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Trust UPDATE

Stillman BANK

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Practical trust plans

The emergence of "quiet trusts"

At the 2013 Berkshire Hathaway annual shareholders' meeting, one attendee raised the question of estate planning. Warren Buffett is known to advocate giving children an inheritance large enough so that "they can do anything, but not so large that they can do nothing." "How much is that?" the shareholder asked.

Mr. Buffett declined to name a dollar figure, suggesting that the behavior of heirs is influenced more by the conduct of their parents than the amount of money they receive. Charlie Munger, also on the dais with Mr. Buffett, seemed to object to the question, saying that it's a bad idea to discuss estate planning with one's children.

Mr. Munger may represent the majority view.

The 2012 trust picture

Last year was one of grave uncertainty for estate planners and affluent families. There was a threat that the amounts excluded from estate and gift taxes would be curtailed drastically, as a result of a "sunset" provision in a 2010 tax law. One recommended strategy for wealthy families was to "lock in" the higher exclusions before they expired. As it turned out, Congress extended those exclusions and made them permanent. Nevertheless, before the issue was resolved, a record number of personal trusts were established in furtherance of this strategy.

An item in *The Wall Street Journal* ("Can You Trust Your Kid with $5.25 Million?" January 18, 2013) suggested that some of these transfers were made in trust for younger beneficiaries before the parents were ready to discuss the matter with them. The recommended solution: a "quiet trust," or "silent trust," in which the beneficiary is kept in the dark about his or her trust benefits until reaching a specified age, perhaps 21, 35, or even 50. Such trusts are explicitly permitted in 13 states and implicitly allowed in another 19, according to the story.

Parents or grandparents who decide on a quiet trust evidently are fearful that even the knowledge that a trust exists will sap a younger person's ambition, even if the trust doesn't provide the person with current income. On the other hand, many people are sympathetic to Warren Buffett's views. If young adults haven't yet developed sound values in money management, keeping them unaware of the extent of family financial resources is not likely to help.

Every family situation is unique, but our bias would be toward greater communication with all trust beneficiaries, not less. Still, it is the trust grantor's money, so his or her wishes are paramount.

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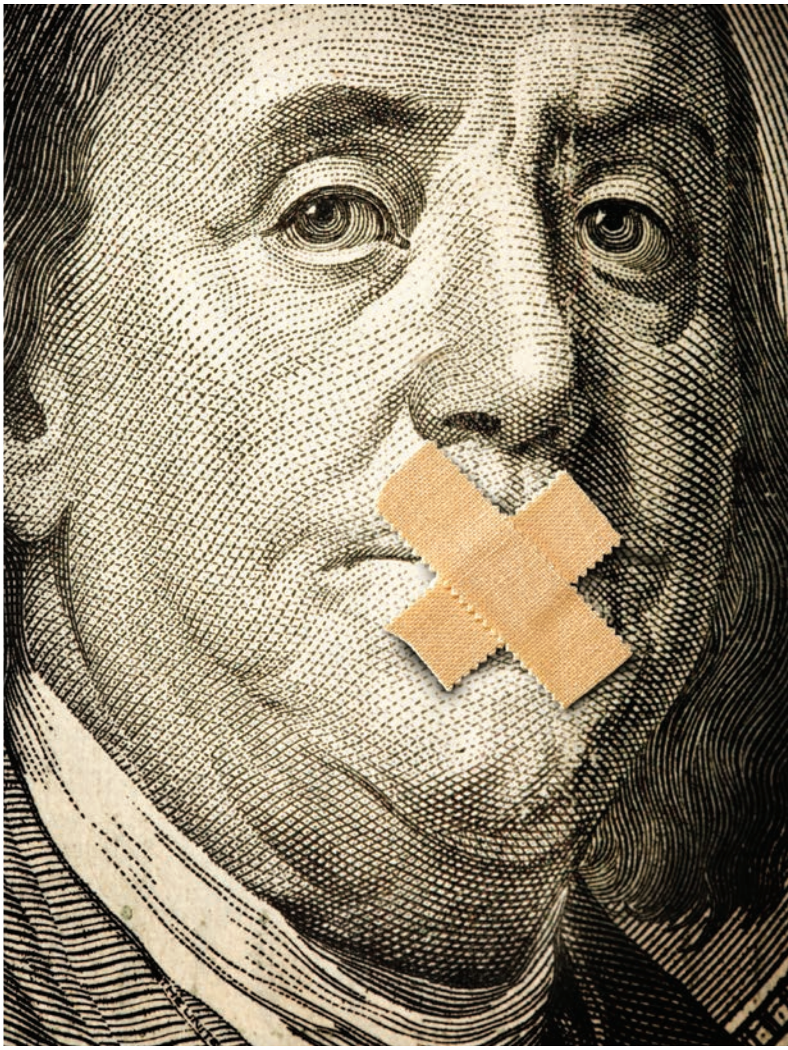


