Heckerling Institute Report
Report #8 - Total Return Trusts

The following is Report #8 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

First, an eratta re Report #7. **Lou Mezzullo**'s presentation on **"Entities"** took place first thing Wednesday morning, not on Tuesday as was mistakenly reported in Report #7. We apologize in advance for any confusion this may have caused anyone, and especially Lou.

This Report covers Wednesday afternoon's **Special Session I-C** entitled **"The Total Return Trust [TRU] Revolution: An Introduction"** that was co-presented Wednesday afternoon by **Robert Wolf, Stephan Leimberg** and **Susan Porter**, and **Special Session II-A** entitled **"CASE STUDY - Total Return Trusts: Techniques and Applications"** that was presented by **Robert Wolf** and **Bruce Guiot**.

The portion of this report on Special Session I-C was filed by none other than on-site reporter, Stephen Leimberg, who was one of the co-presenters of that Special Session. The portion of this report on Sepcial Session II-A was filed by none other than on-site reporter, Robert Wolf, who was one of the co-presenters of that Special Session. Nothing like getting it straight from the horses mouth we always say, especially when it comes to a multi-facited topic such as this one. This is a long post too, but well worth reading.

Summary - Special Session I-C: Wolf and Leimberg began this Special Session by explaining the modern portfolio theory, defining total return investing, and comparing the TRU (Total Return Unitrust) with the traditional "income payout" , "discretionary", and indexed annuity trust design. They explained that, although the TRU was an exceptionally important planning tool that should be considered in any trust situation, it was not a "trust for all seasons" but rather one of many tools to be applied where and to the extent appropriate. They emphasized that one of the most important elements of planning in the decades to follow was the importance of drafting to meet client-monetary as well as tax savings goals - and appraising the client of realistic expectations after considering computer modeling which takes into consideration trust expenses, turnover, inflation, and taxes.

Details - Special Session I-C: Wolf and Leimberg made the following points during their presentation:

TRUs can solve problems that can't be solved by the traditional trust model.

• Future planning and drafting will be based more on our client's needs and desires.

• Total return planning will reinforce our client's financial and investment planning.

• Total return planning and computer modeling will highlight insufficiency in capital to accomplish stated objectives.

• Total return planning will be driven by human needs--not taxes - yet it will help us plan better for taxes too.

• The usual approach to drafting trusts - telling the trustee to "Hold the principal - and pay the income" in what we call the "income rule trust" -- is not just the wrong thing to do: From a long-term financial viewpoint, drafting the traditional income rule trust may be as harmful - or even more harmful - than making a drafting error that causes trust principal to be included in a beneficiary's estate.

• Articles in Standard and Poor's Outlook, Bloomberg Personal Finance, and FORBES MAGAZINE have made the public aware - not only that there is a choice - but that the choice can make a lot of difference!

• Although our clients come to us to create trusts set to last for many years or many generations, those well-intentioned trusts - by definition and design cause conflict between those generations

• This potential for family conflict is inherent in the design itself. It's because trusts create separate categories of beneficiaries, current and future - and the interests of the two are instantly and inevitably in competition. This also places the trustee in a very unenviable position: If the investment portfolio is invested for income, the remainder beneficiaries are unhappy. If the portfolio is tilted toward growth, the income beneficiary is upset. Quite often, a grantor's spouse ends up on opposite sides from the grantor's children or grandchildren, the exact opposite result from the family harmony the grantor intended, hoped for, and assumed.

• In an attempt to be fair and impartial, the trustee will typically purchase a near equal proportion of income (typically bonds) and growth (typically equities) . This produces neither a satisfactory level of income (since so much is invested in equities with very low dividend yields) nor growth (since so much is invested in bonds with no growth potential). Too often, neither party's satisfaction will be achieved and the portfolio will - as a whole - under-perform. This makes both sets of parties unhappy with the trustee's performance - and the ultimate goal of the grantor - financial security for both parties - is thwarted.

