GREENLEAF TRUST

Perspectives

A Greenleaf Trust Newsletter

DECEMBER 2014 VOLUME 23, ISSUE 12

William D. Johnston
Chairman, Greenleaf Trust

Economic Commentary

This week we conducted our annual Year End Seminar providing our economic update summary. For those clients and friends of Greenleaf Trust unable to be with us in Kalamazoo I offer this summary.

We are now a full seven years into our recovery from a very swift and severe recession that began in 2008 and included an equity market collapse of over fifty percent, as well as a near-total freeze of credit markets, resulting in a negative GDP swing of nearly twelve percent.

The recovery has been steady and incremental, but the cumulative effect of that steady and incremental growth has resulted in dramatic improvement in employment and what is now best described as sustainable, organic economic growth. This accomplishment was built upon the backs of the Federal Reserve's policy of quantitative easing and mild government spending on stimulative spending programs with only a touch of austerity. The public policy executed by the Fed is in several key ways different from the policies adopted by the Eurozone and Japan. That contrast is important, because we now see risks to our economy being precipitated by the continued recessions in Europe and the new retrenchment to recession in Japan.

UNITES STATES ECONOMY

Even in the face of increased productivity (+2.3%) as confirmed by the Bureau of Labor release this week, the private sector added 321,000 new jobs to payroll statistics, producing now a string of monthly gains not seen since before the recession of 2008 began. Let's examine some of the larger indicators of employment data.

Employment

	CURRENT	YEAR AGO	CHANGE
Official Unemployment	5.8%	7.2%	-1.4%
U-6 Unemployment	11.5%	13.7%	-2.2%
Employment-Population Ratio	59.2%	58.2%	1.0%
Average Duration of Unemployment (in weeks)	32.7	36.0	-3.3
Unemployed (in millions of persons)	9.0	11.1	-2.1
Help Wanted (in millions of online ads)	5.1	4.7	0.4

Commentary, continued

In general, this report of data affirms a growing employed base. There are over two million more people working full time in our country than there were a year ago, and those workers found jobs in an environment of an expanding, not contracting, population of workers — driving both the duration and percentage of unemployed down. Even with this continued good news for employment we did not see dramatic wage growth and hours worked increases. Wages expanded by 1.3% (annualized) for the period causing some analysts to assume that "slack" in the workforce remains evident and therefore offers the Fed opportunities to keep interest rates low. Evidence that slack has been reduced will be seen in wage rate growth as well as acceleration in help wanted ads, reductions in duration of unemployment and particularly a greater reduction in U-6 unemployment. Recall that U-6 employment data measures that portion of the population that is underemployed in hours and also those workers that would seek employment if they felt there were jobs available.

"Simply put, the economy is building organic sustainable growth. Not robust yet… but more consistent…"

WHY HAS EMPLOYMENT IMPROVED?

Simply put, the economy is building organic sustainable growth. Not robust yet (and that is not to be expected) but more consistent and more organic in nature. Here are some major data releases that affirm the growth:

	CURRENT	YEAR AGO	% CHANGE
Housing/Construction			
• Building Contracts (in billions)	$604	$556	8.6%
• Construction Spending (in billions)	$951	$924	2.9%
• New Housing Permits (in millions, units)	1.1	1.1	1.2%
• New Housing Starts (in millions, units)	1.0	0.9	7.8%
Orders			
• Durable Goods (in billions)	$242	$235	3.0%
• Nondurable Goods (in billions)	$257	$256	0.4%
• New Factory Orders (in billions)	$499	$491	1.6%
• Purchasing Managers' Index	59.0%	56.4%	4.6%
Consumption			
• Vehicle Sales (in millions of units)	16.35	15.15	7.9%
• Consumer Spending (in trillions)	$12.0	$11.6	3.6%
• New Home Sales (in thousands, units)	467	399	17.0%
• Retail Sales (in billions)	$444	$427	4.1%
• Wholesale Sales (in billions)	$454	$432	5.2%

We began 2014 with a negative GDP release for Q1. Recall that we had a historic weather event that impacted very severely the largest portion of our population for much of January and a portion of February. Since that time, when consumer demand was really deferred by nature, our economy has resumed the natural course of more people confident in their circumstances to purchase homes, goods and cars and more people working to fill that production demand.

