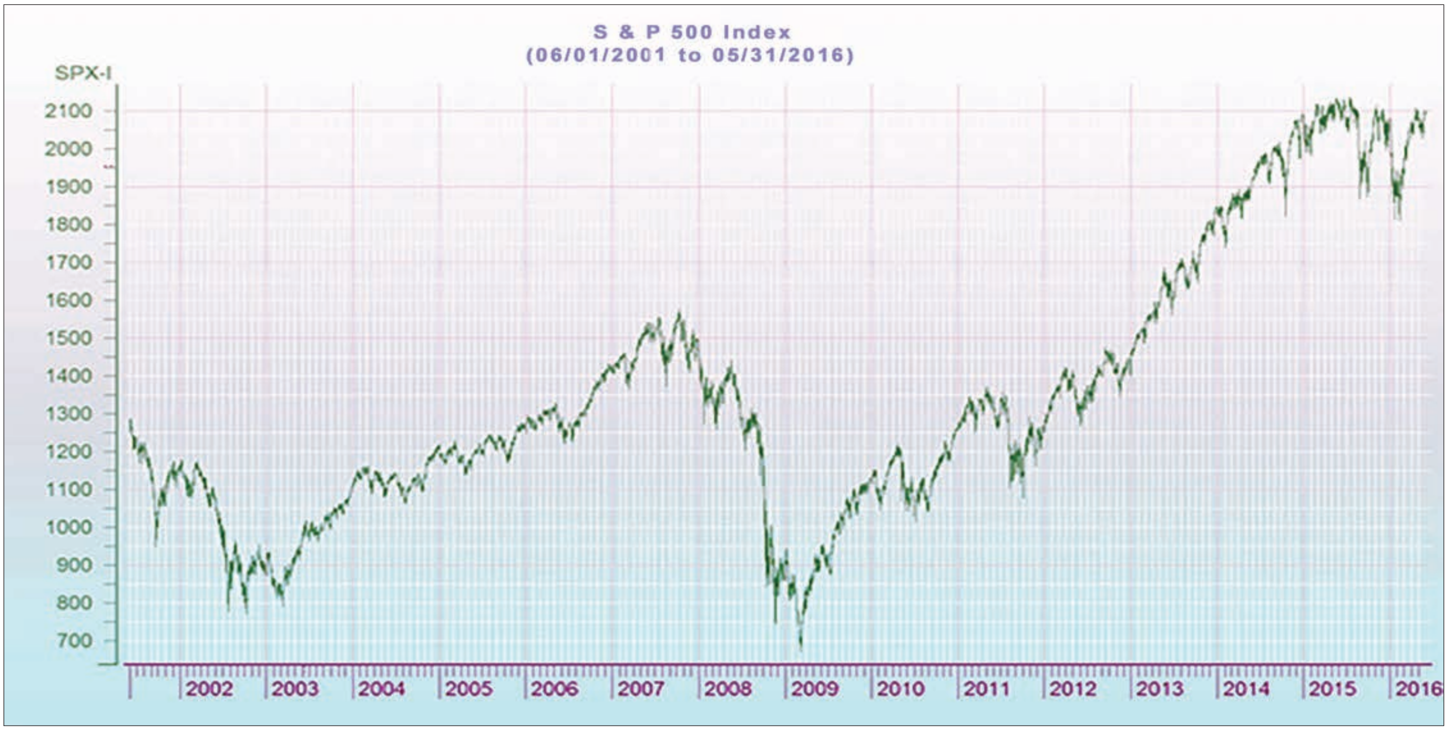
David DeBellis, CFA & Portfolio Manager

These now famous words were first printed on posters by the Ministry of Information as a way of boosting the morale of the British people during World War II. With the now infamous "Brexit" vote behind us, investors from all nations could use these words of encouragement as the "leave" vote roiled global markets, including currencies, causing the British Pound to fall to its lowest level in decades.

For those who don't know what "Brexit" is or what it means, here is a brief lesson for you. Because we now live in a society that communicates with emoji's and acronyms, Brexit is simply an abbreviation of "British Exit" referring to the June 23rd referendum by British voters to exit the European Union. In an eerily similar tone to our own Presidential politics here in the US, the leave vote won on a platform based on nationalism, opposition to immigration, and anti-establishment and anti-elite feelings directed at mainstream political leaders.