- What's not readily apparent without computer modeling is the incredible degree to which the classic trust model dramatically reduces a trust's potential investment returns.

- Assuming the S&P 500 dividend yield remains at about 1.2% , on a million dollars of stocks, a trust invested totally in equities yields (gross) $12,000 a year! After trustee's fees are charged to income, and taxes are paid , that $12,000 shrinks to around $8,000 a year.

- Investing in fixed income solves the income problem - but creates another since Treasury Notes are yielding slightly more than 5.5%. So each "unit" of $1,000,000 generates only $55,000 a year - before trustee's fees and taxes. And that's investing every nickel - the entire trust corpus - in fixed income investments - resulting in zero growth.

- So the trustee has a Hobson's choice -- invest for growth, and there's almost no income or invest for income and there will be no growth.

- Traditional trust documents don't even talk about this choice. Our trusts don't tell the trustee what the client wants - because we attorneys have never asked! Our trusts just say, "pay all the income".

- Trustees are required to be impartial as between the life beneficiary and the remainder beneficiary - which is why most trustees don't want to invest less than half of a portfolio in equity securities.

- If the trustee makes a 50-50 mix, half S&P 500 - at about 1.2% yield - and half 5 Year Treasuries - at about 5.5% return - averages out - after trustee's fees - to approximately 3.3% current return - and minimal growth.

- After taxes, expenses, and inflation, over the long Ibbotson period from 1926 to the present, the only category of investment that had any return at all is stocks; bonds have no net real return--and that has enormous implications upon what we can pay out and how we need to be drafting our trusts!

• Yet, because of the low yield of stocks, there would not be sufficient income for the income beneficiary. So a portfolio solely based on stocks will not accomplish our dual objectives.

• One answer to this problem is total return investing, the achievement of the highest overall rate of return, including both income and appreciation - consistent with the risk tolerance of the investor.

• The TRU (Total Return Unitrust), like its charitable counterpart, is an expanding (or contracting) pie. The current beneficiary is given a fixed percentage of the pie as revalued year to year. So if the pie grows bigger (or smaller), so does the slice. For instance, if we assigned a 4% annual interest in the pie to the current beneficiary and the pie was $1,000,000, she'd get 4% of $1,000,000, $40,000.

• The purpose of TRU is to allow a trustee to invest for total return, eliminate the conflicts of interest between the life beneficiary and the remainder beneficiary, a trust which will work fairly and according to understandable and dependable rules all the parties are aware of - no matter whether the market goes up, down, or how fast. Finally, a TRU allows us to make the distributions to our current beneficiary "smooth" (non-volatile) without unduly risking the trust's principal.

• Section 104 of the Revised Income and Principal Act was designed to alleviate problems experienced by traditional trusts. It gives trustees power to adjust returns between principal and income. And it grants that power without any specific limitations - other than the duty of impartiality -- the duty of fairness. This broad ability to make adjustments between the interests of the current and future beneficiaries gives the trustee a way to increase or decrease what the income beneficiary gets. Although many trustees will be glad for the power to make such adjustments, many others may not want that responsibility (curse?). Nor will some beneficiaries want such a power in someone else's hands. Instead, they (and the trust's trustee and investment advisors) may want - a concrete rule.

• Modern Trustees must have the ability to invest for total return regardless of what is defined as income and what is principal. But in many situations, trustees may need and want - a distribution method, a rule-- not just a power. For many reasons, and in many situations all the parties want and need to know what the rule - or rules are - in advance.

• There are, of course, alternatives. One of our best alternatives to the TRU is to draft more fully discretionary trusts. Give the independent corporate or other trustee the right to distribute or reinvest income or principal with complete freedom, or provide discretion subject to ascertainable standards. Where the family situation permits it, particularly where the family gets along well and is relatively affluent, a fully discretionary trust can work very well. Sometimes, the discretionary trust will be the very best choice!

