Trust UPDATE

Stillman BANK

"I didn't know that you could do *that* with a trust."

Why do so many financially successful individuals and their families look to trust institutions to meet their financial management needs? Several reasons come to mind:

• We provide a *team approach*, a fully staffed department with individuals who bring a diverse range of skills to the job.

• Our services are *fee based*, we are not compensated by generating transactions or through commissions for the sale of particular products.

• We are a *corporate fiduciary*, authorized by the banking authorities to act as a trustee for individuals and institutions in the management and distribution of their assets.

What can be accomplished with this power to delegate the authority to manage property to a trustee? Trusts can be individually tailored to address many different financial goals. As a result, there's no such thing as a "typical trust." However, certain basic trust approaches are widely used. The following fictitious examples may spur your thinking about how trust planning might help you to meet your own financial goals.

Providing for oneself

On the doorstep of retirement. Sam and Diane are about to retire. They want freedom from financial worry, and they have enough wealth to make that happen. The couple has lined up a series of cruises and other vacations that they plan to take. When they are away, the couple will need someone to manage their investments. And they also are concerned about the possibility of incapacity. What happens to the financial management should one of them fall seriously ill?

Our most comprehensive and versatile financial management service is the *revocable living trust.* We'll help Sam and Diane develop an investment management plan, and we'll implement that plan. We provide continuous portfolio supervision, distributing or reinvesting trust income as directed. This service will not be interrupted should the couple decide to extend a European trip, should they plan to divide their time between several vacation homes, or in the event that one of them suffers a serious medical setback.

New job. Lisa's career has involved many job changes, as different companies have been competing for her services. Another switch is looming. The new position will be challenging and rewarding, but she has one important concern. What should she do with the six-figure payout that she'll receive from her current employer's 401(k) plan?

A direct transfer of the 401(k) money to an *IRA rollover* will preserve full tax deferral for Lisa's retirement money. We'll also help her to develop an investment plan for the IRA that takes into account her other financial resources, her risk tolerance and tax efficiencies.

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Providing for others

Planning ahead for widowhood. George and Martha have an estate that's worth about $8 million. George is older, and the fact is most wives outlive their husbands by many years. George wants to make certain that Martha will be financially secure after he dies, and the couple wants their estate to pass to their children after their deaths.

A *marital deduction trust* provides lifetime income for a surviving spouse, and the trustee can be directed to invade the trust in the event of a financial emergency. A *credit shelter trust* (also called a *bypass trust*) provides similar functionality, but is designed to escape estate taxes at the surviving spouse's eventual death. This two-trust plan is one common approach today for bringing estate taxes under control, maximizing the financial assets available to the family.

Two variations are worth noting. If Martha is not a U.S. citizen, George will need to create a *Qualified Domestic Trust* (QDOT) for her in order to secure a marital deduction from the federal estate tax. The terms of this specialized trust are defined by the tax code. If George wishes to provide for children from a prior marriage, he may want to look into a *Qualified Terminable Interest Property Trust* (QTIP trust). He then may specify who will receive the assets at Martha's death.

Doubtful marriages. Scott worries about his children's choice of spouses. He advanced his son Tim a substantial portion of his inheritance, half of which evaporated in a messy divorce just a few years later. Daughter Irene's marriage seems steadier, but her husband lacks ambition, and the couple doesn't seem to be getting ahead financially. In fact, they may have taken on more credit card debt than they can handle.

By using *a spendthrift trust* to provide for Irene's inheritance, Scott will protect the money from the claims of creditors as well as from her husband. In addition, Scott will be providing the couple with professional investment management assistance for the money. Scott also can specify in the trust how the trust principal might be used to benefit his grandchildren.

Doing good by doing well. William has a highly appreciated asset that doesn't provide any current income. He's about to retire, and he'd like to convert that asset into an income stream. However, the asset has a very low tax basis, and William has been hanging onto it for years to avoid tax on the built-in capital gain. By the way, William is very active in several local charities, and he plans to continue to be active during his retirement.

A *charitable remainder trust* provides income for a private beneficiary for life or a specified number of years (up to 20). The income can be defined either as a fixed dollar amount (an *annuity trust*), or as a percentage of the value of the trust, recalculated each year (a *unitrust*). The annuity trust approach provides certainty of income, while the unitrust income amount can increase (or decrease) over time if the value of the trust changes. When appreciated assets are placed in a charitable remainder trust, the trustee can sell them without incurring tax on the capital gain. With a charitable remainder trust, William can provide for his own retirement income without the erosion inflicted by the capital gains tax, and he can provide a lasting legacy for the charities that he cherishes. He'll also secure an income tax deduction for himself, based upon the actuarial value of his charitable gift.