GDP FORECAST 2015

We expect that our full year 2014 will come in as follows:

Q1	- 2.1%
Q2	+4.6%
Q3	+3.9%
Q4	+3.1%
	+2.4%

While the number will reflect a total not too dissimilar to 2013, it actually was a result of weather impact of Q1 and not the real strength of the economy. 2014 felt and acted like an economy that was moving along at a rate above three percent and produced the employment results to match the underlying growth. Historical weather interruptions are not the norm, and absent of that reoccurrence we expect 2015 to produce GDP growth in a range of 3.3% to 3.6% growth.

"2014 felt and acted like an economy that was moving along at a rate above three percent and produced the employment results to match the underlying growth."

RISKS TO OUR CONTINUED ECONOMIC RECOVERY AND EXPANSION

There are four major drivers of GDP and, therefore, its growth year over year. They are consumer spending, private investment, government spending and export/import net effect. Of all of these drivers our riskiest component is exports, and there are three important reasons for those concerns. As I mentioned at the year end economic review, other than our twelve-month-old puppy named Lola, these are the things that keep me up at night.

EUROZONE

This federation of trading partners includes eighteen countries, eleven of which use a common currency (Euro) and have a total population of 322 consumers and comprises 23.2% of the global economy. They are experiencing a slight recession (their third in eight years), have high unemployment, no growth of population or income, high government debt and very high unemployment for those between 10 and 30 years of age. Additionally, the Eurozone has countries with weak central banks, disparate social contracts, and no cohesive public policy agreed upon by members to drive economic growth. Less than two years ago the world was monitoring the sovereign debt of several Eurozone members and fearing massive defaults. Many of those governments chose austerity measures to shore up confidence in their national debt, but in the process paid little attention to measures necessary to stimulate their economies. In recent weeks a greater coalition of European leaders have

Commentary, continued

"Certainly we continue to have geopolitical disturbance risk that could cause economic interruption, and our own political missteps that have unintended economic consequences."

been aligning to form a policy more similar to the US model of central bank support, modest infrastructure stimulation and less austerity in the short run. Until we see actual policy, with timelines for policy execution, we have to recognize that the economic engine of this portion of the globe will be troubled and therefore wind in the face of US exports. It is difficult to quantify the degree of GDP growth risk, but it may well be 0.2 to 0.4% in total.

JAPAN

Unfortunately, a similar theme is developing in Japan — though they have only themselves and not seventeen other countries to argue with. Japan was headed down a similar path with respect to economic recovery. They have kept interest rates low and had a good deal of infrastructure stimulus spending, but to appease their fiscal hawks added a severe sales tax to the equation. The results were disastrous. Japanese citizens have the highest savings rate in the world. And when faced with a high national sales tax, they simply stopped spending, sending their country into recession. Now, faced with these circumstances, they are rushing to defer, if not eliminate, the sales tax and restart the consumer engine portion of their economy. Japan is 6.3% of the global economy, but they are our fourth-largest trading partner, and in particular are very important to our largest state GDP (California) and, thus, a more severe slowdown in Japan would not be great news for our country's GDP growth rate. As a risk level I would term it moderate, with the potential to shave a tenth of a percent from our forecast. Certainly we continue to have geopolitical disturbance risk that could cause economic interruption, and our own political missteps that have unintended economic consequences. Those risks are there, but not quantifiable.

