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Trust UPDATE

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Trust services: An introduction

At their beginning, in the 14th century, trusts were used to convey real estate, a mechanism to defeat the rigid rules of primogeniture (property passing to the oldest son), as well as the taxes then imposed when land passed by intestacy. As the nature of wealth has changed, so has the nature of trusts. Today, typical trusts are flexible tools for managing financial assets, such as stocks, bonds, mutual funds, insurance contracts, pension and annuity interests, and bank accounts.

Among the types of trusts most commonly used by affluent families today:

- ***Living trusts*** provide asset management and financial protection in case of disability of the grantor (and the grantor's spouse, if there is one);
- ***Marital trusts*** protect a surviving spouse for life and are sheltered from federal estate taxes;
- ***Bypass trusts*** expand family protection from death taxes;
- ***Inheritance protection trusts*** can be used to preserve a legacy for heirs for the long term;
- ***Qualified Terminable Interest Property Trusts*** (QTIP trusts) balance the interests of a surviving spouse and children in a blended family situation;
- ***Charitable trusts*** meet both philanthropic and private financial objectives.

See "What a trust can do" on the next page for more details. All of these trusts have something in common. They have assets that require careful management, and that job falls to the trustee.

Anatomy of a trust agreement

The creator of a trust is customarily called the *grantor.* The grantor works with an attorney to prepare the trust agreement, which will give the *trustee* the instructions

about the management of the trust and the distribution of income and principal. Every trust has *beneficiaries*, for whose protection the trust has been created. The grantor may be the first and foremost beneficiary of a *revocable living trust*—or the grantor and spouse. Otherwise, other heirs are named, whose interests will vest at various times, as specified in the trust agreement. If the trust is *revocable*, the grantor may amend it at any time, even terminate it. If the trust is *irrevocable*, such as a trust created at death by a will, it normally cannot be changed without court proceedings.

Finally, there must be a trustee. That could be an individual or a corporate fiduciary, such as us.

Introducing modern portfolio theory

The earliest trustees were amateurs, but the typical modern trustee is a fee-paid professional whose business is to enter into and carry out trust agreements. These professionals, such as ourselves, bring expertise in investment management, trust accounting, taxation, regulatory compliance, and fiduciary administration to this important job.

Over one hundred years ago, trustees tended to focus on low-risk, low-return investments. In fact, some states prescribed narrow ranges of acceptable trust investments through "legal lists." This gave way to the "prudent man" rule, in which trustees had more discretion in asset management. Then modern portfolio theory emerged in the 1970s and 1980s as the accepted best practice in managing trusts. These changes were legally codified in the Uniform Prudent Investor Act.

The thrust of the new rules is to move away from evaluating the appropriateness of individual portfolio components and to examine instead the overall risk and reward characteristics of the entire trust, taking into account the purposes of the trust and the ages of the beneficiaries. The key is total return.

Would you like to know more?

The central feature of today's trusts is professional asset management, conducted under fiduciary safeguards, in a segregated vehicle, which is bankruptcy-remote from the manager. This is what we do. How could a thoughtful trust plan improve the financial security of you and your family? We'd be pleased to explore that important question with you in more detail at your convenience. ☐

What a trust can do

Given the flexibility that comes with trust planning, no single vocabulary has emerged for describing the different types of trusts. The same trust with the same function can go by different names because different estate planners have created multiple monikers. Here is an introduction to some of the types of trust that you might want to explore.

If you need to provide for:	Look into the:	Benefits
Yourself, or yourself and your spouse	Revocable living trust	Professional asset management, continuous financial protection upon incapacity
Your spouse, after your death	Marital deduction trust	Estate tax deferral; spouse receives all income at least annually.
Your noncitizen spouse, after your death	Qualified Domestic Trust (QDOT)	Marital deduction; spouse receives all income at least annually.
Your children, after your death	Family trust	Trustee may be given discretion over trust assets, protecting them from creditor claims.
Your spouse and children from an earlier marriage	Qualified Terminable Interest Property trust (QTIP trust)	For "blended families," preserves everyone's inheritance.
A disabled individual	Special needs trust	May provide for enhanced quality of life while permitting continued government benefits.
Yourself or other individuals for some time, and a charity in the future	Charitable remainder trust	Income interest may be a percentage of the trust's value or a fixed dollar amount; income and gift tax savings possible.

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The trouble with plan loans

A loan from a qualified retirement plan can provide emergency funding during a cash crunch, and be a bridge to a more prosperous time when the emergency passes. But if the financial pressure is sustained, the plan loan just might make the problem worse, as shown in two recent Tax Court cases.

The layoff

David borrowed $36,248 from his 401(k) account in 2011. Such loans are typically allowed up to the *lesser* of $50,000 or 50% of the plan balance, a test David passed easily. Unfortunately, he was laid off later that year. To avoid "being a burden on society," David requested a plan distribution of $127,140. That would be taxable income, so $18,000 in taxes was sent to the IRS, and the plan loan had to be repaid from the proceeds. David thus received just $73,490. He was 49 years old at the time.