So what should investors do? To this question, I refer to the first part of this article's title; Keep Calm. The market hates uncertainty, and typically manifests as a large increase in volatility. And it is likely that this period of uncertainty could stick around for a while as the process for the UK leaving the European Union will take at least two years to complete, perhaps longer. The worst thing you can do is to panic and sell during times of market upheaval, such as we've seen in the two days following the Brexit vote.

The Brexit vote is just one of many panics that the market has experienced through the years. If we just look at the last 15 years, the market has experienced terrible events that would make even the strongest willed investor panic – 9/11, the 2008 financial crisis, Greek government debt crisis & Chinese stock market crash - you will see that the investors who were hurt the most were the ones who panicked and sold. Anyone who stayed invested in the market for this whole time period saw their money increase over 118%.



We can take the chart above back even further to find that the market has survived 9 major wars, multiple natural disasters, and 33 recessions, among other terrible events in our nation's history, and yet the market still increased 10,000 fold in its 140 years of existence.

The portfolios that are managed by Trust Company of Vermont are diversified across asset classes, global regions and economic sectors, providing clients with protection against events such as this. We have no crystal ball to tell us what is going to happen in the near term. We try to invest in businesses that we feel create value for shareholders, and we look to own these businesses for years, not days or months. We will "Carry On" and look for investment opportunities for client portfolios. We won't speculate on what the future holds for the European Union and whether other members will leave, or if another recession is inevitable because of the Brexit. There are just too many questions and not enough answers.

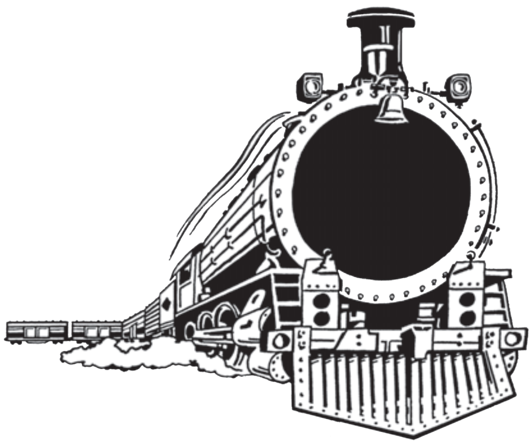
Afterword

The above was my second attempt at an article for this quarter's newsletter. In my first go-around, I had decided to write about the upcoming presidential election and the effects that it might have on the stock market. I wrote in that initial draft that I chose that topic because I felt that the people of the UK would vote to stay in the European Union (the general consensus just a day prior to the vote), proving that when it comes to a 50/50 proposition such as the Brexit vote, even those who invest for a living really don't know.

So stayed tuned for our next newsletter as the contributor from the investment management team may decide to go ahead and expound on how the 2016 presidential election might move the markets. I think you will find the conclusion to that article to be very similar to this one; Keep Calm and Carry On!

Is the Light at the End of the Tunnel a Train?

Vermont's traveling estate tax and its impact on us as beneficiaries



The May 26, 2016 issue of VTDigger reported "New tax law will take smaller bite out of estates, businesses". Did Act 146 (S.55), which was just signed into law, lower the tax? Yes and No. The tax went down for smaller estates and actually went UP, *marginally, for larger estates!*

S.55 also included "On or before January 15, 2016, the Joint Fiscal Office shall report to the General Assembly on the impact of moving Vermont's exclusion amount under its estate tax to an amount that matches the federal basic exclusion ..."

What follows is an attempt to focus on what we still need to do in Vermont. Vermont's Estate Tax may have unintended consequences en route to a better law. S.55 appears to be on a track. Where is this train going to go?

