Trust Company *of* Vermont Quarterly Update

July 2012

Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester ◆ St. Albans

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Vermont Trust Law Modernization Continues

The latest in a series of measures modernizing Vermont's fiduciary law was passed in May – the Uniform Principal and Income Act. It was the third major statutory upgrade to the law governing trusts in eight years.

Although minor in the larger picture of legislative activity, it meant a great deal to us and to estate-planning attorneys around the state. Its passage was also significant to beneficiaries of irrevocable trusts, as it clarifies how income and principal receipts are to be treated and how disbursements are to be made. The new legislation followed the 2009 Vermont Trust Code, which is a comprehensive statute defining trustee responsibilities and beneficiaries' rights. Both the UPIA and the Trust Code were compiled by joint committees of the Vermont Bar and Bankers Associations, which worked literally for years reviewing model legislation and crafting it to meld with other Vermont law.

Those two landmark statutes followed our introduction in 2004 of a law proposing to allow beneficiaries to petition the probate court for the removal and replacement of trustees, essentially for reasons of poor service. With tax law changing fairly rapidly, there is yet more need to modernize trust law, and more initiatives are in the works, once again in a cooperative study arrangement among bankers and estate-planning attorneys. We continue to contribute to the process, recognizing the need to make sure that trusts are managed well in modern circumstances.

Thank you, Chris Chapman, as our representative, for your tireless efforts in three legislative initiatives modernizing our trust laws.

Your Colleagues

Vermont Estate Tax - The Peculiar Law

Jack Davidson

Our legislators recently reduced the uppermost Vermont estate tax rate from 45% to 35% without fanfare.[1] The challenging legislative session spawned many important headlines, and this would not be one of them. Certainly, the impact may be considered modest. That said, the change in the statute modified a peculiar law that behaves in peculiar ways, and the impact may not be readily apparent.

Vermont partially "de-coupled" from a piggyback approach to the federal estate tax. Vermont now exempts estates valued under $2,750,000. By comparison:

Connecticut	$3,500,000
Maine	$1,000,000
Massachusetts	$1,000,000
New Hampshire	No tax
New York	$1,000,000
Vermont	$2,750,000

Our law incorporates pieces of the federal law in a way that may confuse many of us. For example, here is the Vermont Estate Tax rate chart:

Estate equal to or more than:	Taxable estate less than:	Tax on amount in column 1:	Tax rate on amount over column 1 figure:
$0.00	40,000	0	0.00%
$40,000.00	90,000	0	0.80%
$90,000.00	140,000	400	1.60%
$140,000.00	240,000	1,200	2.40%
$240,000.00	440,000	3,600	3.20%
$440,000.00	640,000	10,000	4.00%
$640,000.00	840,000	18,000	4.80%
$840,000.00	1,040,000	27,600	5.60%
$1,040,000.00	1,540,000	38,800	6.40%
$1,540,000.00	2,040,000	70,800	7.20%
$2,040,000.00	2,540,000	106,800	8.00%
$2,540,000.00	3,040,000	146,800	8.80%
$3,040,000.00	3,540,000	190,800	9.60%
$3,540,000.00	4,040,000	238,800	10.40%
$4,040,000.00	5,040,000	290,800	11.20%
$5,040,000.00	6,040,000	402,800	12.00%
$6,040,000.00	7,040,000	522,800	12.80%
$7,040,000.00	8,040,000	650,800	13.60%
$8,040,000.00	9,040,000	786,800	14.40%
$9,040,000.00	10,040,000	930,800	15.20%
$10,040,000.00	+	1,082,800	16.00%

And here are some examples of how the law operates. The examples are based on the 2012 laws, assuming all numbers remain the same upon the donor's eventual death.

Donor A has an estate of $3,000,000. Donor A gives $10,000 to child A, which qualifies for the annual federal gift tax exclusion ($13,000 indexed to inflation). The gift will save $3,500. That's a 35% tax rate saved.

Donor A decides to give another $240,000 to child A, in an attempt to bring his or her estate under the state exemption. The donor will not avoid the Vermont estate tax, though. The tax would be $84,000, a 35% rate on the amount over the exemption (because of the way calculations are made with reference to federal gift-tax rates and the federal gift and estate tax return).