The distribution was reported properly on David's income tax return for 2011. However, he did not pay the additional 10% tax that is required for plan distributions that occur too early in life—that is, before reaching age 59½. In the Tax Court, David asked to be excused from the additional tax because of his genuine economic hardship. Not only did he lose his job in 2011, but also the family had over $9,000 in unreimbursed medical expenses that year. The Court was sympathetic, but it concluded that there is no "hardship" exception in the tax law for premature plan distributions.

But does the 10% penalty apply to the loan? David thought that it shouldn't, because the family didn't get any more cash when the loan was forgiven as part of the distribution. The penalty does apply to the loan forgiveness as well, the Court ruled. When a plan loan, even from an earlier year, is offset in a plan distribution, that is a "deemed distribution" from the plan. As such, it is fully taxable in the year of the loan forgiveness.

The boundary

Ralim participated in the New York State and Local Retirement System (NYSLRS), saving a total of $17,017. He requested several loans over the years. In 2009 Ralim requested a "maximum loan" from the plan, and he received a check for $5,993. That brought his loan balance to $12,802.

Small plan loans are permitted to the *greater* of 50% of the plan balance or $10,000. Ralim's loan crossed both of these boundaries. Accordingly, the IRS said that $2,802 (the amount in excess of $10,000) was taxable income as a deemed plan distribution.

What's more, the IRS asked for the 10% tax on premature distributions. Ralim's age was not included in the materials presented to the Court by either the taxpayer or the government. The IRS argued that the burden of proving the taxpayer's age was on the taxpayer, not on the government.

For that assertion to prevail, the Tax Court held, the 10% additional tax on premature distributions must not be a "penalty" as that word is used in the tax code. With penalties the burden of proof is on the IRS; with taxes it is on the taxpayer. After close reading of the tax code, the Court sustained the IRS' position. Although the taxpayer undoubtedly feels "penalized," the extra 10% due is a tax, not a penalty. Because Ralim did not prove that he was over age 59½, the additional 10% tax also must be paid on the excess loan amount. Note that the 10% tax also applies to the income tax paid.

Start the clock

The proper taxation of IRA distributions has proved tricky for many taxpayers. When there is a distribution, Form 5329 needs to be filed with Form 1040 to document the transaction. If the Form is not filed, the IRS may assess additional taxes—such as the excess contributions tax, the failure to take a required minimum distribution tax, or the premature distributions tax—at any time in the future. It's also important to keep IRA records, perhaps indefinitely, to help resolve such questions should they come up in the future.

See your tax advisors to learn more on this subject. ☐

The Robin Williams solution to a Michael Jackson problem

The federal estate tax is imposed upon the net value of everything that one owns at death. When Michael Jackson died, his financial affairs were in some disarray, and his popularity had been waning. The executors of his estate reported its value at about $7 million.

The value of a celebrity's estate can be particularly tricky, because it necessarily includes the value of the celebrity's name and likeness. Many such estates have generated enormous amounts of income over the years. Jackson's executors valued his likeness at $2,105.

That seemed more than a bit light to the IRS. They put a value of $434 *million* on Jackson's publicity value. That level of severe understatement of value triggers major tax penalties, which the estate is resisting in the Tax Court.

Robin Williams' estate planners found a novel solution to this problem, contained in his living trust. Normally, the terms of living trust are kept private, but as a result of a dispute between Williams' widow and children from his earlier marriages, his trust has become a matter of public record.

Williams included severe restrictions on the commercial use of his name and likeness for the next 25 years, as was his right. That will sharply reduce the estate tax value of that asset. More importantly, the rights to his likeness vest entirely in a named charity. Should that organization fail the IRS requirements for tax exemption, alternative charities are named to receive those rights. *Bottom line:* Whatever value that the IRS assigns to Williams' publicity rights will be fully offset by the estate tax charitable deduction.

Another issue for the Jackson estate is the value of his interest in two trusts that held the singer's music publishing rights as well as his half-interest in Sony/ATV Publishing, which owns the rights to much of the Beatles music catalogue. The estate pegged that value at $2.2 million; the IRS said $527.5 million.

Overall, the IRS is looking for $525.6 million in estate taxes and $205.1 million in valuation misstatement and negligence penalties from the Jackson estate. Lawyers for the government and the estate are negotiating a possible settlement, but reportedly they are not yet close to resolution. ☐

Why am I a trust customer?

"After I learned about 'fiduciary duty,' I could settle for nothing less."

May we tell you more?

Kirk Hosler
Senior Vice President & Trust Officer
(815) 332-8872
kirkh@stillmanbank.com

Jeffrey Hartle
Vice President
(815) 332-8843
jeffh@stillmanbank.com

Stillman BANK
Trust & Asset Management
8492 E. State Street • Rockford, IL 61108
815-332-8100
www.stillmanbank.com