The Train ~ The Before & the After of EGTRRA

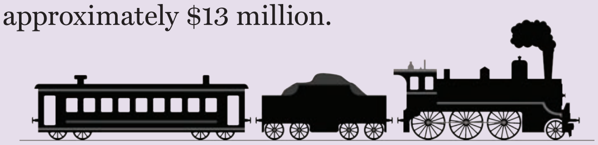
Before

Before Congress passed the Economic Growth Tax Relief and Reconciliation Act in 2001 (EGTRRA) all 50 states and the District of Columbia imposed an estate tax where state estate taxes were linked directly to the federal credit. In short, a portion of the federal estate tax was shifted to the states.

Before EGTRRA, the total estate tax burden was the same for a Vermont resident, a Florida resident, a New Hampshire resident, etc.

Before EGTRRA, Vermont would receive its share if there was a federal tax. The federal tax was assessed on the value of assets above the federal exemption which, at the time, was $1,000,000.

Before EGTRRA, Florida was the beneficiary of approximately $800 million. In Vermont, it was approximately $13 million.



After

Florida and New Hampshire, for example, decided to jettison the state estate tax. Vermont did not. Vermont continued to tax estates above the federal exemption and the federal tax was reduced by the state tax as a deduction. A credit is a lot better than a deduction, but at least we have a deduction. At the time, wealthier Vermonters and their lawyers saw the future. This is what it looked like:

2002 - 1 million	2006 - 2 million
2003 - 1 million	2007 - 2 million
2004 - 1.5 million	2008 - 2 million
2005 - 1.5 million	2009 - 3.5 million

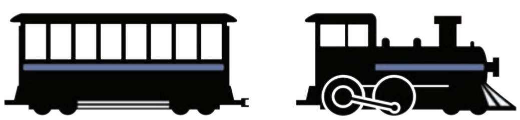
2010: 100% exemption

Although EGTRRA expired December 31, 2010, most planners expected either 100% exemption or an exemption well above $3.5 million. The wealthier Vermonters were not worried. Just stay on the train until 2010 and Vermont will not tax their estates.

THEN THE TRAIN STOPPED IN ITS TRACKS

Vermont decoupled at 2 million. Whatever Congress decided, Vermont will continue to tax estates above 2 million. It was a jolt, and enough of a jolt to subsequently increase the exemption to $2,750,000. Now, as Vermonters, we have to compete with states that have no state estate taxes. And the list keeps growing. North Carolina joined the list in 2013 and some of my neighbors have relocated to North Carolina. It's not as hot as Florida in the summer and some sections remind them of Vermont.

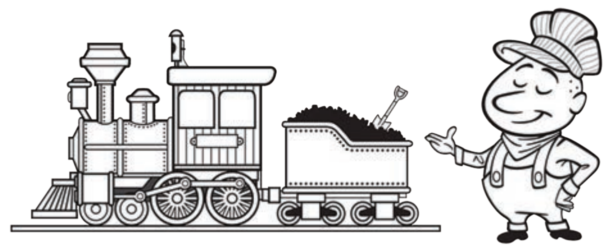
Decoupling



Decoupling is when a state decides to have an exemption from tax that does not match the federal exemption. The current federal exemption is $5,450,000 (inflation-adjusted each year). Vermont's exemption is currently $2,750,000. Just the word "decoupling" evokes emotions. When I spend days trying to write these newsletters, grumbling late into the night, I fear decoupling with my wife.

My perspective of the Vermont estate tax is that it is very complex. Understanding the tax is just one component. Vermonters leaving the state to avoid the tax is another: are we decoupling relationships born and bred in Vermont?

AND THEN THE TRAIN JUST STOPPED AGAIN FOR REFUELING



Our legislators recently passed S.55 which was signed into law on May 26, 2016, effective for estates as of January 1, 2016. Its objective was to keep wealthier residents from leaving for tax-friendlier states, and make it easier for small business owners to pass their companies on to the next generation. It is the beginning of a process designed to address this issue of losing our wealthier Vermonters.

Before S.55 smaller estates were taxed at the federal rate and subject to the federal rules, including gifts, and larger estates were subject to the 16% tax and the ability to make gifts to save taxes. S.55 simply moved all estates to the simpler Vermont formula accompanied by "other changes".