The Evolution of TEAM IMPROVE PROCESSES for CLIENTS

Michael F. Odar, CFA
President

In past issues of Perspectives, I have explained our strategic plan construction process and how it involves both a bottom-up and top-down approach with input from everyone in our company. We engage in this process annually to stay on track with what we want to accomplish. Our view is that successful strategic plans don't attempt to address everything at once and are not wrapped-up neatly over the course of a calendar year. They involve tactical moves over the course of a longer measurable timeframe that help achieve the ultimate goal. At the beginning of 2013, we set out to create more focused time for our talented team to spend 'with' and 'for' our clients. It was an acknowledgement that we wanted and could be doing more for them by improving many of our processes and work flows to make us more efficient.

I believe we have accomplished a lot over the past two years and our agreed upon plan for 2015 is to keep on going. We will do this by focusing on four key initiatives: Culture, Stewardship, Innovation, and Purposeful Growth.

Culture

In our annual corporate Strategic Planning Questionnaire, our culture and clients are consistently what our employees rank as most important to them. We consider our culture to be the behaviors and beliefs that are alive within our workplace environment. We work hard to develop and strengthen our culture every day for good reason. With a vibrant culture whose pillars include Client's Side of the Desk Always, No Conflicts of Interest, Team Delivered Service, Continuous Improvement, Fiduciary Excellence, and Honest and Honorable, we have a work environment that engages and inspires our team to do great work for our clients.

Stewardship

Stewardship involves the responsible overseeing and protection of something considered worth caring for and preserving. Beyond the responsibility we have for managing our clients' wealth, we are all obviously stewards of our culture at Greenleaf. Protecting what we have built ensures we will be around from generation to generation.

Innovation

Innovation is more than just process improvement. Innovation is transformation of workflow, more sophistication, more automation, and more operational excellence. We believe innovation continues to be the path to creating more value-added time 'with' and 'for' clients.

"I believe we have accomplished a lot over the past two years and our agreed upon plan for 2015 is to keep on going."

Purposeful Growth

Finally, our end goal is not growth for the sake of growth. Our goal is to provide world class service for our clients. We know from experience that remarkable service is worthy of remark. More remarkable service means our clients will talk and our footprint will grow. By striving to be top of mind with our clients, we create more business development opportunities thereby enhancing both the breadth and depth of our services for clients.

Christopher J. Tarkowski
Trust Relationship Officer

Keeping Real Estate in the Family… New Law May Provide a Solution (Part III)

"… House Bill 4753 became effective December 31, 2013, allowing real estate owners to transfer property between family members without uncapping the property tax…"

On December 31, 2014, the Family Transfer Exemption (FTE) becomes effective in Michigan, providing clarification to House Bill 4753, a law previously passed by the Michigan Legislature in 2013. As Trust Relationship Officer Lauree VanderVeen (Kosobucki) explained in her June 2013 article, House Bill 4753 became effective December 31, 2013, allowing real estate owners to transfer property between family members without uncapping the property tax, ultimately providing many property owners with financial relief upon the transfer of property to their loved ones.

Before the passage of that law, the tax consequences of passing real estate down to the next generation could be enormous, as the property tax cap would be lifted as a result of the transfer, and the property tax owed would be calculated based on the property's assessed value instead of its taxable value. This change in tax calculation could cause significant tax consequences and potentially jeopardize the financial well-being and continued ownership of the property by future generations.

The law passed in 2013 amended the General Property Tax ACT (GPTA) and states that a transfer of ownership subject to the uncapping of property tax does not include a transfer of residential real property if 1) the transferee is related to the transferor by blood or affinity to the first degree and 2) the use of the residential property does not change following the transfer. In July 2014, I wrote a follow-up article outlining some of the challenges that the bill has created for property owners and advisors due to its vagueness. Specifically, property owners have questioned which relatives qualify as "blood or affinity to the first degree," as well as what type of use will not be considered a "change in use" of the property. To address these issues, the Michigan Legislature recently passed the Family Transfer Exemption with the intent to clarify the bill's language which will go into effect December 31, 2014.

