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Trust UPDATE

Why your family may need a corporate fiduciary

The terms "fiduciary" and "fiduciary duty" keep cropping up in the news.

- In March the Government Accountability Office (GAO) issued a report on rollovers from qualified retirement plans when an employee separates from service. The agency found that plan service providers tended to favor IRA rollovers in their advice, downplaying the admittedly more complicated options of leaving the money in the former employer's plan or rolling it into a new employer's retirement plan. GAO recommended extending the definition of "fiduciary" to cover these advisors. Industry spokesmen objected, warning that such a change to legal obligations of advisors likely would decrease communication and ultimately be counterproductive.
- The Dodd-Frank bill in 2010 directed the Securities and Exchange Commission (SEC) to study the idea of imposing fiduciary duties on all stockbrokers, a standard that already applies to investment advisors. The idea is not without its critics. In March the SEC released a white paper on the subject, and requested additional industry feedback (http://www.sec.gov/rules/other/2013/34-69013.pdf). Industry resistance may be expected.

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The fiduciary standard is the highest standard of care recognized by the law. A salesman is under no obligation to determine that his product is appropriate for a buyer, or that the buyer can afford it, or that the purchase is in the best interests of the buyer. A fiduciary *does* have those obligations and more.

The fiduciary duties of every trustee

The fiduciary standard always has applied to trustees and their dealings with beneficiaries. The simplest way to explain it is that the interests of the beneficiaries must come first, ahead of the financial interests of the trustee. However, that generalization can be expanded to cover more specific obligations or duties owed to beneficiaries.

- ***Duty to administer a trust by its terms***. Every trust agreement should make plain the purposes of the trust, as they provide the critical benchmarks for evaluating the trustee's actions.
- ***Duty of skill and care.*** A high standard of performance is required, even if an amateur is named who has no prior experience as a trustee.
- ***Duty to give notices.*** Notices may concern legal rights of the trust beneficiaries, such as a power to make withdrawals, or they may cover such ministerial matters as designating a successor trustee or an agent to assist in trust administration.
- ***Duty to furnish information and to communicate.*** The trustee must respond to requests from beneficiaries concerning the trust and its administration.
- ***Duty to account.*** A written accounting of the assets, liabilities, receipts and disbursements of the trust must be provided to the beneficiaries regularly.
- ***Duty not to delegate.*** Although a trustee may employ professionals to assist in trust administration, the trustee may not accept blindly the advice of such persons. The trustee retains supervisory responsibility. Matters concerning the exercise of judgment and discretion generally cannot be delegated.
- ***Duty of loyalty.*** Trusts must be administered solely for the benefit of the trust beneficiaries.
- ***Duty to avoid conflict of interest.*** This is closely related to the duty of loyalty, and may come up when a beneficiary is named as cotrustee. Generally, the trustee should not engage in transactions with the trust unless such activities are authorized by the trust.
- ***Duty to segregate trust property.*** Trust assets must not be commingled with personal funds or other nontrust assets.
- ***Duty of impartiality.*** The trustee must not favor one beneficiary over another, unless the trust document directs that providing for a particular beneficiary is a principal purpose of the trust.
- ***Duty to invest.*** Trust assets must not be left idle. In addition to making the trust investments, the trustee has a duty to diversify the investments and develop an asset allocation plan. This is a job for professional investors or corporate fiduciaries.
- ***Duty to enforce and defend claims.*** Reasonable steps must be taken to protect the trust from adverse claims and enforce the rights of the trust and its beneficiaries.
- ***Duty of confidentiality***. Normally, the terms of a trust, the identity of its beneficiaries and their respective interests, and the nature of the trust assets cannot be disclosed to anyone except the beneficiaries and those who need such information in order to be able to administer the trust.

Add in corporate characteristics

Given this list of responsibilities, one easily can see the value of corporate fiduciaries, organizations such as ours, dedicated to trust administration as a business. To be in the business of administering trusts and estates, trust companies and bank trust departments are granted "trust powers" by financial regulators. With these powers come regulatory supervision as well as the legal duties of every trustee.

