Prologue: In Defense of Coffee

My contribution to our newsletter is a process that inflicts pain. I sometimes call it "pain in the chain". The first draft may arrive on time but the final draft is always late. The chain of editors starts with my wife and then several colleagues in our office and Ellen Lowery, who guides, creates the art and completes the process.

It is very consistent. I write early in the morning under stress, become inspired, run upstairs bragging to my wife that I have created a masterpiece, tender the draft, and I encounter "how many cups of coffee have you had?" Deflation begins.

It is my opinion that I feel the most pain in the chain but others in the chain disagree. Fortunately, I have a reliable, inspired friend in the chain. My coffee.

I am a coffee snob. When I first encountered a snob, I was combative. Who likes snobs? Does anyone want to be a snob? Do they not see how unattractive they can be? Then one day I became one: a coffee snob. Coffee is not a drug. It is a drink that prolongs life, increases mental acuity, and makes people happy. Me: "What! You only have Folgers?" "Why do you only have milk and not half and half?" "What is wrong with this hotel?"

It felt good. I was only trying to elevate those who might benefit from my experience of this noble drink.

The article that follows has an "edge". Some of my colleagues will again blame the coffee. In defense of coffee, coffee fueled the article but it did not contribute to the edge. The edge comes from being a 40 year member of the Vermont Bar specializing in fiduciary taxation and law. Coffee only softened the edges.

Jack Davidson

Your Well-Intentioned Broker May Imperil Your Trust

While still in college and car-less, I borrowed my parent's Studebaker Lark and suggested to my girlfriend that it would be fun to sit in a gazebo overlooking Roslyn Harbor. Unfortunately, it started snowing, I got stuck and I was on private property. Fortunately the owner forgave my inadvertent trespass. Little did I know that the cast of characters would be featured in a drama that was about to unfold.

After graduating from law school I choose a profession by chance rather than choice. In retrospect, I think I made the right choice. I liked being a trust administrator.

Trust administration is a craft born of ancient laws, genetically modified by taxation, and thus made incomprehensible but for a few. The Rockefellers and Carnegies employed professionals steeped in the tradition of the craft. They created trusts to protect

assets and family members. The trustee understood his or her craft and the need to balance the interests of income beneficiaries and those who will receive the trust assets sometime in the distant future. In our shop, we categorize those that benefit as income or principal beneficiaries.

The early craftsmen, lawyers and professional trustees, focused on the equities of ownership, not tax law. Prior to World War I, the top federal income tax rate was 7%. During the war, the top rate increased to 77% and the Revenue Act of 1916 created a federal estate tax with a top rate of 10%. As a result, the design and administration of trusts became even more complex.

In the fifties, many banks housed specialized trust departments managing significant assets. The securities industry was keenly aware of assets under bank control and trust officers were the target of choice for many brokers. Broker commissions were regulated and very attractive. Brokers, for the most part, simply needed to build relationships with institutions that included trust officers. In the early seventies only 15% of households had some degree of exposure to equities. In those days we loved brokers and they loved us. The trust officer was the beneficiary of expensive dinners, and tickets to sporting events, as brokers worked to build relationships.

Then the perfect storm hit. In 1974, Congress enacted the Employee Retirement Income Security Act (ERISA). One of the key components of ERISA was the individual retirement plan or IRA. Pensions were controlled by institutions and IRAs were controlled by the beneficiaries. Three decades later and 50% of households have some exposure to equities. And then on May 1, 1975, the Securities & Exchange Commission abolished the broker's fixed commission schedule.

Before the storm, the trust officer and the broker complemented rather than competed. After the storm, the marriage started to slowly fall apart. Divorce was inevitable. The broker needed to survive.

Before the downfall of the fixed rate, a purchase or sale of 1,000 shares of stock, regardless of value, would generate a $350 commission. Trust officers bundled multiple accounts in one trade, so it was not unusual for a broker to receive much larger orders. A purchase or sale of 10,000 shares would generate a commission of $3,500. In those days you could buy a new Volvo station wagon for $3,500. Now the trust officer, as a fiduciary, had an obligation to seek lower commissions and the broker started to compete with other brokers by lowering commissions. Today the same trade might generate between $300 and $600.

In response, the securities industry started to promote the more lucrative mutual funds. At first, trust officers would not buy mutual funds. When the benefit of diversity overcame the fiduciary prohibition of delegation, trust departments would favor the use of no-load funds, thus depriving the brokers of their commission. The divorce was inevitable.

Many brokers found the change unsettling. For the most part, they were selling investment products. They were not selling investment management. The right investment for a client may not generate enough commissions for the brokerage house. One of our trust officers started her career working in a bank trust department. After several years, she moved over to a brokerage house, substantially increased her salary, experienced the culture, and returned to

the trust world at a 40% drop in compensation. She simply was uncomfortable selling risky derivative bond securities with a 4% commission.