• But absolute discretion placed in the hands of a trustee will not work everywhere. For instance, if the grantor's spouse doesn't want to have to ask the trustee for money, a fully discretionary trust just will not meet the client's objectives - even with a built-in right to change trustees. And when things get tough (such as when there is animosity between the income and the remainder beneficiary), the trustee's job can get very difficult. The very discretion that is such an asset in some situations can be a curse in others! Because a fully discretionary trust by definition provides no real guidelines, each year a trustee must still decide(and neither income nor remainder beneficiaries can be sure how that decision will be made or what it will be): " How much should I, or How much can I - distribute?" The grantor must be willing to give to the trustee the full control, even over the overall division of the economic pie. This loss of control may not please the very people who the trust was created to protect and unify.

• A second alternative to the TRU is to use an index pay out trust. The way this works is to provide in the instrument for the initial pay-out. The trust provides that the pay-out will be adjusted each year for inflation. In some situations (e.g. a relatively short term trust) this can be a very appropriate choice. But a payout linked to inflation can also be risky because the trust can be quickly exhausted and high payouts occur by definition and design at the worst possible time.

• In the TRU the payout to the current beneficiary each year is based not on accounting income but on a percentage of the average trust values in the 3 previous years. This back averaging ("smoothing") avoids the potential for volatile swings in income. For example, the payout, the distribution rate - say 4% - is multiplied by an average of the year end values for the last three years. By using this simple three year smoothing rule, it is possible to decrease distribution volatility by almost 50%.

• The TRU provides an identity of interest among the three key parties to the trust, the current beneficiary, the remaindermen, and the trustee. When one profits, all profit just as when one suffers, all suffer together, because the distribution, the trustee's fees and the principal value all depend on the total return from the trust--they are all true partners in the trust venture.

• Because there is a formula -stated in advance - a rule that everyone can understand - and easily compute - the expectations of the parties are both realistic and likely to be met. Everyone - the trustee - the current - and the future beneficiaries - all know how the distribution will be measured. For example, a 4% distribution on a $1,000,000 trust will be - $40,000. There's nothing to argue about. There's no guessing, no mystery, nothing to be disappointed about, and no decision-maker to be angry with.

• A TRU can qualify for the marital deduction if the document specifically requires that all trust income be distributed annually or more frequently. This is unlikely to be a problem - since the actual unitrust pay-out amount will almost always be in excess of the accounting income of the trust.

• An "ordering provision" requires the trust to pay out income. Then to the extent the income isn't sufficient, the trustee is to allocate short term capital gain to income. To the extent that's not enough, long term capital gain is forced out. To make up any remaining shortfall, the trustee is to pay out the trust principal. So essentially, the TRU works like a CRUT (without - of course - the onerous 5, 10, and 50% tests charitable remainder trusts must meet.) We don't know at this point if the IRS will respect this ordering provision. It should because it clearly and honestly reflects the payments being made to the current beneficiary. But if the IRS does not follow this order (as it does in CRTs), a slight (say 1/4 of a percent) reduction in payout to the current beneficiary may be necessary. (The ABA's Fiduciary Income Tax Committee has submitted this issue to the IRS for determination).

• TRUs should typically include the usual discretionary distribution language (based on ascertainable standards unless the trustee is independent) because, even with the power and advantages of the TRU, flexibility is appropriate. However, it is not possible to give the trustee discretion not to pay the distribution amount. The TRU's strength is predictability. If the beneficiary may not need the income, or the grantor feels it is important to be able to withhold income from the current beneficiary for any reason, a fully discretionary trust or the power to adjust may be more appropriate.

• The TRU is much more than a CRUT - without the charity - or without messy charitable rules and restrictions. It allows us to think about investing and tax planning - in a whole new way! For example, there is a very simple but very special technique which can significantly increase the current beneficiary's after-tax return. It's called "stock pruning" or "cherry picking" : It's a way to trim some of the growth while letting the portfolio continue to grow. Stock pruning is the methodical sale of a small amount of appreciated stock - say 1 to 3% of the portfolio each year - to help make up the difference between the targeted distribution pay-out and the actual income produced by trust assets. So if trust income is insufficient to pay the promised percentage of the last 3 years' average trust value, the shortfall is made up by selling appreciated stock. But this pruning is more than a necessity--it's an important tax planning opportunity!

