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Trust Topics®

STANDARD BANK AND TRUST CO.

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Everything you always wanted to know about trusts*

***But were afraid to ask**

What do you think of when you hear the words "trust fund"? Many people will associate those words with the Kennedys, the Rockefellers or the financial titans of the 19th century. But more and more affluent families these days are exploring the unique financial management and financial protection advantages of trusts.

You certainly don't need Buffett or Gates levels of wealth to benefit from employing a trust in your planning. Most of our clients don't think of themselves as "rich." But they *are* affluent, and they do have a significant sum that needs management. Fortunately, modern technology has made trust planning accessible and affordable to a much wider segment of the population than was true in the past.

Trusts and taxes

In most cases, tax management is an important but secondary consideration in establishing and funding a trust. For example, a revocable living trust offers no tax benefits at all. On the other hand, a bypass trust could save a family millions in federal estate taxes. A charitable remainder trust can save on capital gains taxes even as it generates a charitable deduction.

Fundamentally, trusts provide a structure for long-lasting family financial protection. This can be especially valuable when the family includes beneficiaries from more than one generation. See "Five ways to use trusts" on the next page for examples of the situations in which a trust can be most useful, and the types of trusts that may be considered.

There is no "best age" for setting up a trust. As a practical matter, a great many people first give serious consideration to establishing a trust as they approach retirement, or when they do their estate planning.

Trusts versus ordinary investment accounts

A trust has an independent legal existence. That makes it more durable than an ordinary investment account, because the trustee continues to perform its duties upon the disability, or even the death, of the trust's creator.

In general, a trust cannot be used to shield assets from one's creditors. On the other hand, all states allow

trusts to be used to protect a beneficiary who is not the trust creator from creditors' claims. Perhaps the most common example is the use of a trust to protect a child's or grandchild's inheritance in the event of a future divorce.

Living trusts

Living trusts are so named to distinguish them from *testamentary trusts*, which are created with a will and take effect after death. A living trust goes into operation during life. Usually, such trusts are revocable and created for the benefit of the grantor. Living trusts are popular for four key reasons:

- ***Sound asset management.*** The trustee will provide professional supervision of the portfolio, consistent with the grantor's vision.
- ***Protection in the event of incapacity.*** Trust management continues, even if the grantor becomes unavailable for any reason, such as medical reverses.
- ***Probate avoidance***. Estate settlement is necessarily a public process, and it can be a lengthy one. Living trusts normally avoid probate completely, creating a zone of financial privacy. They continue to function, providing financial resources to beneficiaries, while the estate settlement process continues.
- ***Financial privacy***. The terms of a will become public during the probate process, while the terms of a trust normally are not publicized.

One recent case of the living trust in action was the estate of actor James Gandolfini. There was some negative publicity immediately after his death about the terms of his will, which had been made public. It turned out that the outcry was misplaced, as the bulk of his fortune was controlled by trusts that he had established during life.

Who should be my trustee?

Experience counts. Look for a trustee who has managed many kinds of trusts in all sorts of financial markets. Also, you'll want a trustee who can be fair and impartial, one whose judgment will be respected by all the trust beneficiaries.

In short, look to us. We will be pleased to tell you more about our qualifications for handling this important job for you and your family. ☐

Trust advantages—A checklist

No single trust can do everything, but for almost any imaginable need, there is a matched trust solution. How many of these objectives do you share?

- ☐ Continuous financial management in the event of incapacity
- ☐ Professional investment management
- ☐ Financial privacy
- ☐ Probate avoidance
- ☐ Asset management for inheritances
- ☐ Creditor protection for heirs
- ☐ Lifetime financial protection for a surviving spouse
- ☐ Inheritance for children from an earlier marriage
- ☐ Protection from current and future estate taxes
- ☐ Lifetime protection for a disabled individual
- ☐ Future legacy for charity
- ☐ Current income for charity, keeping assets in the family at lower cost

Five ways to use trusts

1. Trusts to grow on. Trusts can provide professional management for assets set aside for young beneficiaries. The management can continue, if desired, even after a beneficiary reaches age 18 or 21.

2. Continuing help for a disabled individual. With proper planning (qualified legal guidance is a must), a trust can provide extra support and some of life's comforts without disqualifying a disabled person from receiving government assistance.

3. Marital bequest to a noncitizen spouse. Anything that a married person leaves directly to his or her spouse will qualify for the estate-tax marital deduction—unless that spouse is not a U.S. citizen. In that event, a special marital trust is required to preserve the marital deduction.

4. Gaining the marital deduction without disinheriting children. Individuals with children from a prior marriage may qualify assets for the marital deduction by means of a trust that pays lifetime income to the surviving spouse, then passes its assets to the children.

5. True tax savings. There are many ways in which trusts can be crafted to reduce the tax burdens on family wealth, especially estate and gift taxes. With a federal estate tax exemption for 2016 of $5.45 million ($10.90 million for married couples), these taxes won't be a concern for most families. But those with larger fortunes may want to become familiar with the Grantor Retained Annuity Trust, the *Crummey* Trust, or the Dynasty Trust. Some of these are under review in the tax-writing committees in Congress.