First, the newly passed bill provides a specific list of people who are considered qualified relatives and may receive property without causing uncapping. The list replaces the abstract terms "blood or affinity to the first degree" and includes: mother, father, brother, sister, daughter or son (whether adopted or natural), grandchild or grandparent. Next, the Family Transfer Exemption provides specific transfer methods to qualified relatives that will prevent uncapping. The transfer of property under a will, transfer to a trust, transfer by distribution from a trust, or transfer by changing a trust beneficiary will not result in uncapping. The FTE is silent, however, as to whether transfers of property by a deed outright, through a life estate deed, a Ladybird deed or LLC interest to a qualified relative will result in uncapping. Therefore, although these transfer methods were recommended in 2014 to avoid uncapping they may not be the preferred methods moving forward.

A final major clarification to the bill passed in 2013, outlined in the new bill, is in regard to the "change in use" of the property. The bill that will be going into effect on the last day of this year states that once the property is transferred, it may not be used for any "commercial purpose," or uncapping will occur. This rule applies even if it is not a change in use of the property and the transfer is to a qualified relative. For example, if a mother who owns a lake cottage and has rented it out each summer for the last 20 years passes that cottage to her son at death, to prevent the taxes from uncapping, the son must cease renting out the cottage in order for the property taxes to remain capped.

The new law, although much clearer than its predecessor, has once again changed the rules, and in turn the strategy, for many property owners and their advisors when considering succession planning for 2015 and beyond. By being aware of the major changes made by the new law you can better prepare for any action that may be necessary to adjust your estate plan accordingly.

We recommend that you consult with a real estate and/or an estate planning attorney before making any changes to the titling of your property. If you would like a copy of Part I or II of this article it can be found at www.GreenleafTrust.com under the "OUTREACH" tab and clicking on "PERSPECTIVES," or you can contact any member of the Greenleaf Trust team.

"The new law, although much clearer than its predecessor, has once again changed the rules, and in turn the strategy, for many property owners and their advisors when… planning for 2015 and beyond."

Nicole E. Asher, CFP®, CPWA®, ChFC
Senior Wealth Management Advisor

Ghosts of Social Security Past, Present and Yet to Come

During his presidency, Franklin Delano Roosevelt delivered a radio address each Christmas Eve. One of his favorite parts was reading Charles Dickens, "A Christmas Carol." In his own words, "Reading between the lines and thinking as I always do of Bob Cratchit's humble home as a counterpart of millions of our own American homes; the story takes on a stirring significance to me." Roosevelt's address on December 24, 1939 was particularly significant as it fell just a week before the first Social Security checks were to be mailed. "Who a generation ago would have thought that a week from tomorrow – January 1, 1940 – tens of thousands of elderly men and women in every state and every county and every city of the nation would begin to receive checks every month for old age retirement insurance… a measure of protection that will reach down to the millions of Bob Cratchits, the Marthas and the Tiny Tims of our own 'four-room homes'."

"The history of Social Security dates back to the Great Depression. It was established to provide for senior citizens when the poverty rate within that demographic exceeded 50 percent."

Ghosts of Social Security Past

The history of Social Security dates back to the Great Depression. It was established to provide for senior citizens when the poverty rate within that demographic exceeded 50 percent. There were many Scrooges who opposed the original concept and feared that it would cause a loss of jobs. The supporters of the Act claimed the opposite. They felt that the program would encourage older workers to retire, thereby creating jobs. Governor Alfred "Alf" Landon of Kansas, who lost his bid for president against FDR, declared in his campaign that Social Security was a "cruel hoax." Bah Humbug!

The Social Security Act was signed by FDR on August 14, 1935 with taxes being collected for the first time starting in January of 1937. The first one-time lump sum payments were made that same month. Ernest Ackerman, a motorman from Cleveland, retired one day after the Social Security Administration (SSA) began issuing lump sum payouts. He paid 5 cents into the system and got a lump sum check of 17 cents - enough to buy himself a gallon of gas and a fruitcake.