Sometimes "other changes" complicate a bill designed to simplify. As I struggled to understand S.55, the Vermont Tax Department saved the day. The new Vermont Tax Return just came off the presses, and they simplified the process. S.55 is complex, but the tax return is not. Understanding prose is often best understood by simply looking at the numbers.

The track changed. The curve ahead reveals where we are now.

THE TRAIN ~ BEFORE & AFTER S.55
SINGLE TAXPAYER

Estate Size	Vermont Tax Before			Vermont Tax After			
	State	Fed	Total	State	Fed	Total	Difference
$3,000,000	$100,000		$100,000	$40,000		$40,000	($60,000)
$3,500,000	$229,200		$229,200	$120,000		$120,000	($109,200)
$4,000,000	$280,400		$280,400	$200,000		$200,000	($80,400)
$4,500,000	$335,600		$335,600	$280,000		$280,000	($55,600)
$5,000,000	$391,600		$391,600	$360,000		$360,000	($31,600)
$5,500,000	$450,800		$450,800	$440,000		$440,000	($10,800)
$6,000,000	$510,800	$15,680	$526,480	$520,000	$12,000	$532,000	$5,520
$7,000,000	$638,000	$364,800	$1,002,800	$680,000	$348,000	$1,028,000	$25,200
$8,000,000	$773,200	$710,720	$1,483,920	$840,000	$684,000	$1,524,000	$40,080
$9,000,000	$916,400	$1,053,440	$1,969,840	$1,000,000	$1,020,000	$2,020,000	$50,160
$10,000,000	$1,067,600	$1,392,960	$2,460,560	$1,160,000	$1,356,000	$2,516,000	$55,440
$20,000,000	$2,666,800	$4,753,280	$7,420,080	$2,760,000	$4,716,000	$7,476,000	$55,920

The numbers on the chart above were based on doing tax returns before and after S.55. The calculations are based on a single taxpayer. A married taxpayer would show a different tax as a result of federal portability and estate planning. For example, a $10,000,000 total estate using a credit shelter trust, would incur a tax of $671,200 before passage of S.55, and $720,000 after passage. Did our legislators realize that the tax went down for the smaller, "wealthier" estates but actually went up for the larger, "wealthier" estates? An estate of 6 million increased from 5.11% to 5.20%.

Some of the "other changes"

Before S.55, larger estates (above approximately 3.3 million) were able to save the Vermont tax by making gifts. Now, gifts will be brought back into the estate if death occurs within two years of the gifts (exclusion gifts up to $14,000 per donee per year are not taxed). Out-of-state real and personal property will no longer be taxed, but the break is not as much as anticipated. For example, one would think a $4,000,000 estate consisting of Florida real estate valued at $500,000 would save $80,000 (16%). The actual savings: $25,000. And.......Vermont did not address portability.

Portability

Vermont does not have "portability". Portability saves taxes for estates above $2,750,000. S.55 did not address portability. Portability may not be on the train. Portability is not like decoupling. For me, it does not evoke emotion. It simply says "How do I explain this to people who didn't go to law school?" So here is my latest version: Picture you and your spouse getting on a train with two suitcases..... each suitcase has the exemption. If you simply left your estate to your spouse, in the past you lost one of the suitcases. If you went to a lawyer, she or he would save the first suitcase by using a trust. Congress felt sympathy. If you forgot to go to a lawyer, they now give the surviving spouse the lost suitcase.

Not so for Vermont. For example, a couple with an estate up to $10,900,000 (double the federal exemption of $5,450,000), all in joint name, would be subject to a federal estate tax of zero. A Vermont married couple with an estate of $5,500,000 (double exemption of $2,750,00) held in joint name, would be subject to $440,000 upon the second death, which could have been avoided if the couple went to a lawyer. Our Vermont legislators may want to consider, when we are in heaven or purgatory or wherever, our feelings of guilt if we procrastinated and our heirs lost $440,000.

CAN YOU TRUST THE BAGGAGE HANDLER ON THE TRAIN?

Speaking of guilt, our legislators should have a reason to feel guilty with S.55. Now, gifts made in the last two years will be drawn back into the Vermont estate. Until the passage of S.55, many gifts were not subject to tax, and those completed in the last two years cannot be unraveled; absent clarification either by legislation or costly litigation.