Practical trust plans . . . continued

Benefits from today's trusts

With their great flexibility, trusts can be crafted to achieve a wide range of financial and estate planning objectives. This can be especially valuable when beneficiaries from several generations will be affected. Here are some examples.

Asset protection. One of the most frequent questions that we hear is "How can I keep my money and property out of the hands of my son-in-law (or, sometimes, my daughter-in-law)?" The inquiry is understandable, given the high divorce rates in this country. Our answer: Use a trust to own and manage the property, and give your child the beneficial interest in the trust instead of the property. A carefully designed trust plan can protect assets in divorce proceedings and from improvident decisions by impulsive members of the younger generation.

Ensuring an inheritance. Once something of a novelty, multiple marriages resulting in blended families are not unusual today. Someone in this situation might ask us: "I'd like my surviving spouse to have the income from my investment portfolio for life, but the portfolio itself eventually should be divided equally among my children from my first marriage. And I don't want the plan to be altered after my death. Can that be done?"

The Qualified Terminable Interest Property Trust, or QTIP trust, was developed for that very purpose. Such a trust provides a lifetime income to a surviving spouse and secures the benefit of the estate tax marital deduction. The QTIP trust may end when the surviving spouse dies, and assets pass to named beneficiaries. Or the assets may pass to a successor trust for those beneficiaries. Neither the surviving spouse nor any other party has the power to alter the distribution plan.

Flexibility in distributions. In contrast to the certainty of distributions of the QTIP trust, some people are looking for a trustee to use some judgment in deciding how to achieve a trust's larger purpose. We might be asked: "My oldest grandchild is 28; the youngest is just three. In between, we've been blessed with a half-dozen others. I can't predict who will need money for graduate school, who might have a medical emergency, and who might turn into a bum or worse. Can I set some criteria in a trust plan, and then leave the final decisions up to a trustee?"

Yes, you can do just that. We are a corporate fiduciary, and making impartial decisions to allocate distributions among beneficiaries is one of our fiduciary responsibilities.

Our invitation to you

Does your estate plan reflect the values that you wish to impart to your heirs? Would you like more information about the choices that you have when planning your will?

We specialize in estate settlement and trusteeship. We are advocates for trust-based financial planning. If you would like a "second opinion" about your estate planning, if you have questions about how trusts work and whether a trust might be right for you, we're the ones you should turn to. We'll be happy to tell you more. ☐

How to leave your estate to the state

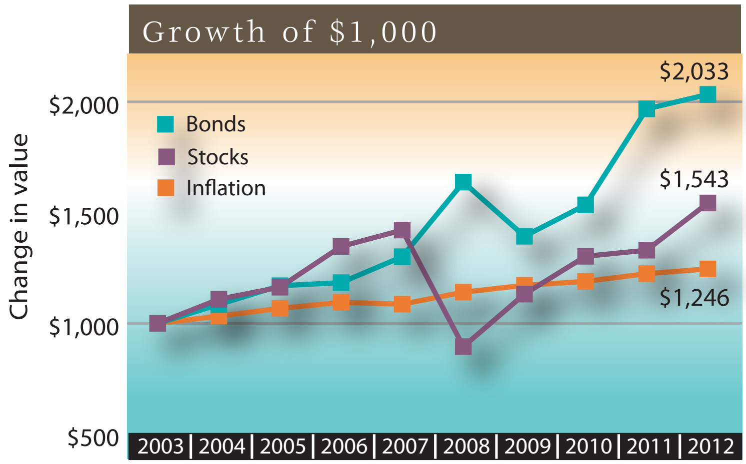
In April *The New York Times* reported on the estate of Roman Blum, who died in January 2012 at age 97. Blum was born in Poland, fled to Russia during World War II, and married a survivor of the Auschwitz concentration camp after the war. The couple lived in a camp for displaced persons in Germany until they emigrated to the United States in 1949. They settled in Queens, New York, joining a closely knit community of Holocaust survivors. Blum became a very successful real estate developer. By one estimate, his net worth at his death was $40 million. But he didn't have a will—or at least none has been produced to date. Roman and Eva Blum never had any children. They divorced after 50 years of marriage. There was a rumor that Roman had relatives, perhaps a first wife and children, back in Poland. However, no relatives have been located who might be eligible to make a claim on the estate.