In 1936 the first Social Security number (SSN) was approved. It contained nothing of significance about an employee, other than their State. Less than a year later the twenty-five millionth old-age benefit "Master Name Card" was entered into the system. Originally, the first three digits were assigned based on where you lived. The numbers started in the northeast and moved west. The last six digits were randomly assigned. In 2011, the SSA launched a new randomized assignment method. There are many rumors that have been spread over the years about how SSNs are assigned, one being that the SSA reuses numbers when someone dies. It might be hard to believe, but while they have already issued over 453,700,000 numbers and they assign about 5,500,000 new numbers a year, the current system will provide us with enough new numbers for several generations, with no changes to the system and without using the numbers of the ghosts of Christmas past.

Another rumor is that if you are African American or a Minority the 5th digit of your SSN is even, and odd if you are Caucasian. My 5th digit is 8 and I'm Caucasian. I sampled several of my co-workers and based on this scientific research there was no validity to the rumor. It has also been alleged that flipping your SSN creates a secret code. A young man actually claimed in a lawsuit against Google, for $5 billion, that his SSN upside down spelled Google. His claims were unfounded.

Ida May Fuller was born on a farm in Vermont. She was the first American to receive a monthly Social Security check. It was for $22.54. She retired in 1939 and contributed $24.75 over her last three years of work. She lived to be 100 years old and collected $22,888.92 from the system. She collected the same amount for the first ten years. It wasn't until the 1950s that Congress increased benefits and automatic cost - of - living adjustments (COLAs) didn't start until 1975.

Over the years the SSA has evolved. In 1956 they went high tech when they began using the IBM 705. In 1957 they announced that you did not have to be "living with" someone in order to be entitled to spousal benefits. It wasn't until 1962 that President Kennedy signed into law that SSNs would be used as tax identifying numbers by the IRS, in hopes of cutting down on tax cheating. In 1965, President Lyndon B. Johnson presented a Social Security check to the 20-millionth beneficiary of the system. President Carter signed the Social Security Amendments of 1977 that was designed to restore the financial soundness of the Social Security system into the 21st century. The Omnibus Budget Reconciliation Act of 1981 and an Executive Order by President Reagan were critical moves that were made to address the financial integrity of the Social Security system.

Dial 1-800-SSA-1213 was implemented in 1988 and the administration joined the World-Wide Web in 1994. The 800-number handled its one billionth transaction 20 years later. The website celebrated their one-millionth online claim for retirement benefits in 2007.

"President Carter signed the Social Security Amendments of 1977 that was designed to restore the financial soundness of the Social Security system into the 21st century. The Omnibus Budget Reconciliation Act of 1981 and an Executive Order by President Reagan were critical moves that were made to address the financial integrity of the Social Security system"

Ghosts of Social Security, continued

Later that year, Kathleen Casey-Kirschling, who was the first baby born in 1946, became the first official "baby boomer" to file for Social Security. She filed online.

Ghosts of Social Security Present

In 2011, the administration decided to use Patty Duke and George Takei, Lt. Sulu to all you Trekkies, to encourage Americans to Boldly Go to www.socialsecurity.gov to apply for benefits online. Here is a snippet from their ad:

Patty Duke: You've navigated through asteroid belts, right?

Lt. Sulu: Oh sure, plenty of times.

Patty Duke: Well, compared to that, navigating socialsecurity.gov is a snap…It's so easy even Kirk could do it.

In 2012 it became possible for us to view our Social Security statements online.