In the trust world, we do not sell securities. We are a "fee only" advisor. Brokers then and now still wrestle with the same issue faced by our trust officer. Fortunately, many brokers now offer "fee only" advice (distinct from "fee based" where they charge a fee to manage and also receive commissions).

After the divorce, a well-intentioned broker may imperil a trust simply because he or she no longer has a relationship with those who understand fiduciary law and fiduciary taxation: the trust departments.

Aided and abetted by lawyers branching out into middle class estate planning as a result of tax laws, the securities industry helped to create an infrastructure to bypass the professional fiduciaries, principally the bank trust departments. The lawyer would name a family member as trustee, the broker would handle the management of assets and send the statements to the accountant who would prepare the fiduciary tax return. Then, more often than not, the lawyer would exit and the family member would administer the trust assisted by the broker and the accountant steeped in tax law, perhaps even fiduciary tax law, which is a specialty, often unaware of fiduciary law as distinct from fiduciary tax law.

This infrastructure, absent those familiar with fiduciary law, is not equipped to handle the responsibilities of being a trustee. The driving force for this change has continued at an accelerated pace. Some brokers are wrecking a profession, creating chaos and potential litigation, unaware or unconcerned about the craft and its complexity.

For most, it is simply not easy to see the pitfalls. For example, a trustee sold real property that had not produced income for the past two decades while held in the trust. When the check arrived, both the trustee and the accountant did not question the allocation of 100% of the sale proceeds to principal. Makes sense; it's a sale of an asset and it is only subject to capital gains. The income beneficiary had not benefited from the appreciation. Under the fiduciary law at the time, one of our specialists, at the request of the income beneficiary, informed the trustee that the income beneficiary was entitled to approximately one third of the proceeds. The trust paid the capital gains tax and the income beneficiary received approximately $84,000 tax free. [1.]

Fiduciary law, not fiduciary tax law, required a different allocation, and a pleasant surprise for this beneficiary.

If you want to bypass the craftsmen, you better use an investment firm that has two, not one, very, very important columns: Income and Principal. In the trust world, one set of beneficiaries owns the income column and another set owns the principal column. Sometimes they compete against each other.

A trustee of an irrevocable trust has to maintain an income and principal accounting. Failure to do so means the trustee violates his or her fiduciary duty. It's that simple. Fortunately in most cases, we see little or no damage and rarely do we see litigation.

Broker Statement		
Description		Column 1
Dividend on IBM		$100
Sale of GE		$5,000
Trustee Fee		-$100
Accounting Fee		-$500

Trust Statement		
Description	Income	Principal
Dividend on IBM	$100	
Sale of GE		$5,000
Trustee Fee	-$100	
Accounting Fee		-$500

If a trustee, unaware of the rules, materially affects an interest, the trustee will probably not encounter a litigious lawyer waiting in the wings, either because the infraction is not meaningful, undetected or the other family member beneficiaries forgive and maybe forget.

That said, there may be someone else waiting in the wings ready to create hell: the IRS.

Examples that I have encountered recently:

- Trustee of a trust designed to save estate taxes, unaware of her "technical" responsibilities, asks the broker for $100,000. Broker obliges without warning the trustee of her duties. The trust is now vulnerable to estate taxes because she was both unaware of the standards and did not meet the standards.

- A generation-skipping trust was created to save estate taxes for the creator's grandchildren while providing income to children. The accountant reported the income to the children but the trustee did not pay out the income. If detected, hell and havoc would affect both income taxes as well as possible estate taxes.

- A child added her own assets to a generation-skipping trust and the broker facilitated the transfer. Hell and brimstone awaits.

- The accountant, motivated by the need to avoid the high income tax rates if the income is accumulated in the trust, told the trustee, who was also an income beneficiary, what she needed to withdraw, unmindful of the technical details for the distribution of income. Hell and havoc await.

Trust administration is a craft. It is a complicated craft. The craftsman's journey started to change about the same time as the Studebaker Lark could not manage a thin layer of snow. By many accounts, the road to ERISA began when Studebaker shut its doors in 1963 with an underfunded pension plan. The property owner was William J. Casey. He was chairman of the Securities and Exchange Commission from 1971 to 1973 and his political influence was a factor in deregulating brokerage commissions. Fortunately, my trespass occurred well before he became head of the CIA.

Curiously, I did not start drinking coffee until after 1975.

[1] *Note: at the time this occurred the prior version of Vermont's Uniform Principal and Income Act dictated the allocation absent trust provisions creating more discretion.*

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