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Trust UPDATE

Stillman BANK

The 2012 top ten questions about trusts

What do you think of when you hear the words "trust fund"? Many people will associate those words with the Kennedys, the Rockefellers or the financial titans of the 19th century. For a more recent example, think of Steve Jobs. But you don't need to have megawealth to benefit from a trust-based wealth management plan, thanks in part to advances in technology. More and more affluent families these days are exploring the unique financial management and financial protection advantages of trusts. Here are questions that we hear frequently, and our answers.

1. What can a trust do for me and my family?

Trusts provide a structure for family financial protection; they deliver financial resources to multiple beneficiaries over a span of time. See the sidebar on page two for a listing of some of the uses of trusts.

2. How old should you be to set up a trust?

There is no "best age" for setting up a trust. As a practical matter, a great many people first give serious consideration to establishing a trust as they approach retirement, or when they do their estate planning.

3. How are trusts different from other investment accounts?

A trust has an independent legal existence. That makes it more durable than an ordinary investment account, because the trustee continues to perform its duties upon the disability, or even the death, of the trust's creator.

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. . . you don't need to have megawealth to benefit from a trust-based wealth management plan . . .

4. What is "fiduciary duty"?

This question comes up because Congress and the SEC have been debating whether to increase the duty of care that financial advisors owe to their clients. The highest such level is "fiduciary duty," and it is the level that always has applied to the trust industry. In a nutshell, to fulfill our fiduciary duty to our clients, we must put their interests ahead of our own.

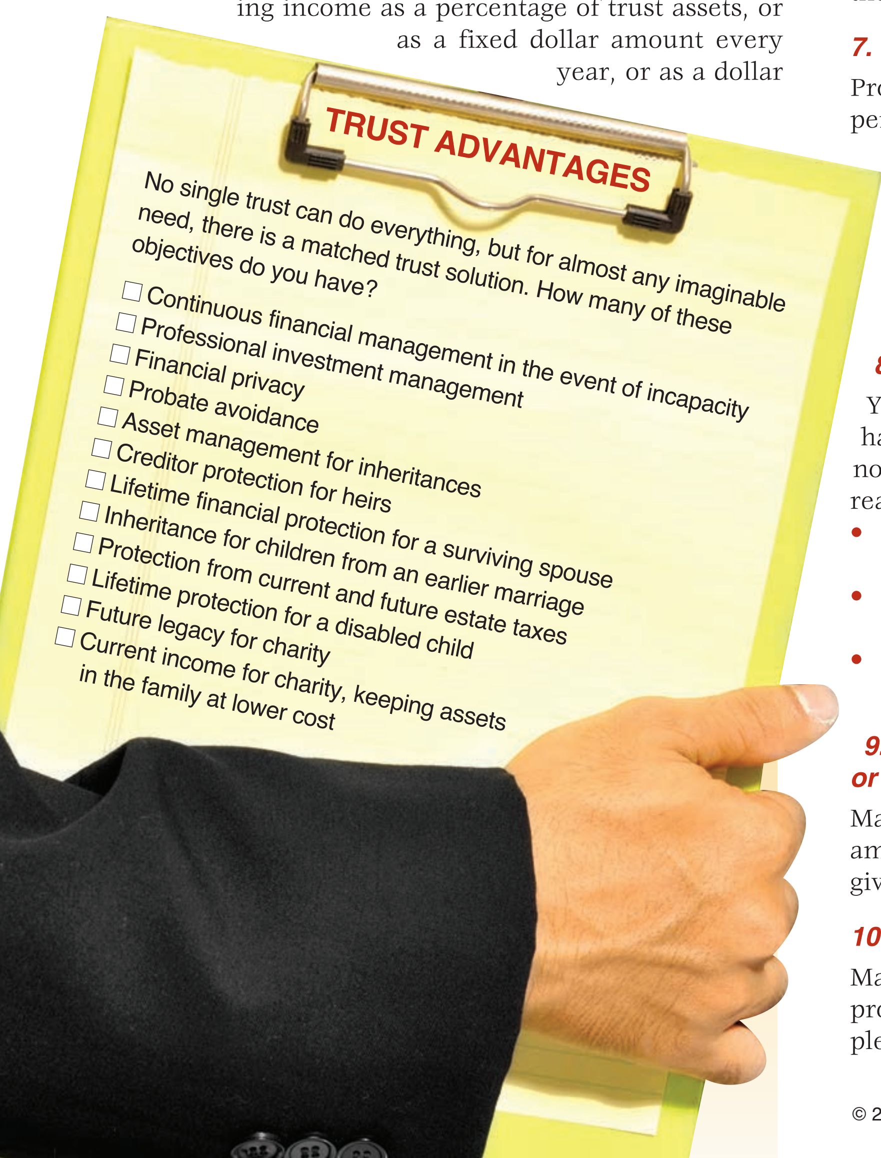
We are very comfortable working within the legal strictures set by fiduciary duty, given our daily experience of it.