Reportedly, Roman discussed having a will with his accountant, but he never got around to having one drafted. According to the New York State comptroller's office, $40 million would be the largest unclaimed estate in New York history. When one dies without a will, state laws provide an alternative inheritance plan, formally known as intestate succession. Property may pass to a surviving spouse, to children, to descendants, to other relatives—the exact pattern varies from state to state. If there are no living relatives, the entire estate passes to the state of the decedent's residence. New York State is looking at a $40 million windfall.

The estate tax is sometimes called a voluntary tax, because the wealthy have a great many tools available to reduce the impact of death taxes. In Mr. Blum's case, by not attending in any way to his estate planning, he may have lifted the effective "tax" on his wealth to 100%.

Questions of balance

Investors cheered as stock market indices reached new highs earlier this year. Portfolios do better during periods of economic growth, and the economy has been growing since June 2009, even though the rate of growth is less than most would hope for. Bonds did better in the decade ending at the close of 2012 than stocks did, as the graph illustrates.



Source: *Ibbotson SBBI 2013 Classic Yearbook*; M.A. Co.

However, key supports for high current bond prices are the sustained low interest rates across the yield curve that the Federal Reserve Board has been encouraging. As interest rates rise, bond prices necessarily will fall.

An important contributor to portfolio performance is the asset allocation strategy employed, the mix among stocks, bonds and other portfolio components. For example, in the decade of the 1990s, large-company stocks produced a compound annual return of 18.2%, versus 8.8% for long-term government bonds, according to Morningstar. Stocks have outperformed bonds handily, albeit with greater investment risk, in every decade except the 1930s. However, during the past ten years, the performance of these two asset classes has been pretty close. Here is a comparison of various portfolios, assuming that they are rebalanced each year.

Compound annual rates of return, 2003-2012

Portfolio	Return
100% large company stocks	7.1%
90% stocks, 10% bonds	7.4%
70% stocks, 30% bonds	7.7%
50% stocks, 50% bonds	7.9%
30% stocks, 70% bonds	7.9%
10% stocks, 90% bonds	7.7%
100% long-term government bonds	7.5%

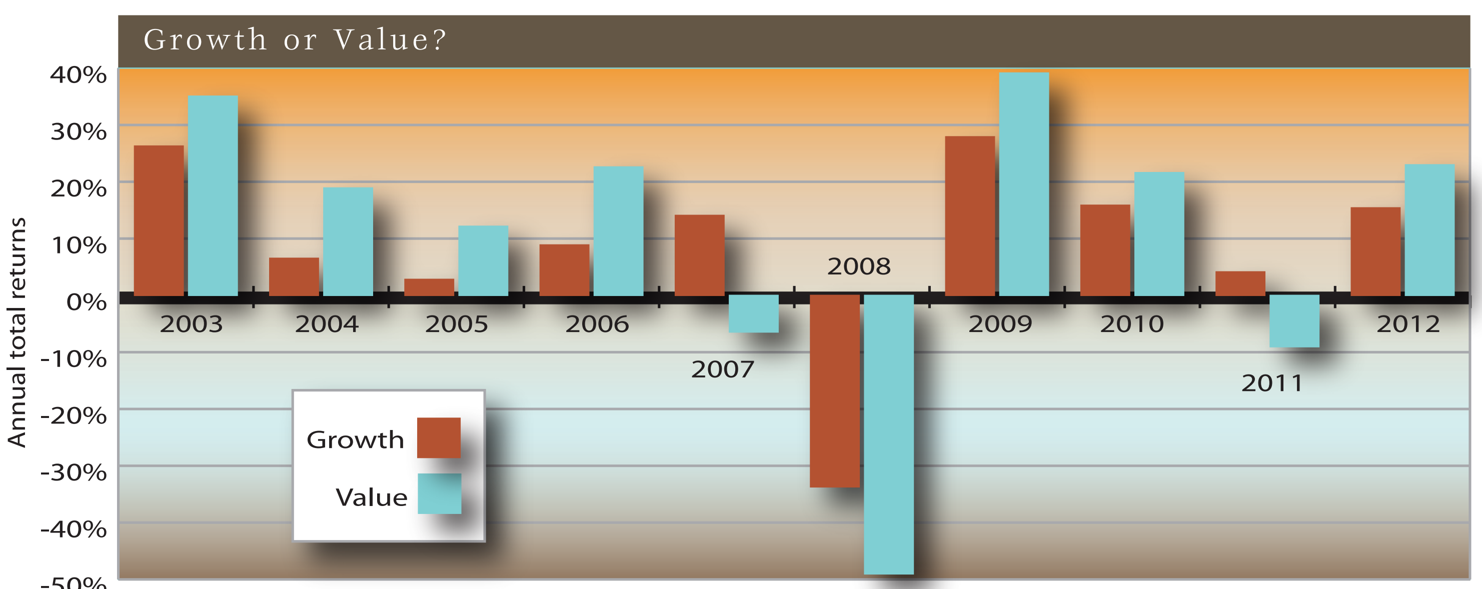
Source: *Ibbotson SBBI 2013 Classic Yearbook*; M.A. Co.

