IN THIS ISSUE

Trust UPDATE

Stillman BANK

March 2019

Total return trusts: A thoroughly modern approach

"Trust income shall be paid to my wife at least annually, and the trust remainder shall be paid to my children at her death." That common phrase, familiar to generations of trust lawyers, sounds simple, but it is not. What is "income"?

In a traditional trust, income generally consists of interest and dividend payments. Price changes—capital gains and losses—affect the value of principal, and hence benefit the remainder beneficiaries. For example, assume that a marital deduction trust invests in a technology stock that pays no dividends at all, but it doubles in price in just five years. How much income does that create for the surviving spouse? None at all. A spouse who is looking for maximum reliable current income from trust assets likely would favor heavier investment emphasis on bonds and their regular interest payments.

However, we have just come off a period of historically low interest rates, in which even an all-bond investing strategy might not yield enough income to satisfy a current beneficiary. What's more, failure to keep some exposure to equities in the trust portfolio could mean that the assets fail to hold their purchasing power during periods of significant inflation.

There are several alternatives to the traditional definition of trust income.

The example of the charitable unitrust

When Congress became concerned in the late 1960s about a possible mismatch between the charitable deduction and the amounts that a charity actually might receive from a charitable trust, the resolution included a new statutory

definition for a charitable income interest. Thus was born the unitrust, in which each year the income beneficiary receives a fixed percentage of the value of the trust assets, regardless of how those assets are invested.

During the 1990s, when interest and dividend rates fell to historically low levels, estate planners began to look to the unitrust model for private trusts as a way to resolve conflicts between income and remainder beneficiaries. At the same time, the Uniform Prudent Investor Act was introduced and began to be adopted around the country. That legislation provides standards by which trustees are measured in the discharge of their fiduciary duties in the investment arena. The new emphasis was less on the appropriateness of each individual trust investment, more on adequacy of the total trust return.

Thus was born the total return trust, a trust without a charitable beneficiary that follows the conventions of a charitable trust in determining what the income beneficiary gets.

The first state law authorizing the conversion of existing trusts to the total return format was enacted in June of 2001, and 17 states followed suit within three years. Most states have such legislation today. A majority of states also permit "equitable adjustment." In the earlier example of the no-dividend technology stock, a trustee could use equitable adjustment to allocate a portion of the stock's capital gains to the income beneficiary. Alternatively, during periods of high interest rates and high inflation, the trustee may allocate some income payments to principal, to build the trust for the future.

Total return trusts are not a magical solution to investment management issues. They don't guarantee growth; they don't prevent losses. But they can ease conflicts among trust beneficiaries and meet beneficiary expectations by providing bright-line definitions of income.

IRS approval

Trusts have tax consequences, and in 2001 the Internal Revenue Service weighed in on total return trusts. Adjustments between income and principal that are consistent with state law will not impair the marital deduction, and a unitrust interest will qualify for the marital deduction if provided for by state law. Generally, the IRS considers that a unitrust interest of not less than 3% and not more than 5% is a reasonable apportionment of the total return of a trust. Existing marital deduction trusts may be converted to total return format under IRS regulations that were finalized in 2004.