5. How much income can I get from a trust?

The very low interest rates in 2012 have meant that many investors have not been satisfied with their portfolio income. Everyone would like more income, but without more risk, which leads to the question about trust income.

Using a trust doesn't necessarily change the amount of income that a portfolio generates. In a traditional trust, "income" means collected interest and dividend payments. With that approach, as interest rates and dividend yields rise and fall, income changes with them. Changes in asset values—growth in stock prices, for example—accrue to the remainder beneficiaries.

Some trusts today take alternative approaches, defining income as a percentage of trust assets, or as a fixed dollar amount every year, or as a dollar amount adjusted for inflation—there are many alternatives to consider. However, if a fixed percentage is used to determine distributions, and the income falls short, the trustee will have to invade the principal to make up the difference.



6. Are trust assets secure?

Unlike bank deposits, which become assets of the bank on its balance sheets, the assets of trust accounts are held completely separate from a bank's own assets. The bank has no access to its trust assets. It cannot borrow against the value of trust assets, nor can it lend the assets themselves for any purpose. In the unlikely event of a bank failure, its trust accounts would be transferred to a healthy bank under the supervision of government regulators.

Each trust in our care is managed in accordance with an investment plan matched to the desires of the trust's creator and the needs of the beneficiaries. The trust managers use a disciplined process of diversification, sometimes called *asset allocation planning*, to balance investment risks and rewards.

Does that mean that the value of trust assets can't go down? No, it does not. Trusts are subject to the same market forces as any other investment account. There's no point in sugarcoating it—when the bottom falls out of the market, it falls out for everyone.

7. How do I avoid probate?

Probate is the court-supervised implementation of a person's last will and testament, and it is necessarily a public process. To avoid publicity, many wealthy families rely extensively upon trusts, which are not normally made public.

We generally recommend using a revocable living trust with a corporate trustee, such as us, when probate avoidance is an important objective.

8. Can I be my own trustee?

Yes, you can be the trustee of your trust, or you can have a trusted family member be the trustee. But that's not a course we would recommend. Some very important reasons to let us be trustee of your trust are:

- To gain access to unbiased, professional management of your assets.
- To have someone available to stand in your financial shoes should illness or incapacity strike.
- To provide financial support for your loved ones during your lifetime and beyond.

9. Can I change my mind about my trust, or is it permanent?

Many people begin with a revocable trust, which can be amended or terminated at any time. That way they can give the trust idea a "tryout" to see how they like it.

10. How can I learn more about trusts?

Make an appointment to meet with one of our trust professionals at your earliest convenience. We will be pleased to tell you more. ☐

Year-end portfolio planning, 2012 edition

While politicians have been debating the wisdom of adding another income tax bracket or two for the highest-income taxpayers, the more serious issue for investors is the looming increase in the tax on capital gains. Boosting the top income tax rate from 35% to 39.6% is an increase at the margin of 13.1%, which qualifies as "modest." Expiration of the "Bush tax cuts" for the wealthiest, plus implementation of the new Affordable Care Act taxes on investments, will lift the tax rate on long-term capital gains from 15% in 2012 to 23.8% in 2013. That's a 58.6% increase in the tax rate!

That means, if you are George Lucas, you sell your Star Wars franchise to Disney in 2012, locking in the lower taxes. The same logic may apply in portfolio management.

