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"Fiduciary." What this word means to investors

Wealth management with us is a bit different.

When a financial professional provides investment advice, one of two different standards applies:

1. the recommendation is "suitable" for the client; or
2. the recommendation is in the client's best interest.

To the layman, the difference in these two statements may not seem like much. To lawyers and regulators, there is a world of difference. Standard 2 is the "fiduciary" standard. Under the Dodd-Frank financial regulation bill, the Securities and Exchange Commission has been charged with studying the feasibility of making all financial professionals subject to the fiduciary standard.

In a recent speech before the National Association of Plan Advisors, SEC Commissioner Michael Piwowar seemed to suggest that the agency is not yet near the end of its study period. He said: "As demonstrated by the endurance and passion of arguments on all sides, this question is not just really hard to answer. It is really,

A partial checklist of fiduciary duties

How do the investment responsibilities of trustees differ from those who are not considered "fiduciaries" under the law?

The American College of Trust and Estate Counsel, a professional organization of lawyers dedicated to improving probate and trust practices, has created "What It Means to Be a Trustee: A Guide for Clients." The Guide notes that the following obligations are imposed upon the trustees of most trusts:

- Duty of skill and care.
- Duty to give notices.
- Duty to furnish information and to communicate.
- Duty to account.
- Duty not to delegate.
- Duty of loyalty.
- Duty to avoid conflict of interest
- Duty of impartiality.
- Duty to invest.
- Duty of confidentially.

Although one might have an intuitive understanding of what each of these duties might entail, they can be quite complex in specific cases. Entire legal treatises might be written about any one of these duties, as well as upon their interactions. Every trustee is charged with having this body of legal knowledge at his or her fingertips at all times.

really, really hard—with three 'reallys.'" Some in the brokerage industry have voiced concern that extending fiduciary duties to all financial professionals may decrease consumer choice or increase costs.

Those in the trust industry are not affected by these developments, for the simple reason that we are *already* governed by fiduciary standards and *always have been.* You might say that we were the pioneers of fiduciary responsibility!

When might you want to turn to a corporate fiduciary, such as us, for help with your wealth management issues? To sum up, we offer:

- professional investment management;
- experience in estate settlement; and
- unbiased trust administration.

Whether our customers employ our full trusteeship capabilities or opt for an investment management account, our fiduciary responsibility comes into play—we put the customer's interest first; there is never any conflict of interest. See the box on the front page for a partial listing of what fiduciary duties entail.

Should you consider a trust?

Trusts offer advantages in wealth management that are not available with ordinary investment accounts. Trusts can be used to achieve some or all of the following objectives:

- Provide lifetime financial protection for a surviving spouse.
- Establish inheritance management for minors and incapacitated or disabled family members.
- Protect assets from creditors.
- Reduce or eliminate death taxes.
- Increase financial privacy and confidentiality regarding wealth distribution.
- Implement a program of philanthropy.
- Protect an estate plan from claims by disgruntled heirs.
- Provide complete financial management in the event of your own incapacity.

Whatever the reason for creating your trust, the next question is crucial: Whom should you choose as your trustee? Who has the qualifications to see to it that your trust plan will succeed? Where would you look for the right trustee?

Typically, a trust grantor is deciding between a corporate fiduciary (a company that has been granted the legal right to act as a trustee, such as us) and an individual, such as a family member, friend or business associate. Factors that should be considered include:

Judgment and experience. Inexperienced trustees may dissipate the trust assets or make administrative mistakes that result in delay or other problems.

Impartiality. 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 that all the beneficiaries can respect.

Investment sophistication. The Uniform Prudent Investor Act and other laws governing the investment of trust assets must be adhered to. The trustee should be able to increase returns or reduce portfolio volatility and must be able to diversify the portfolio.

Permanence and availability. Many trusts are expected to last a decade or more. Corporate trustees have the advantage of perpetual existence.

Sensitivity to individual beneficiaries' needs. Understanding the individual needs of trust beneficiaries is very important, and on this issue many will assume that the friend or family member has the advantage. This is not necessarily the case, but sometimes an individual will be made cotrustee to handle such decisions. Even so, a corporate trustee might be brought into the process for an objective voice and to prevent unreasonable distributions.

Accounting and recordkeeping. Detailed trust records are required, and few individuals are equipped to handle this chore properly.

Fees. There is a chance that the fees charged for trust administration will be lower when a friend or family member is named as trustee. However, when a trustee is serving for little or no compensation, it becomes hard to give the trust the attention that it deserves.

In the usual case, the trust assets consist of ordinary investment assets, such as stocks, bonds or mutual funds. In that situation, a corporate trustee is likely to be a very cost-effective alternative.

Special considerations

In addition to the personal characteristics, there are situations in which having an independent and professional trustee will be important.

- ***Potential for self-dealing.*** Will the trustee be purchasing assets from related parties or affiliates? The trustee should not be on both sides of these transactions, and many states have statutory restrictions on self-dealing.
- ***Power to allocate gains to income.*** The Uniform Principal and Income Act, which applies in many states, permits (but does not require) the trustee to allocate realized capital gains to income. In a trust that distributes all of its income every year, such as a marital deduction trust, the trustee will be greatly favoring the income beneficiary by allocating gains to income. Such a decision should not be made by a party with an interest in the trust.
- ***Discretionary distributions.*** If the goal of the trust is to provide for long-term protection against the squandering of an inheritance, the best course may be to have an independent corporate trustee with wide discretion over distributions. Such an approach minimizes the chance that the beneficiary might be able to force a distribution through the courts.