Ghosts of Social Security Yet to Come

The good news is that we are living longer and interest rates have tanked. The bad news is that we are living longer and interest rates have tanked. For the last twenty years the program has been taking in more tax revenue than it is spending. This will begin changing as more baby boomers retire, leave the work force and start collecting Social Security. There has also been a drop in birth rates during this time, which means fewer workers are paying into the system for each beneficiary of the system. It doesn't take a miser like Ebenezer Scrooge to tell us that if you spend more than you make you will eventually run out of money. Social Security benefits are projected to continue until 2037, when the trust fund reserves are expected to be depleted. At this point, ongoing tax payments will be enough to support 76 percent of scheduled benefits. Social Security currently provides benefits, in some manner, to over 50 million people. This is paid for by payroll taxes from over 150 million employees and their employers. In order to remain viable the system will require continuous adjustments to the benefit schedule as well as the sources of revenue for the program.

> "Social Security benefits are projected to continue until 2037, when the trust fund reserves are expected to be depleted. At this point, ongoing tax payments will be enough to support 76 percent of scheduled benefits."

While it has been fun traveling Over the River and Through the Woods of the history of Social Security, many are facing the decision today of how and when to take Social Security. There are literally 894 different ways that you can take your Social Security payments. The team at Greenleaf Trust stands ready to help you with those decisions. It's time to go eat some figgy pudding, but I resolve in the New Year to tell you about a few of those ways.

Happy holidays!

IRS Rule a Bundle of Fun

Earlier this year the Internal Revenue Service (IRS) published a final rule under Internal Revenue Code Section 67(e) that requires certain fiduciary fees to be "unbundled" for tax purposes.

Generally when computing a taxpayer's taxable income, miscellaneous itemized deductions are allowed only to the extent that they exceed 2% of the taxpayer's adjusted gross income – the 2% floor. However, Section 67(e) of the Code makes an exception for costs that are incurred in connection with the administration of an estate or trust when such costs would not have been incurred if the property were not held in the estate or trust.

Under this exception, these deductible costs are not subject to the 2% floor for miscellaneous itemized deductions. Instead, the costs are fully deductible from the income of the trust or estate.

Under the new IRS rule, fiduciaries must "unbundle" their trustee and executor fees into two buckets: (1) costs subject to the 2-percent floor and (2) costs that are not.

To determine whether the cost is subject to the 2% floor, the trustee must consider whether it is one that an individual would "commonly" or "customarily" incur. If the individual would commonly or customarily incur such a cost, it is subject to the 2% floor and is not fully deductible from income. The final rule lists, by example, the following costs as subject to the 2% floor:

- Certain tax preparation fees;
- Certain appraisal fees; and
- Investment advisory fees.

The final rule also mentions examples of costs that are not subject to the 2%:

- Real estate taxes;
- Certain tax preparation fees, such as for generation-skipping transfer tax, fiduciary income tax, and decedent's final individual income tax returns;
- Probate court fees and costs;
- Legal publication costs of notices to creditors and heirs;
- Cost of certified copies of decedent's death certificate;
- Costs related to fiduciary accounts; and
- Certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor.

If a "bundled" fiduciary fee is not computed on an hourly basis, the rule requires that the portion of that fee that is attributable to investment advice is subject to the 2% floor, while the remaining portion of that fiduciary fee is fully deductible.

In other words, only the portion of the fiduciary fee attributable to investment advice needs to

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"Earlier this year the Internal Revenue Service published a final rule… that requires certain fiduciary fees to be "unbundled" for tax purposes."

Bundle of Fun, continued

> "In the final version of the rule, the IRS made the effective date for the rule for tax years beginning on or after January 1, 2015."

be unbundled and subject to the 2-percent floor.

Under the rule, a fiduciary may use any "reasonable method" to allocate bundled fees, including allocating a portion of the bundled fee to investment advice. Greenleaf Trust will adhere to the rule by consistently allocating according to our prevailing fee schedules including a 50% allocation to investment advisory fees. The "reasonable method" provision is intended to permit some level of flexibility in how a trustee allocates specific fees. However, consistent application of a "reasonable method" may be very difficult for smaller trustees.