The balanced portfolios did better than those concentrated in either stocks or in bonds.

Equity styles

Investment analysts sometimes categorize stocks as growth or value choices. Growth stocks have relatively higher rates of increase in earnings, sales or return on equity. As investors are hoping for more of the same, growth stocks typically will have relatively high price-to-earnings ratios (P/E). Value stocks will have lower P/Es and higher dividend rates. Value-oriented investors believe that the prices of such stocks have been beaten down unfairly, below "intrinsic" value, and so the shares are poised for a comeback.

During the 2000s, large-cap growth stocks had a negative compound rate of return, -1.8%, according to Morningstar. Large-cap value stocks stayed in the black, with a meager 0.3% return. During the past ten years, the overall advantage goes to growth stocks, 7.3% return compared to 7.1% for value issues. The graph below breaks out the performance year by year. ☐



Source: *Ibbotson SBBI 2013 Classic Yearbook*; M.A. Co.

Audit stats

In March the IRS published its 2012 IRS Data Book, tabulating the tax returns and audit activity for the fiscal year that ended September 30, 2012. Some 237 million tax returns were filed in fiscal 2012, and the IRS collected nearly $2.5 trillion in revenue. The chance of being audited that year was about one in 100.

However, the higher one's income, the greater the audit risk. Some 2.67% of tax returns showing zero adjusted gross income were selected by the IRS for examination. In the range from more than zero to less than $200,000, which accounted for 94% of all tax returns, audit coverage was closer to 0.80%. Above that income level, the audit rate rises sharply, as shown below:

IRS 2012 tax audit coverage

Income range	Percentage of all returns	Percentage of returns audited
$200,000 - $500,000	2.41%	1.96%
$500,000 - $1 million	0.38%	3.97%
$1 million - $5 million	0.18%	8.90%
$5 million - $10 million	0.01%	17.94%
Over $10 million	0.01%	27.37%

Source: *2012 IRS Data Book;* M.A. Co.

Being audited by the IRS isn't necessarily bad news. Of the 1.5 million individual tax returns examined, nearly 54,000 resulted in additional refunds. Or in mathematical terms, if you've been unlucky enough to draw the one in 100 chance of being audited, you might yet be among the one in 27 who receive a refund instead of a higher tax bill.

The Tax Watch blog has reported that the overall audit rate for 2012 was down about 5.3% from the previous year, and early indications are that the trend may continue this year. Sequestration may mean fewer IRS agents available to conduct examinations. However, even if the odds are improving in favor of the taxpayer, this is a lottery that one should avoid playing. In fact, the rate of correspondence audits is growing. These are audits conducted by mail based upon IRS software used to match reported income with Form 1099s.

That matching has been made easier by the dramatic shift to electronic filing of tax information. In 2012 the IRS received over 2.23 billion information returns, of which over 1.98 billion were electronic. Only 38 million information returns were on paper, with the balance categorized as "other."

Final note: From calendar 2010 to calendar 2011, the IRS reported that math error notices sent to taxpayers more than doubled, from 1.2 million to more than 2.7 million. Still, that is an astonishingly low error rate for something as complex as the Form 1040. ☐