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Social Security benefit reform

The "Senior Citizens Freedom to Work Act" was signed by President Clinton in 2000. The most important change was the elimination of the earnings test for receiving Social Security benefits upon reaching full retirement age. Retirees who reach age 66 this year may collect benefits in full, no matter how high their income may be. Of course, with a higher income the amount of benefits subject to income tax goes up as well.

Another option created with that legislation was the opportunity to suspend benefits after they started in order to allow for earning delayed retirement credits. However, sharp-eyed financial planners soon developed additional legal claiming strategies that may have gone beyond what Congress intended.

In November 2015, as part of the budget agreement, Congress enacted significant reforms curtailing some of these strategies. No hearings were held; no legislation was proposed; the changes simply showed up in the budget. Anyone who already has implemented one of these strategies may continue it, but the ability for everyone else to use them is being phased out.

File and suspend

Married couples have been able to have their Social Security cake and eat it, too, in a sense. For example: Husband files for benefits at age 66, and wife immediately claims her 50% spousal benefit. Husband then suspends his benefit, waiting until age 70 to begin collecting. By doing so, his benefit will be boosted by 8% for each year of delay, up to a maximum of 32%. This approach maximizes Social Security income for the couple in their 70s and beyond.

File and suspend has not been eliminated, but during the suspension period the spousal benefit will no longer be available (nor will a child's benefit). The new rule goes into effect May 1, 2016. Only those who are age 66 or older before that date may file and suspend their benefits under the old rules until that date.

Spousal benefit only

Couples with two incomes have paid Social Security taxes to earn two primary benefits and two spousal benefits. A person may claim only one benefit at a time, so something will be going to waste. However, the deferred retirement credit could be used to reduce the loss, especially if the husband and wife are close in age. When Wife claimed her benefit at age 66, Husband (also age 66) claimed his 50% spousal benefit based upon her work record. That allowed his own benefit to grow until he reached age 70. At that point he would claim a benefit based upon his own work record, now increased by 32%.

This option now has been limited to those who reach age 62 by December 31, 2015. In other words, no one born in 1954 or later will have this choice. This phase-in lasts much longer, as those born in 1953 will not turn 66 until 2019.

No more lump sum refunds

Let's say that Husband suspended his benefits at age 66, when he was entitled to $2,000 per month. A year later, his benefit had grown by 8% to $2,160. However, when he went to start the benefits then, Husband had the option of sticking with the $2,000 monthly benefit and taking a lump sum of $24,000 for the year of missed benefit payments. This choice also has been eliminated after April 30, 2016.

Because these strategies were not widely understood by retirees, they provided excellent talking points for financial planners. The number of people using these strategies has not been quantified, but likely was growing. Elimination of these choices has been projected to reduce Social Security shortfalls by about 1%. ☐

A bad IRA idea

Barry Kellerman and his wife were co-owners of Panther Mountain, a real estate development. They needed a four-acre parcel adjacent to the land that they already owned in order to provide sewer access to Panther Mountain. Kellerman owned an IRA worth more than $200,000, and he decided to use it to acquire the target property. The IRA entered into a partnership agreement with Panther Mountain, in which the IRA would contribute the property and $40,000 for its one-half partnership interest. Kellerman directed the IRA custodian to buy the property for $122,000.

The purchase did not meet ERISA requirements. Kellerman and his wife were "disqualified persons" under that law, and the purchase was an act of self-dealing, a prohibited transaction. A prohibited transaction eliminates the tax-qualified status of the IRA in that tax year and subsequent years.

Interestingly, the IRS did not spot the problem. However, in 2009 the Kellermans declared bankruptcy, as did Panther Mountain. In their bankruptcy petition, they sought to protect their IRA from creditor claims, which is normally allowed. Unfortunately, the bankruptcy petition by Panther Mountain listed the IRA as one of its creditors, as opposed to making a capital contribution. Such loans are prohibited from an IRA to a disqualified person. Accordingly, the bankruptcy judge found that because the prohibited transaction changed the tax status of the IRA, it also lost its customary protection in bankruptcy.

Income tax refunds are subject to the estate tax

Russell Badgett died in March 2012. His executor obtained an extension for filing his 2011 income tax return and made the filing on May 1 of that year. Badgett had paid $924,411 in taxes for that year, but owed only $495,096. The executor asked for $25,000 of the refund to be applied to Badgett's income tax obligation for the three months that he lived during 2012. When the 2012 tax return was filed in 2013, it turned out that the bill was only $10,874, so a refund of $14,126 was due.

The executor filed the estate tax return for Badgett's estate on time in December 2012. The return did not list either of the income tax refunds, and, of course, at that time the amount of income tax due for 2012 was unknown.

In 2015 the IRS issued a deficiency for the failure to include the income tax refunds as estate assets. The estate appealed to the Tax Court, arguing that a tax refund is only an expectancy, not an interest in property. The Tax Court disagreed, ordering the payment of additional estate taxes. ☐

Inheritance.
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