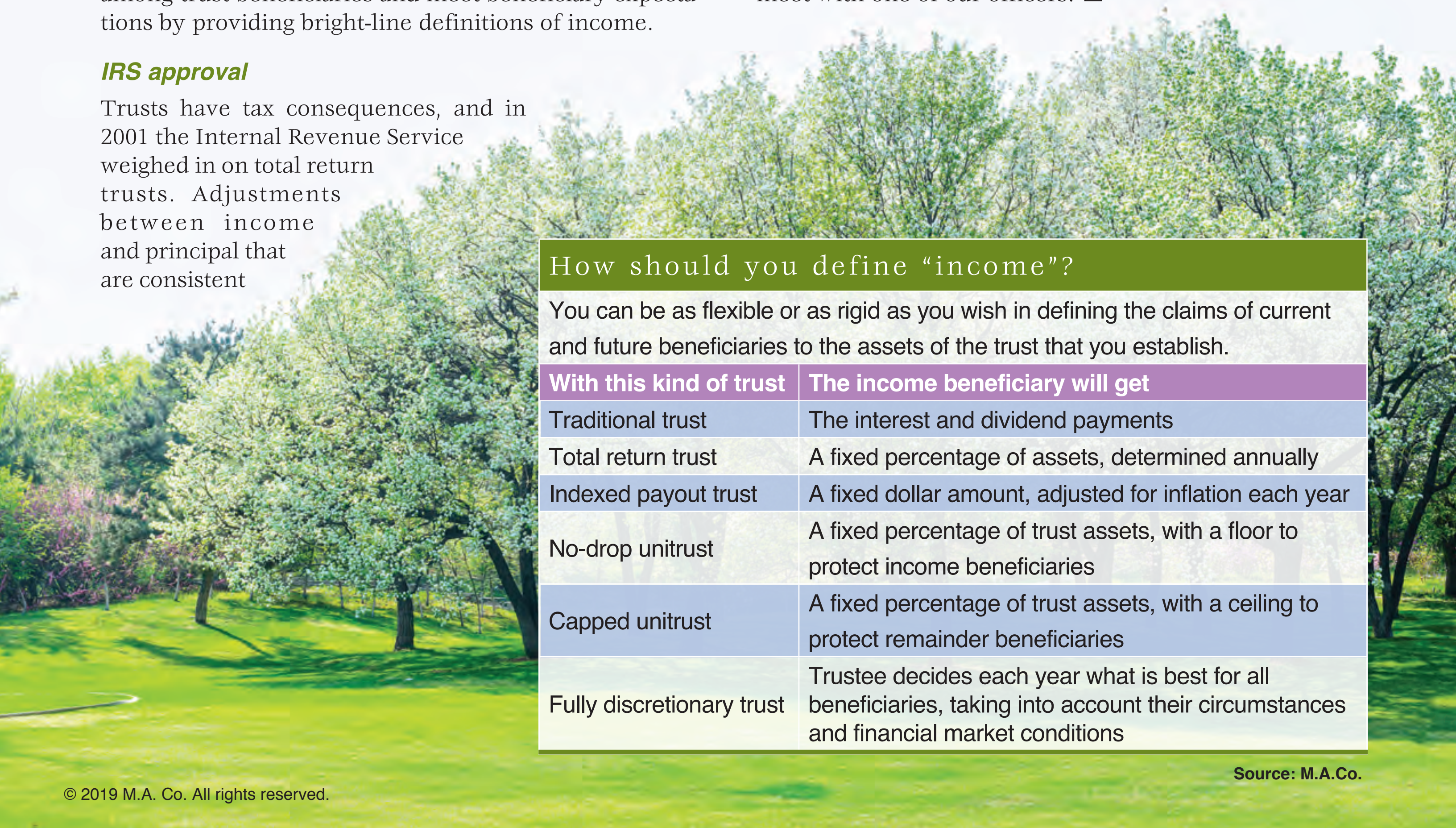
When "total return" is not paramount

The rigidity of the total return format may not be appropriate in all cases. See the table below for examples of alternative income definitions that estate planners have developed over the years. Situations in which a traditional trust may be satisfactory:

- Maximum return is not the goal of the trust. Some grantors are most worried about protection of capital and controlling investment risk.
- The surviving spouse is the primary beneficiary. A traditional trust that also permits discretionary invasions of principal to meet the spouse's needs will be adequate in many situations.
- The trust has a short time horizon. Because stock prices tend to be volatile over short time frames, increased equity exposure may not be appropriate for a trust with a short shelf life.

May we tell you more?

As you can see, modern trust design permits flexible trustee response for maximum financial security. Might you and your family benefit from trust-based financial management? We'd be pleased to tell you more about our services. Why not make an appointment this month to meet with one of our officers? ☐



How should you define "income"?

You can be as flexible or as rigid as you wish in defining the claims of current and future beneficiaries to the assets of the trust that you establish.

With this kind of trust	The income beneficiary will get
Traditional trust	The interest and dividend payments
Total return trust	A fixed percentage of assets, determined annually
Indexed payout trust	A fixed dollar amount, adjusted for inflation each year
No-drop unitrust	A fixed percentage of trust assets, with a floor to protect income beneficiaries
Capped unitrust	A fixed percentage of trust assets, with a ceiling to protect remainder beneficiaries
Fully discretionary trust	Trustee decides each year what is best for all beneficiaries, taking into account their circumstances and financial market conditions

Source: M.A.Co.

Back to investing basics

With the broad sell-off in stocks in the last two months of 2018, followed by gains in the early months of 2019, volatility has returned as a factor for investors to take into account. It's been so long since the last bear market (2009) that some investors may need a refresher on dealing with volatility.