Example. Pat, a top-bracket taxpayer, has a 1,000-share position in XYZ stock that is worth $200,000. He bought the shares long ago, for $20,000, so his gain is $180,000. Pat has felt for some time that he should diversify out of the XYZ stock, but he has been put off by the tax cost of doing so. He'll owe $27,000 in taxes if he sells this year. Waiting until January to sell, assuming no change in the share price, his tax bill zooms to $42,840.

The tax pressure to accelerate sales of appreciated assets is evident. However, what if Pat does not want to diversify? Can he sell his shares and repurchase them? Should he do that?

The wash sale rules bar claiming a capital loss on the sale of stock if identical shares are repurchased immediately. The rule does not apply to gains. So Pat could sell and repurchase the shares to take advantage of this year's tax rule.

Two paths

Whether that's smart investing is a more difficult question. After he's paid the taxes, Pat's portfolio will be smaller; he'll have just $173,000 working for him. True, his basis will be higher, so his exposure to future taxes will be reduced. But if the market enters a strong growth period, it might well be that Pat would be better served by deferring taxes, even if they will be imposed at higher rates. See the box below for details.

Still better, if Pat wants to stick with his XYZ investment for the long term, perhaps he can wait to sell the shares during retirement, when he may be in a lower tax bracket again. In that case, he has the full amount of his investments working for him today, and the benefit of lower rates in the future.

See your tax advisors before making any final decisions. ☐

Sell now or sell later?

This table tests whether it is better to sell appreciated shares of stock in 2012, to lock in lower capital gains tax rates, or to defer all taxes until a future date, even if tax rates are higher then. The table assumes that an asset worth $200,000 has a tax basis of $20,000, so a sale in 2012 requires a tax payment of $27,000. The remaining $173,000 is reinvested in the same stock, and after-tax accumulations are compared for various holding periods and two rates of return. The capital gains tax rate on a disposition after 2012 is assumed to be 23.8%, and the table shows the after-tax proceeds on these assumptions. The table shows that the longer the holding period and the higher the rate of return, the better it is to defer all payment of taxes until the future.

	No sale in 2012		Sale and reinvestment in 2012	
Year	4% return	8% return	4% return	8% return
2	$169,596	$182,519	$183,757	$194,936
4	$183,046	$212,099	$195,392	$220,522
6	$197,595	$246,600	$207,976	$250,365
8	$213,330	$286,842	$221,587	$285,175
10	$230,349	$333,780	$236,309	$325,776

Source: M.A. Co.

The case of the missing inherited IRA

Here's an unfortunate story that we heard recently.

"My brother Sam was divorced three years ago. He has a fair amount of assets in a 401(k) plan and in an IRA. He planned for these assets to go into a trust for his three children, who are all minors. Sam saw an estate planning attorney, who drafted a new will for him and the necessary trust documents, and also provided the beneficiary designation forms for the retirement accounts. The documents were under review, but there was no problem. Sam had done everything except sign the forms.

"Then Sam was killed in a car accident. So the IRA, which has no beneficiary, apparently must be paid to the estate. Sam's ex-wife is still the named beneficiary on the 401(k) plan—must she get that? Isn't there some way that inherited IRAs can be set up for my nephews, so that the money can be set aside for their future college expenses?"

This unfortunate tale points up just how important it is to finish the job of estate planning. None of us can know when the estate plan will be required, so it must be made ready.

There is no way to create inherited IRAs for the nephews now that Sam has died, even though it is certainly what he wanted, based upon all the available evidence. Without a named beneficiary, all the IRA money must be distributed and taxed during the five years following Sam's death.

The odds are that the ex-spouse will inherit the 401(k) money, unless there was a Qualified Domestic Relations Order served on the plan sponsor to the contrary, although state laws vary on this point. Unless the divorce decree provided otherwise, Sam could have changed this outcome at any time after the divorce was final simply by filing a change of beneficiary designation form. There's an argument to be made that the fact that he didn't do so meant he wanted the 401(k) account to go to his ex after all.

If you haven't finished your estate planning yet, why not resolve to complete it this holiday season? ☐