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View of Rockwood, Tarrytown on the Hudson, residence of William Rockefeller

Mrs. Wm. Astor Drayton

# FAQs About Trusts

What do you think of when you hear the words "trust fund"? Many people will associate those words with the Astors, the Rockefellers, or the financial titans of the 19th century. Those families did indeed employ trusts for the long-term care of family wealth. But you don't need to have billions to benefit from a trust-based wealth management plan, thanks in part to advances in technology. More and more affluent families these days are exploring the unique financial management and financial protection advantages of trusts. Here are questions that we hear frequently, and our answers.

### *What is a trust?*

A trust is a formal, legal arrangement for the continuing care and management of property. Typically a trust is created when someone transfers money or property to a trustee—either an individual, a trust institution, or bank trust department. The trustee holds title to the trust assets and manages the trust fund solely for the benefit of one or more beneficiaries.

*Continued on next page*

### *Can the person who creates a trust also be the beneficiary of the trust?*

Yes, that is a very common approach. In a typical revocable living trust, a husband and wife might transfer their investment assets to the trustee with the expectation that the trustee will handle their investments for the rest of their lives. The trustee may remit trust income to the couple as needed, or may be authorized to pay their bills directly from the trust.

### *Can I be my own trustee?*

Yes, you can be the trustee of your trust, or you can have a family member be the trustee. But that's not a course we would recommend. Some very important reasons to let us be trustee of your trust are:

- To gain access to professional management of your assets;
- To have someone available to stand in your financial shoes should illness or incapacity strike;
- To provide financial support for your loved ones during your lifetime and beyond; and
- To put all the chores of trust administration into experienced hands.

## Core competencies for trusteeship

Here are the basic benefits that a corporate fiduciary, such as us, provides in fulfilling the duties of a trustee:
• We treat estate and trust administration as a full-time job.
• We have facilities and systems for asset management that individuals lack.
• Estate assets and trust funds in our care are doubly protected, by both internal audits and regulatory oversight by state or federal officials.
• We have an unlimited life, while an individual may die, become incompetent, or just disappear.
• We bring long experience and group judgment to the job of investment management.
• We will treat all beneficiaries impartially, and most beneficiaries will appreciate that.
* We can withstand pressure when a wayward beneficiary asks for more from a trust than was intended, while an individual trustee might give in to requests for "more."

### *What's the 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. However, many young entrepreneurs have used trusts for their wealth management once they achieve early success. There really is no "best age."

### *How is a trust different from other investment accounts?*

A trust has an independent legal existence that makes it durable. It can survive the incapacity or death of its creator. The trustee continues to manage the trust according to its stated purposes, stepping into the shoes of the person who created the trust.

### *If a trust has an independent legal existence, does that mean it must pay income taxes?*

In the more usual case, trust income is distributed to the beneficiaries and they pay the taxes. However, if the trust accumulates its income, yes, the trust does pay income taxes, and the tax brackets for trusts are very compressed.

### *Can I change my mind after I create a trust?*

That depends upon what sort of trust we're talking about.

Usually, this question arises about revocable living trusts, and in that case the answer is yes; you remain in full command. You can change the beneficiaries, add assets, withdraw the assets, even terminate the trust should you decide that it is not right for you and your family.

### *What is a living trust?*

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 health issues.
- ***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.

### *How much income can I get from a trust?*

Using a trust doesn't necessarily change the amount of income that a portfolio generates. In a traditional trust, "income" means collected interest and dividend payments. With that approach, as interest rates and dividend yields rise and fall, income changes with them. Changes in asset values—growth in stock prices, for example—accrue to the remainder beneficiaries.

Some trusts today take alternative approaches, defining income as a percentage of trust assets, or as a fixed dollar amount every year, or as a dollar amount adjusted for inflation—there are many alternatives to consider. However, if a fixed percentage is used to determine distributions, and the income falls short, the trustee will have to invade the principal to make up the difference.

### *Whom should I choose as my trustee?*

Choose us. We have the financial strength, the investment capability, and the experience that you need to make implementing your trust plan a success. You want a trustee who will be fair and impartial, and, more importantly, you want the beneficiaries to recognize and respect that impartiality. That's us. Your trustee needs to manage your trust all year long, not be away on vacation or dealing with other pressing business. Again, that's us—focusing on trust management every business day, all year long. ☐

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# The 2020 Report of the Social Security Trustees

In April, the Social Security Trustees issued their annual report. Their figures and conclusions are based upon last year's experience, and do not take into account the effects of the novel coronavirus pandemic. The report for 2021 will certainly be much worse, because the high unemployment we are experiencing now must lead to a major drop in payroll tax revenue. It's also possible that the pandemic will cause an increase in disability claims and accelerate early retirements, increasing the benefit payouts. Finally, there are serious proposals to suspend payroll taxes for a period of time, though such proposals usually include a proviso for a transfer to the Social Security trust fund from general tax revenue to offset lost collections.

That is all speculative. Here is what we know for certain.

### Key findings

Because the American economy was strong in 2019, Social Security's reserves increased by $2 billion during the year, reaching $2.9 trillion. Under the intermediate economic assumptions, the trust fund will be sufficient to pay full benefits until 2034. Because disability claims have fallen sharply since 2010, the disability insurance trust fund should be sufficient until 2065, which is 13 years later than last year's projection. The combined program would go bust in 2035, at which point payroll taxes would only be able to cover 79% of promised benefits.

Reserves in Medicare's hospital insurance fund fell by $6 billion, to $195 billion at the end of 2019. This fund's projected depletion date is 2026.

During 2019, total benefits were paid as follows: $903 billion in Social Security benefits, $322 billion in Medicare's hospital insurance, $145 billion in disability payments, and $463 billion in supplemental medical insurance.