Vermont does not have a gift tax, but the estate tax is computed with reference to federal gift and estate taxes, which do indeed encompass gifts. Consequently, gifts may or may not reduce the effective overall tax savings as a result of this peculiar law. In the above example, what would be the impact if the taxable estate were in excess of $3 million? The tax rate, when blended with the federal rate, tends to decline using the same example of a $240,000 gift:

Estate	Tax Savings	Effective Rate
$3,000,000	0	35.00%
$4,000,000	$24,960	10.40%
$5,000,000	$26,880	11.20%
$10,000,000	$23,712	9.88%

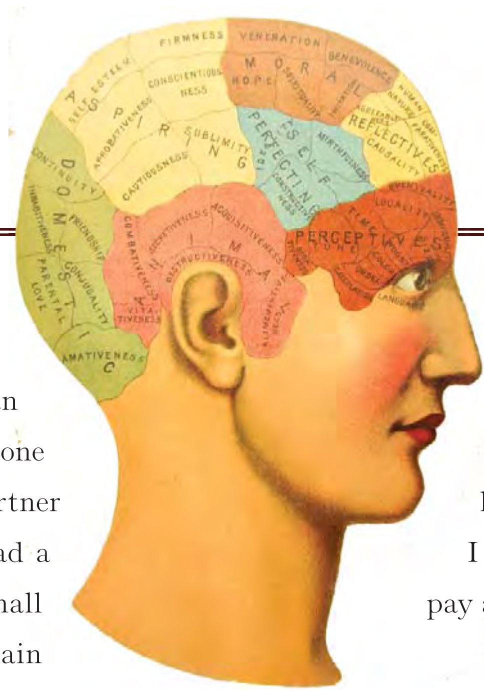
The Tax Form shows a $3,000,000 estate subject to an 8% to 8.8% upper-most rate when in fact it is 35% and the 10 million estate shows the 15% to 16% rate yet the effective rate is under 10%.

It's a peculiar law.

1. Act 143, Section 21

The Brain

Jack Davidson



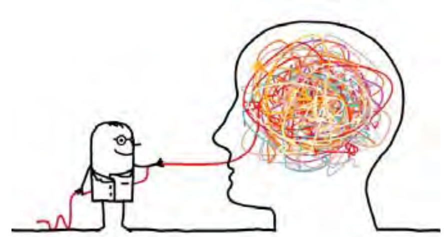
As an adolescent, I found the "brain" uninteresting. I used mine sporadically. It was simply an instrument to help me go from one place to another. It wasn't a partner in decision making. Early on I had a simple goal. I wanted to live in a small town and raise a family. The brain helped me.

I found a job. To keep the job, I needed skills. I learned the skills. My line of business encompassed fiduciary law and investment management, which were like

commodities focused on the brain. I would have preferred to be Steve McQueen, but I could not quite figure out how to become Steve McQueen while maintaining my identity as a Trust Officer at the Vermont National Bank . [1]

As the years passed, I started to view my brain as a partner. Certainly I needed it to maintain my skills, but I also found it be a pleasant companion. It was no longer just an instrument. It was a friend who sometimes suggested "Why don't you just explore without purpose?" Now to be fair, my brain is manipulative. It periodically reminds me that if I don't maintain my skills, I will have to retire and just play golf. Oddly, I find that threatening so I continue to pay attention to our relationship.

At the end of December, my friend almost left me. I had a head-to-head encounter: mine and a head of lettuce. The lettuce won. I collapsed in the produce section at Price Chopper and was unable to have a dialogue with the head of lettuce opposite me as I pondered its features and my inability to at least find someone else to talk to. Fortunately, the Price Chopper was 500 yards from the hospital, and my good fortune of proximity resulted in a dramatic reversal of the effects of a stroke.



After a short hospital stay, I was advised to spend two weeks at home with very limited mental activity. I strayed. My friend and I could not sit in a room for two weeks and not talk. So we did. I pondered not just about my brain but the brains that I work with.

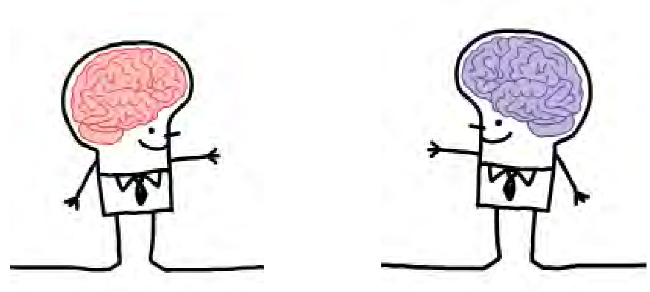
In our business, we rely on "Brains - ours and others - that we call upon to help us invest long-term. "Brains" can be expensive. Often people choose investment managers based on academic credentials and proximity to financial centers. Harvard MBA's tend to be expensive and reluctant to relocate in "sleepy" Vermont towns. The marketing value could be priceless were we to entice one or more to our inventory of managers.

Alas, hedge fund management has accelerated the marketing of the "Brain." There is a widely held belief in the asset-management industry that the hedge-fund industry attracts the "best and brightest." This business adds a dimension not found often in traditional investment management. Traditional Managers look for good stocks. Hedge Fund Managers tend to move in a riskier investment world. They look for good stocks....... and bad stocks, and they leverage the latter.

Over time, we see institutional money grow locally and then move out of state in search of the "best and the brightest." As a result, some institutions have modified their services to embrace "Manager of Managers" programs. This strategy can be both cost effective and, perhaps, effective in managing assets. A local manager selects other managers, usually by way of mutual funds, thus allowing access to "the best and brightest" while still maintaining contact with an in-state provider of management oversight.