In the final version of the rule, the IRS made the effective date for the rule for tax years beginning on or after January 1, 2015.

The final version rule also provides additional guidance on which costs incurred by non-grantor trusts and estates are subject to the 2% floor for miscellaneous itemized deductions under Section 67(a). The exception in Section 67(e) provides full deductibility from the income of the trust or estate for certain investment management costs that would not have been incurred if the property were not held in an estate or trust. Under the final rule, trustees that charge a "bundled" fee must "unbundle" the portion of the fee allocable to investment advice in order to claim the full deduction for those costs.

Crain's Detroit Confirms What We've Long Suspected

Crain's Detroit Business and Best Companies Group have named Greenleaf Trust "The Number One Cool Place to Work in Michigan" among medium sized companies (50-249 US employees). The award identifies, recognizes and honors the best employers in Michigan, benefiting the state's economy, workforce and businesses. Companies enter the two-part competitive process that evaluates each nominee's workplace policies, practices, philosophy, systems and demographics, and then measures employee experience.

A Greenleaf Trust team member summed up why people love working for the company, saying, "Clients first, employees second and shareholders third. We have a spectacular workplace culture."

Bull Markets Still Taxing

Nick Juhle
Vice President
Assistant Director, Wealth Management

With 2014 quickly drawing to a close, I thought it would make sense to dust off an article I published a year ago, "Bull Markets Can Be Taxing." The piece covered the exciting subject of mutual fund capital gain distributions, which can create a tax liability for investors whether or not they sell shares. This discussion is particularly timely and merits repeating for two reasons: first, most mutual funds make capital gains distributions around the end of the year, and second, given market strength, distributions will be more meaningful this year than they have been in the recent past.

Most investors are familiar with basic tax principles for individual shares of stock. Mr. Smith buys shares of ABC Company for $100 and sells them for $110 realizing a $10 profit, or gain, on which he is expected to pay taxes. If Mr. Smith holds the shares for more than one year, the gains are considered long-term and subject to a federal tax rate of up to 23.8% (in 2014). If Mr. Smith holds the shares less than a year, the gains are short-term and taxed as ordinary income. The key here though, is that Mr. Smith has to sell the shares to realize the gains. He controls the timing, and has the ability to delay realization of gains and the resulting tax liability for as long as he holds the shares. The same concept is only partially true when it comes to mutual funds.

A share in a mutual fund represents a share in a portfolio of stocks (or other investments), and the price of that share (the net asset value or NAV) fluctuates with the prices of the underlying securities. The mechanics here are really no different than in the individual stock example above. Mr. Smith buys shares of the ABC Fund for $100, the underlying securities in that fund collectively appreciate by 10%, and Mr. Smith sells them for $110, realizing a $10 gain and the associated tax liability. Pretty straight forward right? Here's where it gets a little more complicated...

If a mutual fund sells a holding in which it has a gain, it has to distribute that gain to the fund's shareholders in the year it was realized. If the mutual fund buys shares of ABC Company for $100 and sells them for $110, it has to distribute the $10 gain (short or long-term) to shareholders who are responsible for the tax liability. Instead of distributing gains after every transaction, funds typically make a single distribution at year-end which incorporates all gains netted against any offsetting losses or applicable loss carry forwards.

So there are two ways a fund investor can realize gains: 1) by receiving a capital gain distribution from the fund; and 2) by selling

"[The topic is] the exciting subject of mutual fund capital gain distributions, which can create a tax liability for investors whether or not they sell shares."

Bull Markets Still Taxing, continued

a fund share for more than the purchase price. Mechanically, capital gains distributions are processed similarly to dividends. There is a record date (holders of record on this date will receive the distribution), and an ex-date (the first day you can buy the fund without receiving the distribution). This means that a fund could set a record date of December 15 and if our friend Mr. Smith bought shares on December 14, he would receive the distribution and a tax bill. Likewise Mr. Smith could have bought shares earlier in the year and sold them on December 14th and he would avoid the distribution altogether.