These figures might seem pretty good, but the fact is that these programs are facing difficult demographic hurdles. The Centers for Disease Control and Prevention announced that the year 2019 saw the fewest number of babies born in the United States in 35 years, just 3.745 million. That is a 1% drop from the year earlier. Except for 2014, the U.S. birth rate has fallen steadily since 2007.

Accordingly, in their actuarial assumptions the trustees reduced the expected total fertility from 2.0 to 1.95 births per woman. That means fewer taxpayers paying into the system in the future as current workers reach their retirement age.

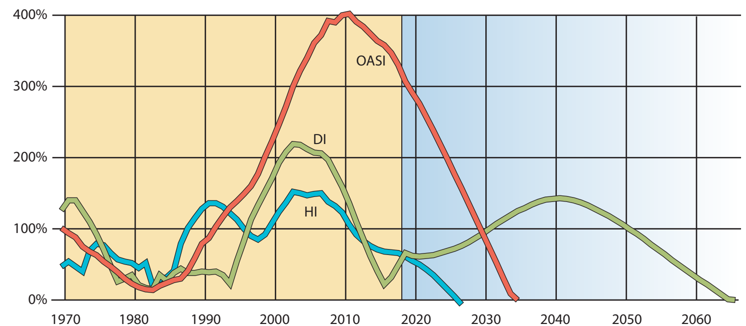
The graph above shows the historical and projected trust fund ratios since 1970. At its peak in 2010, the Social Security trust fund was large enough to cover four years of benefits. Now it is less than 3½ years. The downward slopes in the graph for the years after 2020 is based upon the current demographics and cost projections, *not* the effects of the pandemic. That will only make it worse.

### Perspective

The graph also shows that the Social Security trust funds nearly ran out in 1983. In 1982 it was projected that full promised benefits would not be payable by July 1983. A commission was created, headed by Alan Greenspan, to make recommendations to head off the disaster.

**OASI, DI and HI Trust Fund Ratios**

**(Asset reserves as a percentage of annual cost}**




In the spring of 1983, just three months away from insolvency, those recommendations were turned into a bipartisan legislative compromise. Key elements included:

- accelerating a previously scheduled tax rate increase;
- phasing in a higher normal retirement age, going from 65 to 67 (that phase-in is not yet complete);
- requiring government workers to pay into Social Security; and
- up to one-half of Social Security benefits were made potentially subject to income tax for higher income retirees. The thresholds for taxation were not indexed for inflation, so over time more and more retirees are making these additional payments to the Social Security trust funds during their retirement.

The effects of these changes were dramatic, as the graph shows. Another key change, one not anticipated by the Greenspan commission, was the boom in women's workforce participation in the late 1980s and 1990s. More women working meant more Social Security taxes collected, even though the benefit payouts proceeded as projected. What's more, there is an underappreciated marriage penalty built into Social Security benefits for two-earner couples. Each spouse must choose between his or her own earned benefit, or the benefits determined by the earnings record of the other spouse.

On the one hand, given that 1983 rescue plan for Social Security was achieved with only three months left before insolvency, one might think that 15 years should be plenty of time to correct the actuarial imbalances in the current system. On the other hand, the country was much less polarized in the 1980s; bipartisanship and compromise were more regular features on the national political scene. The 1983 Social Security tax increases followed 1981's bipartisan Economic Recovery Tax Act, which had cut taxes for nearly all Americans. That may well have made the increases more palatable. ☐

## Expanded relief

The initial announcement from the IRS on moving this year's Tax Day from April 15 to July 15 applied to income taxes. That relief has since been supplemented with a new deadline for estate and gift taxes. Estate tax returns (Form 706) are generally due nine months after a decedent's death, not on any particular date. Gift tax returns (Form 709) are generally due April 15 of the year following the gift. The Service has announced that such returns due after April 1, 2020, and before July 15, 2020, will all have their due date pushed to July 15.

## Retirement accounts in bankruptcy

The general rule is that assets in qualified employer retirement plans and IRAs are exempt from creditor claims. As such, they are protected when an individual declares bankruptcy. A recent case shows the gray areas that surround this rule.

Larry and Jessica declared bankruptcy with over $500,000 of debt. Among their debts was a plan loan that Jessica had taken from her employer's 403(b) retirement plan. Their reorganization plan called for paying that loan back in full, because failure to repay it would trigger a default distribution, which in turn would trigger a 10% penalty tax for premature distributions. What's more, the record showed that Jessica continued to make contributions to a 401(k) plan, which reduced the couple's income for servicing their debts.

Under these circumstances, the Bankruptcy Court held that their plan was not filed in good faith. More of their disposable income needed to be made available to creditors.

## A tax is not a fine

Individuals who have foreign financial accounts that aggregate more than $10,000 during the calendar year must report those accounts to the IRS (generally known as FBAR). The purpose of the reporting is to make certain that foreign accounts are not being used to avoid U.S. income taxes. The penalty for willful failure to make the report is not merely all of the account's income, it is 50% of the account's value!

Isac had several foreign accounts that he failed to report for several years, and the IRS came after him. The failure to report in 2006 was determined to be not willful, so there was no penalty. The 50% penalty did apply to 2007, 2008, and 2009, and it came to nearly $13 million.

Isac argued that a penalty so large violated the Eighth Amendment's ban on excessive fines. The District Court answered that a tax is not a fine within the meaning of the Amendment. Rather, the amount of the penalty ensures that the government "is made whole" when people willfully try to hide their investments off shore. ☐

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1200 Congress Street, P.O. Box 8550 Portland, ME 04102
207.482.7920 • www.norwaysavings.bank

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