Individuals may serve as trustees. Some talented individuals do so serve. However, as a rule, a corporate trustee will be a better choice because a team of professionals will have the responsibility for trust management. The team approach provides:

- better infrastructure support for accounting and recordkeeping;
- broader investment sophistication;
- permanence and availability—the whole team doesn't go on vacation at once;
- judgment and experience.

Another very important advantage of a corporate trustee for many families is the ability to be impartial, and to be recognized by all family members as a neutral decision maker. A trust typically has current income beneficiaries and future or remainder beneficiaries. The interests of both types of beneficiaries must be balanced carefully. Conflicts need to be resolved by a trustee respected by all parties. ☐

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The IRS' "dirty dozen" for 2013

Each April the Internal Revenue Service alerts the public to a list of notorious tax scams. The 2013 scams were largely a reprise of those of 2012, so the report this year was a progress report—or, rather, a lack of progress report.

Identity theft

How many IRS personnel work on the problem of identity theft? Would you believe 3,000? Plus, 35,000 employees are trained to help taxpayers who are concerned about identity theft.

Identity thieves have been filing false tax returns, claiming fraudulent refunds. The issue is big, and getting bigger. In 2011 the IRS intercepted and prevented $14 billion in fraudulent refund claims. That figure ballooned to $20 billion in 2013.

For those who believe that they are at risk, call the IRS Identity Protection Specialized Unit at 800-908-4490.

Phishing

How do scammers obtain information on taxpayers? Typically, with false Web sites or spam e-mail that requests private information. Remember, the IRS never uses e-mail to contact taxpayers, so any such e-mail is fraudulent and should be reported to phishing@irs.gov.

Return preparer fraud

About 60% of taxpayers rely upon paid preparers. The vast majority of tax preparers are honest, but, evidently, there are a few bad apples out there. There's a new Web page on the subject, www.irs.gov/chooseataxpro.

Hiding income offshore

Offshore financial accounts are not illegal, but they have been used for illegal purposes, specifically hiding wealth from the IRS. There are important reporting requirements for offshore accounts now, and heavy penalties for noncompliance. The IRS ran a quasi-amnesty program for holders of foreign financial accounts who came forward voluntarily. Since 2009 some $5.5 billion in taxes have been collected from them.

"Free money" from the IRS and tax scams involving Social Security

Scammers have been preying on low-income individuals, the elderly and members of church congregations with promises of free money for making fictitious claims for refunds. Sometimes the scam is salted with references to legitimate credits, such as the American Opportunity Tax Credit. Other scams involve promises of Social Security refunds or rebates.

Impersonation of charitable organizations

One particularly repellent fraud occurs after a significant natural disaster, such as Superstorm Sandy. Scam artists may pose as charities, either to collect donations to help those affected or to offer assistance. In some cases they may claim to be working for the IRS to help victims file casualty loss claims and get tax refunds. They can use that private information for identity theft.

False or inflated income and expense

Oddly enough, some taxpayers may report more income than they actually receive, if doing so increases their eligibility for refundable credits. One example is the claim for the fuel tax credit, which may be allowable to farmers and others for off-highway business use of fuel. Erroneous refunds will have to be repaid, with interest and penalties.

False Form 1099 refund claims

Have you heard that the federal government maintains secret accounts for U.S. citizens and that taxpayers can access their accounts with Form 1099 OID? The story is going around, apparently, and it is entirely false.

Frivolous arguments

There is a wide range of arguments as to why no one really *has* to pay income taxes. They have all been debunked. The IRS maintains a list of them at http://www.irs.gov/Tax-Professionals/The-Truth-About-Frivolous-Tax-Arguments-Introduction.

Falsely claiming zero wages

Filing a Form 4852 (Substitute Form W-2) or a "corrected" Form 1099 is a technique for improperly reducing taxable income to zero. Filing returns relying upon such claims runs the risk of a $5,000 penalty.

Disguised corporate ownership

IRS continues to work with state authorities to identify sham corporations that obscure the true ownership of business interests.

