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Trust UPDATE

Stillman BANK

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There's "fiduciary." And then there's "corporate fiduciary."

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 1 has been in general use among stockbrokers. Standard 2 is the "fiduciary" standard.

The Dodd-Frank legislation required the Securities and Exchange Commission to study the pros and cons of putting all investment advisors on Standard 2, the fiduciary standard. The SEC never reached a final conclusion. But in the meantime, the Department of Labor got into the picture with a ruling of its own. The DOL decided that Standard 2 would apply whenever investment advice was provided with respect to qualified retirement assets, such as an IRA or an IRA rollover.

The expansion of the fiduciary standard is scheduled to take effect in April 2017. There is some question whether that will happen, given the change in administrations.

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

What's more, being held to a fiduciary standard in giving investment advice is not the same as being able to exercise fiduciary powers. That is something we, as a "corporate fiduciary," can do, and we do it every day. See *Fiduciary Standards versus Fiduciary Powers* on page two for examples.

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.

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When is a trust appropriate?

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 transfer 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 co-trustee 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.

Fiduciary standards versus fiduciary powers

Being judged according to fiduciary standards is not the same as being able to exercise the powers of a fiduciary. Two quick examples:

Balancing current and future interests. A marital trust provides current income for a surviving spouse, with principal to pass to children at the spouse's death. Trust assets may be invested to maximize current income for the spouse, or to target asset growth for the children. The trustee owes a fiduciary duty to all the trust beneficiaries, and must strike a balance when making investment decisions.

Exercise of discretion. A family trust includes a provision allowing for principal distributions to beneficiaries under certain circumstances, ranging from medical emergencies to education and career advancement. The trustee has the fiduciary power to determine when the conditions have been met, and how large a trust invasion for any beneficiary is appropriate.

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.
- *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. ☐.

More trouble for long-term care insurers

More than 400,000 long-term care insurance policies were sold in 1992, according to figures published by *The Wall Street Journal*. These are the policies that help seniors cover the costs of nursing home stays at the end of life. At least 400,000 additional policies were purchased each year in the subsequent ten years, peaking at about 750,000 in 2002.

Then sales collapsed, and never again reached the 400,000 level. Last year, reportedly only 105,000 such policies were sold. What's more, two Pennsylvania providers of long-term care insurance were on the verge of being liquidated in December.

The need for long-term care insurance never has been greater. What happened to the market?

Actuarial errors

A series of actuarial errors were made when long-term care insurance first was introduced. The most important of these was the "lapse rate," the number of policies that will be terminated without ever paying a benefit. This occurs either because the insured stops paying premiums or the insured dies without making a claim. The actuaries chose a fairly conservative lapse rate of 5%. At that rate, if 1,000 policies were sold in year one, only 400 would be in force 20 years later. As it turned out, the buyers of long-term care insurance thought of their purchase as an investment, not as insurance, and so the lapse experience was closer to 1%, which implies that 800 out of every 1,000 policies still will be in force after 20 years. That led to far higher payouts than projected.

When the unanticipated expenses started to pour in, insurance companies had to raise their rates. However, in many cases state insurance regulators would not approve the full amounts requested for existing policyholders.

Two more errors compounded the damage. The first is that medical advances have lengthened life expectancies, which, in turn, increases the likelihood of making a claim on a long-term care insurance policy. The second is that the actuaries generally assumed a 7% rate of return on the invested premiums on these policies. That assumption was fine in the 1990s, but interest rates have been at historic lows since 2008. When long-term care policies are priced today, the projected rate of return on premiums is likely to be 2% to 3%, which drives premium costs still higher.

Getting coverage

If you already have a long-term care policy, you probably want to hang on to it. For the most part, those who have purchased these policies have profited from them.

New long-term care policies are still available, although they are more expensive than in the past, and the terms may be less favorable than older policies. Insurance companies are now using much more conservative actuarial assumptions.

Hybrid policies that combine life insurance with long-term care coverage have emerged, and they have proved popular as well.

The poorest seniors may have the costs of their long-term care picked up by the government through Medicaid. The wealthiest may be able to cover the costs without insurance—even though a year's stay in a nursing home can easily run to $100,000 or more.

For everyone in the middle, planning is necessary. Despite the price increases, long-term care insurance will prove an important part of that plan for many affluent families. ☐

The fate of the federal estate tax

Estate planning experts Jonathan Blattmachr and Martin Shenkman conducted a webinar in December titled *Estate Tax Repeal Is Not a Temporary or Permanent Certainty: How To Plan Now.* President-elect Donald Trump has advocated the repeal of "death taxes," and Congressional Republicans have long favored elimination of the federal estate tax and the generation-skipping transfer tax, which makes this topic very timely.

However, these experts remain unconvinced that the estate tax really will be repealed soon. We first went down this road in 2001. The route then taken was to increase the amount exempt from federal tax each year until 2009, followed by full repeal in 2010. A similar phaseout approach might be in the cards this year. But because the Republicans could not get 60 votes for the tax bill in 2001, it necessarily was limited to being in force for only ten years. That meant the law required a snap-back to the pre-2001 estate tax rules in 2011. In the event, Congress revisited the issue more than once, which eventually led to today's situation of a federal exemption for 2017 of $5.49 million per taxpayer.

Mr. Blattmachr also made the point that those constituents who favor eliminating the estate tax may favor larger income tax breaks even more, as happened in 2001, because they get those benefits sooner.

Both attorneys noted that the Republican plans are silent on the question of the federal gift tax. The traditional reason for having a federal gift tax has been that, without it, the federal estate tax may be avoided by the simple expedient of making lifetime gifts. Now the gift tax might be retained to protect the income tax. Without a federal gift tax, a wealthy person could legally make a gift of appreciated property to a low-bracket relative (perhaps a child), the child could sell the asset and pay low capital gains tax, then re-gift the net proceeds back to the wealthy person.

Some reasons for dropping the federal estate tax are that it raises less than 1% of total federal revenues; it's expensive to administer; and it's too easy to avoid with proper estate planning. Some have argued that the estate tax prevents dynastic fortunes, but our actual experience with decades of estate tax impositions does not support that conclusion.

If the estate tax is repealed, what happens to the tax-free basis step-up for inherited assets? The Congressional plan calls for carryover basis, while the Trump approach would tax unrealized capital gains at death. There is also the possibility of taxing unrealized gains upon the making of a large gift of appreciated assets.

What about existing wills and trusts that refer to federal exemption amounts, or formulas for reducing federal estate taxes to zero? How will they be interpreted if there is no federal estate tax at all?

These tax considerations suggest that estate planning will remain alive and well through the next several years.