Can we tell you more?

We are well qualified for all the tasks of trusteeship. It is a job that we do every day, with our full attention. We are staffed for it, experienced and always ready to serve.

When you are ready to take the serious step of including a trust in your long-term financial and wealth management plans, please call upon us to learn more about how we may be of service to you. ☐

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“Slicing up” art to save on estate or gift taxes

Image courtesy of Wikimedia Commons

James Elkins had a substantial estate when he died—his federal estate tax return reported estate taxes due of some $102 million. However, the IRS wanted still more. Elkins had acquired a substantial art collection during his lifetime, including pieces by Pablo Picasso, Paul Cezanne and Jackson Pollock. All told, the art was worth some $35 million.

Elkins and his wife had created a Grantor Retained Income Trust to transfer some of the art to their children, but unfortunately the wife died before the end of the trust term. Elkins inherited her interest in the trust, and her will left him her community property interest in other art not owned by the trust. Elkins disclaimed a portion of that inheritance, so it passed to the couple’s children. Then the term of the trust expired, and additional partial interests passed to the children. Finally, he and his children entered into an agreement that the art would not be sold without the unanimous consent of the co-owners. The essential point is that Elkins owned only a fractional interest in the art at his death, with the other fractions distributed among his children.

The executors of Elkins’ estate retained the services of professional art appraisers. They determined the basic value of the artworks, then developed an appropriate discount to that value to reflect the difficulty of selling a fractional interest in fine art. Museums are unlikely buyers, for example, because they generally prefer co-ownership with other museums, not private owners. A private collector would be put off by the difficulty of acquiring full ownership or, alternatively, selling a partial interest. The more valuable pieces tended to have lesser discounts, while partial interests in the less valuable art would be most difficult to sell. The overall discount came to 44.75%.

Although the IRS routinely allows discounting of the value of a partial interest in a business or in real estate, it has resisted any such discount for fine art. Without the discount, another $9 million in additional estate taxes would be due.

Two court cases, two taxpayer victories

In the Tax Court, the estate presented its expert testimony as to an appropriate discount, while the IRS stuck to its argument that no such discount is allowed. Because there is no significant market for partial interests in art, the IRS expert testified, full market value must be used.

The Tax Court rejected the rigidity of the IRS position, stating that the uncertainty created by the multiple interests in the art made some discount legitimate. However, the Court was not persuaded by the testimony of the estate’s experts, and it reduced the discount to 10%.

On appeal to the Fifth Circuit Court of Appeals, the taxpayer won a more substantial victory. That Court searched in vain for any evidence to support the 10% discount allowed by the Tax Court. Because the estate’s evidence for a 44.75% discount had not been rebutted, it was the only evidence available and created the appropriate discount to use. In short, a complete taxpayer victory.

Future cases

In coverage by *The New York Times,* the dramatic outcome was hailed as a “potential game changer” for owners of fine art. Owners now may be able to keep highly valuable art work within the family at a reasonable transfer tax cost, instead of being compelled by tax pressures to donate such pieces to a museum. However, two caveats are in order.

First, the Elkins family had the deep pockets needed to pay the appraisers and the lawyers who were essential to their victory. Nothing can be taken for granted in this situation. Second, in the next case the IRS may be expected to present evidence for smaller discounts, instead of relying on an argument for no discount at all.

Bottom line: Owners of fine art continue to have a very substantial estate tax exposure. Sound and early planning for such collections is as important as ever. ☐

The Super-sized IRA

According to a just-released study of IRAs in the 2011 tax year done by the Government Accountability Office (GAO), a taxpayer who made a maximum IRA contribution every year that IRAs have been allowed would have set aside $99,500. Had that fund grown at the same rate as the S&P 500, it would have reached $353,379.

However, large IRAs are usually the result of a retirement rollover from an employer plan, such as a 401(k) plan. Had maximum employer and employee contributions been made to a 401(k) plan for all the years that they've been allowable, a total of $1,185,350 would have been saved. Growing at the S&P 500 rate, the nest egg would be $3,959,753.

The GAO reported that thousands of taxpayers have IRAs larger than that, super-sized IRAs, if you will. Here is a summary of their findings:

IRA Balance	Number of taxpayers	Value of IRA balances ($billions)
$1 million or less	42,382,192	$4,092
$1 million to $2 million	502,392	674
$2 million to $3 million	83,529	198
$3 million to $5 million	36,171	133
$5 million to $10 million	7,952	52
$10 million to $25 million	791	11
More than $25 million	314	81
All taxpayers with IRAs	**43,013,341**	**5,241**

The GAO noted that for the 99% of taxpayers with less than $1 million in their IRA, the median account size was $34,000. For those in the next bracket, the median account was $1.4 million.

The most eye-popping item on the table may be that the 314 taxpayers with IRAs larger than $25 million have among them an aggregate of $81 billion in IRA assets—an average of nearly $258 million each!

How is that possible? These taxpayers likely were able to purchase nontraded financial assets, such as stock or partnership interests, for their retirement plans at a time when the assets had a very low value. Later, perhaps after an initial public offering, those assets may have grown explosively. For example, this was the explanation for Mitt Romney's $101 million IRA, revealed during the last Presidential election.

The GAO report may be a prelude to Congressional action to curtail the tax benefits of IRAs or qualified retirement plans. ☐

Only a corporate trustee, such as us, has all these attributes. Talk to us today to learn more!

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