Misuse of trusts

We have a professional stake in this one. Trusts are legitimate wealth management tools, but they do not usually lead to income tax savings. In particular, trusts cannot be used to convert personal expenses into tax deductions. Check the credentials carefully of anyone who says otherwise. ☐

Penalties on the innocent

A taxpayer, let's call him Bob, left his job and received a lump sum payout of his pension accumulation. Let's say the payment was $100,000. To protect the retirement nest egg, Bob rolled the entire amount over to an IRA. Unfortunately, and unbeknownst to Bob, there had been a serious mistake by the pension plan administrator in calculating his lump sum, and Bob was paid more than he was due. Years later, when the mistake was discovered, Bob was required to repay $20,000 to the pension plan. He took the money for the repayment from his IRA rollover.

Tax consequences?

For Bob, there are three separate tax problems here, according to the IRS Chief Counsel Advice that analyzed the situation.

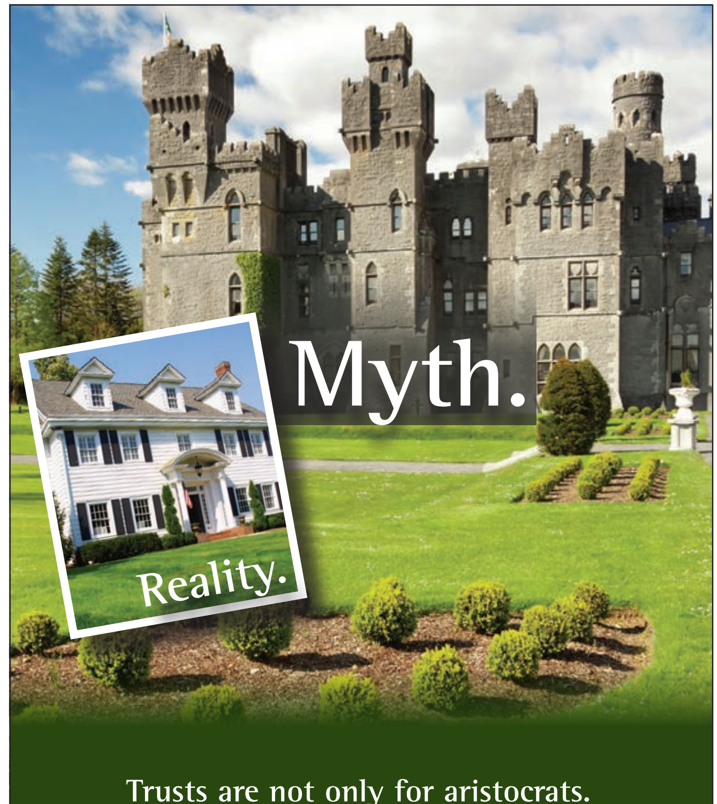
First, Bob was only eligible to roll $80,000 into the IRA the year that he received the lump sum distribution, even though he had no way to know that. The excess $20,000 should have been included in his taxable income that year. However, in the fact pattern the IRS stipulates that so much time has elapsed since the rollover that a collection of that tax is now barred by the statute of limitations.

Second, the extra $20,000 rolled into the IRA is subject to a 6% annual excise tax until it is "absorbed" or offset by later IRA contributions not made. Let's say that in the year after the rollover, Bob was eligible to set aside $5,000 in an IRA, but he made no contribution that year. The "excess" in the rollover then is reduced from $20,000 to $15,000, and so on each year until it is covered. If Bob made a contribution of, for example, $3,000 in the second year, only $2,000 of the excess would be absorbed, leaving $18,000 exposed to the continuing 6% annual penalty.

Finally, the $20,000 that Bob withdrew from his IRA to repay to the pension plan must be included in his taxable income in the year of the withdrawal. That would be consistent with the way Bob reported the rollover the year he received the lump sum, and he can't change that now that the statute of limitations has expired. However, if the problem had come up earlier, before the statute of limitations had expired, Bob might have been able to mitigate the problem through a corrective procedure in the tax code.

Also, Bob will be able to take a tax deduction for the repayment, but that will be a miscellaneous deduction. These are only deductible to the extent that they exceed 2% of adjusted gross income.

What should someone in Bob's situation do? Ideally, in the year of the lump sum distribution, an independent actuary should be consulted to confirm the accuracy of the calculations. ☐



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