• Although, from a total return investing perspective, "a dollar is a dollar is a dollar (neither the current nor the remainder beneficiaries care whether it came from income or principal), from a tax perspective - a dollar of principal will typically be worth far more than a dollar of income - after taxes. Picture, for example, a dollar generated from bonds and compare it to a dollar generated from pruning long term capital gain stocks. The dollar from bonds is subject to income tax at the highest federal and state rates. The dollar from stocks is partially capital gain and partially a return of capital. The bottom line is that pruning results in the current beneficiary netting more - after taxes and much more market value in the trust for remainder beneficiaries. Using a richer equity mix coupled with judicious stock pruning, both the current beneficiary and the remaindermen win. So the trust has both a better overall investment mix and a much better tax result! Maximizing total return (only possible in a total return type trust) works far better than the compromise between income and growth that is inevitable with the traditional trusts we have been drafting!

• Because Code Section1014 eliminates income tax on any appreciation in the trust, total return investing is useful not only in the family trust where we know we are going for growth but also in a marital trust where we have traditionally invested heavily in bonds to try to fill the income needs of the surviving spouse.

• The "ideal payout rate" for a TRU will depend on the client's goals. The remaindermen will be best served by the lowest pay out to the life beneficiary. From the current beneficiary's perspective, the payout rate should be based on the beneficiary's needs and the likely duration of the trust. Our computer modeling indicates that 3.7 to 4.1 percent work well over long periods in many cases. The lower the payout rate, the more likely the TRU will accomplish both income and remainder beneficiary's objectives.

• Why not use a "5or 5" power rather than a TRU? Although it remains a highly useful tool (even inside a TRU), it remains only a power and has the following shortcomings: First, it forces the current beneficiary to make a year by year decision (and the power and extent it is exercised is beyond the control - and to the detriment of the remainder beneficiary - thus increasing rather than eliminating the diametric opposition between the two classes of beneficiaries). Second, it is awkward to administer smoothly since it was not designed to be used continually but was rather intended to be an escape valve. Third, if the income beneficiary takes too much too often and at the wrong times (and in addition to trust income), the long term integrity of the trust is threatened. Fourth, as its name implies, the 5 or 5 provision is a power and not a system: neither the beneficiaries nor the trustee can plan since there is no rule governing what will be paid out.

• The most revolutionary and important thing about total return planning and the TRU is that this new paradigm forces us to ask and with computer modeling - for the first time we can - realistically analyze: How much income does my client's family want/and/or need?, and "Are my clients' assets - realistically adequate (after taxes, trustees' fees, turnover costs, and inflation) - or do they need to be supplemented (through life insurance or other means) to accomplish my client's objectives?" Drafting a legally perfect trust is no longer sufficient - if it is not designed to accomplish this specific client's objectives. Old style trusts are flawed - by design. They are producing woefully inadequate investment results - despite a booming stock market. So understanding both what's wrong with current trust design and how to design them better is essential to every financial services professional.

• Selecting a form of trust should start by considering what trust design will best match the family's goals. That will often entail mixing or matching of different types of trusts. We should start thinking about changing our habits of the past - and use Total Return type trusts (such as the TRU) first, next, the fully discretionary trust, less often the Indexed pay out trustand lastly choose slowly and least frequently--the traditional income rule trust! The proper choice will often not be either the TRU or a discretionary trust but rather a custom designed mix.