Last year, a lawyer advised a client with a very short life expectancy to make a gift of property of low basis stocks in order to save approximately $380,000 in Vermont taxes. The lawyer knew that when gifts of appreciated securities are made, the client would pass on the future capital gains that would otherwise disappear if the securities were held by his client upon death. He ran the calculations. The future capital gains tax would cost less tax than the pending Vermont estate tax. He relied on a law that clearly defined what he could do for his client. Now he is at risk that his client's estate

will still pay both the Vermont estate tax and the subsequent capital gains taxes if his client dies within 2 years of the gift. Our lawyers need to rely on our tax laws and not have the laws change retroactively.

THE COMPLEXITIES OF PERCEPTION

When Vermont decoupled, many lawyers and estate planners sensed a change in their wealthier clients. Does their wealth now make them an outsider?

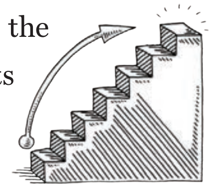
One of my heroes, President Franklin Roosevelt, defended his tax reforms as a means to slow the concentration of wealth. "Such inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our Government," he told Congress in 1935.

Our tax laws are often key to the sense of belonging, fairness and economic stability. Most often the best place to deal with these issues is at the federal level, if possible. Often, such as the implementation of EGTRRA, we have to deal with the byproduct of changes to federal law and its implications. EGTRRA changed our Vermont estate tax. We may simply want to restore that which we lost. But do we understand its true implications?

As our legislators struggle with the responsibility of balancing the budget, some are sensitive to the more complex component of the distribution of wealth. Those that want to maintain or increase the estate tax and those that want to "couple", so that Vermont has the same exemptions as the federal exemption, may have one thing in common: a balanced budget. What will be the impact, long-term, if the wealthy leave?

GRADUALISM

Attempts have been made to project the loss in revenue if we match our exemption to the federal exemption. Some proponents advocate a gradual increase. Some states have passed "gradualism"[1].



New York, for example:

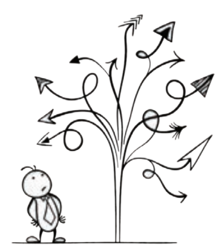
- Deaths between April 1, 2014 and March 31, 2015: $2,062,500
- Deaths between April 1, 2015 and March 31, 2016: $3,125,000
- Deaths between April 1, 2016 and March 31, 2017: $4,187,500
- Deaths between April 1, 2017 and December 31, 2018: $5,250,000
- Deaths on or after January 1, 2019: New York exemption will match the federal exemption.

Some States dispensed with gradualism. Maine's exemption jumped from $2,000,000 in 2015 to the federal exemption in 2016. Some states simply got rid of the tax and one of our neighboring states, Connecticut, lowered the exemption from $3,500,000 to $2,000,000, but also lowered the top rate from 16% to 12%.

Leaving Vermont grows more attractive the larger the estate. I know someone who has an estate of approximately 10 million. His plan was to leave everything to his wife and she would leave everything to him. He would avoid all state taxes. The survivor would move to Florida. The savings in Vermont tax: $1,160,000. For the moment, their estate plan keeps them in the Vermont. They went to a lawyer who designed credit shelter trusts and reduced the projected tax to $720,000. As they get older, saving $720,000 for their children by simply moving to Florida is often considered at the dining room table rather than infrequent trips to the lawyer's office. Another client found a retirement home near and dear to him in Vermont but plans on selecting a retirement home in New Hampshire unless Vermont changes its estate tax.

Wealthier families often participate actively in local non-profits. They donate both money and time and energy. If they leave, time and energy will be the first casualty, and money may shift to where they reside.

Attempts have been made to project the loss in revenue if we match our exemption to the federal exemption. S.55 may have been designed to protect the projected revenues for the next two years by curtailing deathbed gifts.