I might add that our company embraces the "local movement." We were locally grown, we are locally owned, and, although the data is still debatable, we are not genetically modified. We do not embrace the "Manager of Managers" concept and all of our managers live locally.

How effective in management of assets is the "Brain?" In 1994, Salomon Brothers bond trader John Meriwether launched Long Term Capital Management and brought on board Nobel Prize-winning economists Myron Scholes and Robert Merton. At the time, many in the investment community were in awe of the prowess of this group. However, their spectacular demise in 1998 also stunned the community. Despite the collective acumen of this enviable group, it was unable to foresee the impact of the Russian financial crisis.[2]



At the time, I recall a wise observation that still resonates - the best managers have a "knowing" of when trends change which can be independent of academic pedigree. At the time I assumed this individual was talking about the left and right brain in investment management.

The Investment Community seems to have co-opted the definition of right and left brain. The community defines the right-brain investors as emotionally impulsive and left-brain managers as cloaked with the wisdom of those who carefully weigh the costs and benefits of a particular investment.

My definition of "knowing" is the "adaptive unconscious," which I first encountered in Malcom

Gladwell's book, "*Blink.*" Gladwell writes, "When we talk about analytic versus intuitive decision making, neither is good or bad. What is bad is if you use either of them in an inappropriate circumstance."

Often I see right- and left-brain conflicts. If you are a lawyer, you take pride in your left brain. If you are an artist, you wear the right brain badge of honor. The concept of the "adaptive unconscious" may simply be an effective way of saying that the whole brain wins, not just one of its parts.

How effective is "Brain" power in effective investment management? Certainly those who designed the algorithms and tranches evident in the subprime funds made famous in 2008 were highly creative but, on the whole, the investment community suffered profoundly and the damage is not yet complete.

How do we find "knowing" people? It is a challenge.

But I know what I and my colleagues want to avoid. We avoided the subprime funds of 2008-2009 simply because we refused to buy something we did not understand. As a result of the current low interest rates, we see an increase of late in "murky" investments that remind us of funds that fueled the last market before the crash. We plan on staying the course. It is not easy; we are certainly aware that safe, fixed-income securities yield appallingly low rates.

I recently met a women who worked for an international non-profit based in Connecticut. Her organization had a strict philosophy of avoiding risk. The organization's policy did not allow for investing in stocks; "A" rated Bonds and bond funds were permitted. Relying on Moody's, the portfolio declined by 40% at the end of 2008 as a result of holding A-rated sub-prime funds.

In our company, fixed income securities stabilize the value of portfolios. They need to be safe. Now the siren call to increase yield is suspect. This world is growing more unsafe. Are these new funds, designed to attract the risk-adverse investor, the product of creative brains who work for us - or are they working against us?

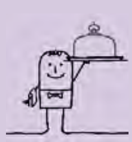
So at the Trust Company we need to be agile. We need to understand the market. We also need to understand our clients and their needs. This is our responsibility.

When I returned to work after my two week period of rehabilitation, alone with my brain, I may have emerged as an "enlightened" man.

I now know how to adjust my brain power and exert positive efforts to increase my brain's effectiveness. Monitoring IQ can be important.

Quoting our esteemed Warren Buffett: "You don't need to be a rocket scientist. Investing is not a game where the guy with the 160 IQ beats the guy with 130 IQ."

I have learned to adjust my IQ and I created a scale to assist me:

Trait or Activity		Effect
Arrogance		- 10
Impulsivity		- 20
Ability to Listen		+ 20
Running late		- 10
fear		- 20
Cognitive Dissonance		- 20
Cup of Coffee (per cup)		+ 5
Focusing on client needs		+ 20

I suspect that I need to nurture the minuses so I can get into the 130 range. Some of my colleagues, on the other hand, have suggested that I should focus on the pluses.

My Mother had a "Third Eye"[3] Facts, logic - none of it mattered. She just seemed to come to the right conclusions. Were she here today she would probably say "If it's too good to be true, it's not true."

In this current environment, we need to repeat this advice more then ever. The infamous Bernie Madoff was well aware of this immutable truth. He manipulated his stated yield so it stayed just below the radar of "too good to be true."

If a company's interest is congruent with the clients' interest, the "Brains" stand a much better chance of realizing the clients' goals. Otherwise, the outcome is unpredictable and perhaps dismal. This is what I know.

"Look closely, Ms. Fleere—do you see the man who managed your hedge fund?"

1. Even after buying a motorcycle.

2. The Nobel Foundation just announced that it was reducing the cash awarded with Nobel Prizes by about 20 percent. The reduction was the result of poor returns on its invested capital, which was valued at $419 million as of Dec. 31, down 8 percent from the previous year.