Dollar cost averaging

Imagine that you have $100,000 to invest today in the stock market. The trouble is, prices fluctuate from day to day, and you don't want to buy at the "top" of the market. Your fear of loss may cause you to delay making the investment—but that same hesitation might cause you to miss out on price gains!

One approach to consider to get over the emotional hurdle is to spread your investment over time. For example, instead of investing the entire sum at once you might invest $25,000 each week for four weeks. This approach is called "dollar cost averaging" because equal dollar amounts are invested, which means that if prices go lower, more shares will be purchased. This may give a lower average price per share when prices are volatile. Here's a simplified example.

Assume that XYZ company shares are selling for $200 today, so that $100,000 could buy 500 shares. Now say that the price falls to $180 in a week, to $175 the following week, then to $190, and rallies to $205. If you made a single lump sum purchase of 500 shares at the beginning, it would be worth $102,500 at the end of the period, a gain of $2,500.

With dollar cost averaging, you would buy 538.31 shares, rather than only 500. The average price per share falls from $200 to $185.76. In this example, when the share price rallies to $205, the gain from the investment is over $10,000, some four times higher than with the lump sum investment.

However, dollar cost investing certainly does not guarantee that the investor avoids a loss. What's more, in a steadily rising market, the investor will be worse off with dollar cost averaging, as each $25,000 buys progressively fewer shares.

The question of balance

Rapid price changes may throw an investor's asset allocation out of whack. Say an investor is comfortable with his 60% in equities and 40% in bonds. Then stock prices fall 15%. If bond prices are unchanged, his allocation has drifted to 56% stocks, 44% bonds. To restore the balance, the investor may want to take advantage of the price dip to add more equities to the portfolio.

On the other hand, should equities spike upward, the investor may want to lighten up on stocks to return to the target balance. However, rebalancing may incur tax and transaction costs, so these also must be entered into the equation.

Required Minimum Distributions

Those who are 70½ or older must take annual minimum distributions from their IRAs. The amount is geared to one's life expectancy, so the percentage gets a bit larger every year.

In the early years, the interest and dividend income from the IRA investments may be sufficient to fund the required minimum distributions (RMDs). As time goes on, however, eventually some IRA assets may have to be sold. The owner can choose any time during the year for making the sale, and one would hope to choose a date near the top of the market. It may be possible to take an RMD in-kind, as a distribution of shares or securities that then can be placed into the taxable portfolio. That eliminates the need to sell, but cash will then have to be generated from another source in order to pay the income taxes on the distribution. ☐

A trust must go on

Yvonne Cosden's revocable trust became irrevocable at her death in 2010. The trustees of the trust were Yvonne's only child, Christopher, and Yvonne's personal assistant and friend, Joseph Horgan. The trust provided for an immediate distribution of $250,000 to Horgan and the payment of all trust income to Christopher at least quarterly for life. At Christopher's death, the remainder will be divided among several charities.

After five years of payments, Christopher grew dissatisfied with his income interest. He negotiated a termination of the trust with the charitable remainder beneficiaries, under which he would receive some $2 million immediately and the charities would get the balance, about $1 million. Unfortunately, Horgan refused to go along with the plan so Christopher sued.

The trial court found for Christopher, and ordered the trust to be terminated, essentially to avoid the expenses of additional trust administration. The Florida Court of Appeals then reversed. The intent of Yvonne was clearly expressed in the design of the trust—she wanted to protect her son with an income for life, and she may not have trusted him with a lump sum distribution. What's more, the trust included spendthrift provisions to protect the income interest. There was no waste of trust assets, and the expenses of administration have not been extraordinary. Early trust termination would contradict Yvonne's purpose. Although there was no trust provision prohibiting early termination, the other provisions make clear that termination would frustrate the settlor's intentions.

Expanded protection for older trusts

The "blue book" explanation of the Tax Cuts and Jobs Act, released by the Joint Committee on Taxation last December, included a footnote that says the temporarily increased exemption from the generation-skipping transfer tax may be applied to transfers in trust that occurred before the legislation was enacted. In the footnote, Taxpayer created a $6 million GSTT trust at a time when the exemption was $5.4 million, so that the inclusion ratio for the trust was 0.1. According to the blue book, Taxpayer may now apply his expanded exemption to that trust, to reduce the inclusion ratio to zero. (Having an inclusion ratio of zero means that transfers from the trust will never be subjected to the 40% tax on generation-skipping transfers; it is fully protected from future transfer taxation.) If the trust assets have gone up in value, more of the exemption will have to be used up to provide this protection. ☐