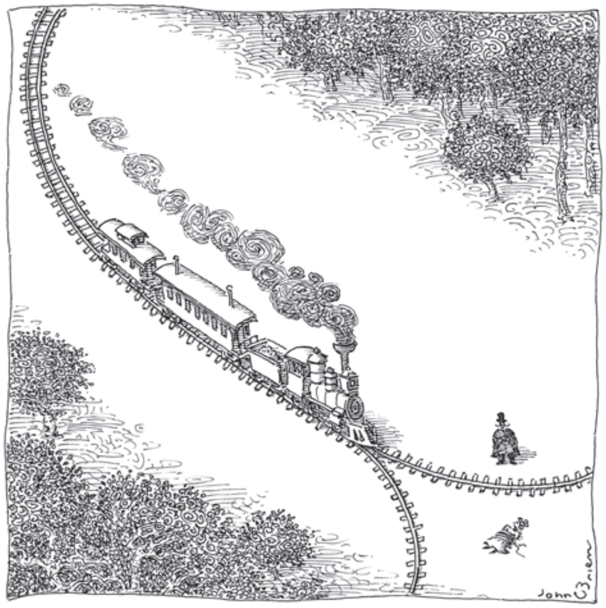
How do you project lost revenues? If we drive businesses out of state, what will happen to the State's bottom line?

Wealthier Vermonters tend to add to the bottom line in so many different ways. In addition to the non-profits, family businesses, craftsmen, tradesmen, local bankers, lawyers, trust officers and many others benefit if they stay in town. If we drive them away, we decouple them.

Where is the train going? If we reconcile with our past partner, the Fed, and couple with the federal exemption, only the very large estates will be taxed. Should we couple? Should we abolish the tax altogether? Based on existing law, without further changes, the light at the

[1] *Unlike "decoupling" and "portability", "gradualism" is my creation and I am willing to share it without attribution.*

end of a tunnel is a train going south with stops along the way: Virginia, North Carolina, South Carolina, and Florida.



Afterthoughts, Extra Thoughts & Grumblings

For Lawyers:

If you are unhappy with S.55 not grandfathering gifts made in the last two years, oddly enough there is a Supreme Court case that stated that our legislators can change the rules after the fact that may actually help you. In United States v. Carlton, 512 US 26-1994, the Supreme Court rejected a Due Process challenge to the retroactive elimination of an estate tax deduction. Favoring the IRS, the court's position also gave us guidelines where we can challenge the retroactive change in a tax law such as length of time, whether the change was designed "... to correct what it reasonably viewed as a mistake in the original provision.....", and whether the amendment was designed to bring in revenues.

For Trust Officers:

On second thought, trust officers who depend on tax-savings trusts for those who don't want to leave, may see less business if we increase the exemption. If Vermont enacts portability, trust officers may be on a train. The train will be going south but only needs to go as far as Massachusetts, where the exemption is only 1 million, and no portability. But don't worry. Don't buy the ticket yet. There are so many other reasons to use trusts to protect beneficiaries and save probate costs.

For those who market Vermont:

Discard the 16% cap. Tell Kiplinger the top rate is not 16%. The top rate may look like 16% but it will never get to 16%. Change the prose and look at the numbers. Look at the effective rate. The effective rate is the tax divided by the taxable estate. The picture would be different. Larger estates can deduct the Vermont tax which reduces the federal tax. Simply comparing a Vermont estate to a Florida estate, which has no estate tax, and subtracting the difference, is the effective rate for the Vermont tax. It is that simple. Here is the effective rate:

Estate	Vermont Effective Rate
$3,000,000	1.33%
$3,500,000	**3.43%**
$6,000,000	5.07%
$10,000,000	**6.88%**
$20,000,000	8.24%

Well, 20 million is a small estate for plutocrats. Perhaps the rate will start to look like 16% if we have a 100 million dollar estate. The effective rate is 9.3%.

For those who own family farms in Vermont:

Don't worry. If your principal asset is a family farm (more than 35% of your taxable estate), your family farm will not be taxed. This law has been on the books for years.

For Sen. Ginny Lyons, D-Chittenden, the sponsor of the bill:

Kudos for the "interim" bill. You corrected an inequity. Before S.55 the tax rate for a 3.5 million estate was greater than a 10 million dollar estate.

~ Jack Davidson

(Jack's opinions, wandering thoughts and grumblings are purely his own and do not necessarily represent the views of TCV.)