Perhaps this seems unfair. The fund accumulates gains all year and then distributes them to whoever happens to be holding the shares on the record date. Fortunately, there is a mechanism in place that prevents fund investors from being taxed twice – specifically, the distribution results in a corresponding reduction to the NAV or price of the fund share, which effectively reduces any gain in the shares themselves.

To illustrate, let's say Mr. Smith buys one share of ABC fund for $100 on December 14 and the fund distributes $10 in capital gains on December 15. Mr. Smith receives the $10 and will pay taxes on that amount (clearly unpleasant), and his share immediately re-prices to $90. Sounds like a lose-lose, but it means Mr. Smith's share could appreciate as much as $10 (from $90 back to $100) before he would realize gains on a sale.

In 2012, the average distribution across our fund focus list was about 2% of NAV with a maximum single fund distribution of 8%. Last year, the average distribution was about 4% with a maximum distribution of 16% and this year, the average will be about 6% with a maximum of 22%. Why such large increases? Funds previously had tax losses on their books carried over from the bear market which they could use to offset incremental portfolio gains, but six years into the post-2008 recovery, much of these tax-losses have been exhausted as the market has continued to move higher.

“Fortunately, our hands are not completely tied. In fact, several steps in our process are inherently geared toward managing tax liabilities generally and specifically as they apply to mutual funds.”

Fortunately, our hands are not completely tied. In fact, several steps in our process are inherently geared toward managing tax liabilities generally and specifically as they apply to mutual funds. First of all, this discussion does not apply to 401(k)s, IRAs, or other qualified accounts and we ensure clients are maximizing these vehicles in the context of a broader wealth management plan. For non-qualified accounts, our fund selection process carefully considers turnover rates - typically, higher turnover (more trading) means more realized gains while lower turnover means the opposite. We also monitor funds closely for manager or prospectus changes which may drive higher turnover if the portfolio is repositioned. Additionally, we analyze capital gains estimates to inform decision-making around year end - under unique circumstances, there may be benefits to strategic repositioning during the distribution season based on a host of account-specific factors. You can rest assured that we are thoroughly examining every account for opportunities.

Lastly, perhaps a little perspective is in order. Nobody looks forward to paying taxes and rational investors will make every effort to avoid, minimize, or delay them. Greenleaf Trust is in your corner working diligently to ensure that we're sheltering, minimizing, and delaying every chance we get. But at the end of the day, taxable gains are, well… gains. So don't lose sight of the fact that while taxes are a certainty, they're also a certain indicator of a growing portfolio.

"Nobody looks forward to paying taxes… But at the end of the day, taxable gains are, well… gains"

Stock Market Pulse

Index	11/30/2014	Total Return Since 12/31/2013
S&P 1500	476.89	13.16%
Dow Jones Industrials	17,828.24	9.85%
NASDAQ	4,791.63	16.01%
S&P 500	2,067.56	13.98%
S&P 400	1,442.63	8.87%
S&P 600	676.82	2.82%
NYSE Composite	10,955.41	5.34%
Dow Jones Utilities	599.70	26.57%
Barclays Aggregate Bond	110.61	5.84%

P/E Multiples	11/30/2014
S&P 1500	17.3x
Dow Jones Industrials	14.9x
NASDAQ	27.9x
S&P 500	17.1x
S&P 400	19.7x
S&P 600	20.8x

Key Rates

Fed Funds Rate	0% to 0.25%
T Bill 90 Days	0.01%
T Bond 30 Yr	2.91%
Prime Rate	3.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	476.89	17.3x	1.89%
S&P 500	2,067.56	17.1x	1.96%
Dow Jones Industrials	17,828.24	14.9x	2.11%
Dow Jones Utilities	599.70	NA	3.31%

Spread Between 30 Year Government Yields and Market Dividend Yields: 1.02%

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