What type of trust is right for your *family?*

We have just scratched the surface of what can be accomplished with a trust. To learn more about these ideas, or to explore other trust-based planning approaches that you've heard about, we invite you to come in and talk over your needs and concerns. ☐

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

Source: M.A. Co.

Permanent tax savings steps to consider at year end

Tax deferral is a good thing. Making deductible IRA contributions, delaying income, accelerating deductions, these are ways to pay less in tax now. Eventually, the piper will have to be paid.

But there are a few tax-planning strategies in which the tax savings are permanent. Perhaps the best one of these is the step-up in tax basis at death. The tax basis of an inherited asset is its fair market value at the date of death of the original owner. That means that the tax on all the unrealized gain is forgiven and never will be collected. The theoretical offset to that savings is that the asset will be subject to the federal estate tax, which applies at a 40% rate. Given that the federal estate tax exemption is now $5 million (plus inflation adjustments), that tax exposure is very theoretical indeed for the majority of families.

Still, holding appreciated assets until death is not much of an active strategy. Here are other ideas to consider as the year concludes.

Avoid short-term gains

The tax rate on a capital gain from the sale of an asset held for more than a year is generally about half of that on the sale of something held for a year or less. This can create a quandary. Should an investor lock in a gain while the price is high, or risk a market downturn by waiting until the longer holding period is satisfied? No doubt, in today's volatile financial markets, this call is often not an easy one to make. Still, a bias toward longer-term holding periods will lead to better overall tax results.

Use tax-deferred accounts wisely

There is a temptation to hold appreciating assets, such as stocks, in a tax-deferred account, such as a traditional IRA. Years of tax-free compounding are certainly attractive. On the other hand, all distributions from the traditional IRA will be taxed as ordinary income. There is no preferential tax rate for long-term holdings. What's more, the basis step-up at death doesn't apply to assets in retirement accounts. Accordingly, the better result for some investors will come from owning their appreciating assets in a taxable account, and investing their IRAs in bonds and other income-oriented choices.

The zero tax on some capital gains

Taxpayers in the 15% tax bracket and lower pay no tax at all on their capital gains (up to the end of the 15% bracket). Should the taxpayer experience a year of falling into that low bracket, it's a great time to harvest gains at no tax cost. The more likely scenario for an affluent family is in the realm of gifts. A grandparent who would like to give $10,000 to a grandchild, perhaps to help with higher-education expenses, would be well advised to instead give the grandchild appreciated securities. Assuming that the grandchild has only nominal income, the stocks may be sold without any tax drag on the proceeds.

Convert to a Roth IRA

Conversion of a traditional IRA to a Roth IRA is a taxable event, and the tax can be substantial. However, with the Roth IRA all future income and capital appreciation have the potential of being fully tax free. Should a taxpayer find himself or herself in a lower bracket than usual, it well may be a good time to consider such a conversion.

See your tax advisors before making any final decision. ☐

Tom Clancy's widow wins her court battle.

The estate plan of noted author Tom Clancy had three equal trusts, one for the children of his first marriage, a marital trust for his surviving second wife, and a family trust for the second wife and the daughter they had together. The trusts were funded from the residuary estate (whatever is left after paying expenses and any specific bequests), and Clancy's will also called for estate and/or inheritance taxes to be paid from that same remaining fund. The personal representative of the estate (who also had drafted the will) proposed to pay half of the federal estate taxes due on Clancy's $83 million estate from the trust for the adult children, the other half from the family trust. The taxes came to roughly $15 million.

Mrs. Clancy objected. Before his death, Clancy had executed a codicil to his will, to clarify that he intended both the family trust and the marital trust to qualify for the federal estate tax marital deduction. That suggests that the trusts for Mrs. Clancy should not be tapped to pay taxes, because assets that don't share in the creation of the estate tax burden should not have to pay those estate taxes. To the extent that the widow's share is used to pay the estate tax, the marital deduction must be reduced, which means still more estate tax, and a further reduction in deduction, and yet more taxes, in an extended circular computation. In fact, if Mrs. Clancy's share is free from the tax burden, the actual estate tax due will drop by nearly a third, to roughly $11 million.

That's what the probate court decided was proper, it's what Clancy apparently intended with his codicil to the will. In a 4-3 decision the Maryland Court of Appeals agreed with that conclusion in August. A savings clause in the codicil "explicitly directs that the personal representative not act to adversely impact the benefit of the marital deduction of the marital trust and the family trust." Three dissenters believed that Clancy probably did not appreciate just how much that seemingly minor savings clause would upend the overall result of his estate plan.

The result is decidedly unequal for the five children. The child from the second marriage will get roughly one-third of the estate, undiminished by taxes. The share for the other four will be reduced roughly 40% for taxes, and then split four ways among them. Whether Mr. Clancy expected an outcome for his estate plan as convoluted as the plots of the books that he wrote remains an open question. ☐