Susan Porter of U.S. Trust Company then presented her portion of Special Sesssion I-C:

Susan made four major points:

<u>First</u>, she made it clear she's not in agreement with certain of the provisions in the recent New York State Legislative Advisory Committee recommendations. These recommendations would (a) give trustees of existing trusts Section 104 (of the Revised Principal and Income Act) type power to make adjustments between principal and income and (b) treat new trusts - by default - as 4% unitrusts unless the governing instrument proves otherwise. She described the latter proposal as "more of an override than a default rule" and expressed further concern that the N.Y. proposal, if enacted, would apply to estates as well as trusts.

<u>Second</u>, she stated that "I have a bias for a fully discretionary trust",

noting that "the trustee can never be criticized unless the trustee was arbitrary or capricious." She feels strongly that a fully discretionary trust should almost always be the trust of choice. She cited the strong protection afforded by discretionary trusts against governmental reach and expressed concern that total return unitrusts might force more payout of income than income beneficiaries might need.

<u>Third</u>, she expressed the opinion that the D. N. I. of a unitrust doesn't carry out capital gains.

<u>Fourth</u>, she noted that the N.Y. proposal, defining income as a 4% unitrust interest (with a three year smoothing rule) presents an issue as to marital deduction qualification. While she personally felt it qualified, she noted that it is an open issue which is being discussed with Treasury officials.

She concluded that planners should use unitrusts for predictability and discretionary trusts for flexibility.

Special Session II-A: Case Study Session on Total Return Trusts, presented by Bob Wolf and Bruce Guiot:

The **general thrust** of the session was to display the variety of ways in which Total Return Trusts can be used to satisfy human needs and investment goals, while helping us leverage our tax planning and estate planning. By definition, a total return trust is any trust which allows the trustee to invest for total return and which does not base what the beneficiary receives on principal and income distinctions. It is not limited to total return unitrusts, but includes fully discretionary trusts, indexed annuity trusts, total return unitrusts and other hybrid trusts Real life estate planning situations and solutions were used to illustrate real families, real problems and real solutions (if a Total Return Unitrust was used, a TRU Solution).

The **initial case study** tracked a real trust where the trustee was forced to hold the principal and pay the income (only) over a 10 year period. Because of a high income need, the trustee adopted a 50/50 asset allocation, periodically rebalancing to preserve the allocation and attempt to prop up the income. During the 10 year period chronicled, while the market value of the trust almost doubled, the actual income distributed to the beneficiary declined by about 10% because of the decline in interest rates, which
outweighed the dividend increases during the period. The question was then raised: what should be done with this type of trust which is already irrevocable. The answer was-1) look for discretionary powers in the instrument; 2) use Section 104 of the UPAIA if it is in your state, and if

not, consider ;3) reforming the trust by court action into a Total Return Unitrust (TRU).

Key tip in the reformation area is the issue of GST grandfathering. The question is -- if you reform, might you lose the grandfathered status. The answer is that you may well, but there is new regulatory guidance under Section 2601 addressing modification. Such modifications will not cause a loss of grandfathering if:

1. You don't extend the vesting of a GST interest (by another generation, for example).

2. You don't shift a benefit to a lower generation. This raises a strange and intriguing question, because life estates (such as an income interest) are valued as if the total return were accounting income and distributed to the beneficiary. That is--the income beneficiary is assumed to receive a 7.4% rate of return! Hence, even though a conversion into a 4% unitrust may double the rate the income beneficiary actually receives, it may be considered to have been decreased-hence violating the rule. ANSWER: The suggestion on the reformation issue is to make the reformation into an income or 4% unitrust distribution, whichever is the greater. This should satisfy the rule.

The **second case study** shows how TRU's can help not only satisfy the NEEDS of the beneficiary, but also leverage the Applicable Credit Amount. By using a high rate unitrust (or income, whichever is greater) for the marital and a fully discretionary trust for the credit shelter trust, the amount remaining after tax for the next generation is increased over a long period (1960-1998) by 800% over the traditional income model.

<u>One of the most important points of the case studies is</u> that because most Total Return Trusts try to set a payout, or a payout rate, we are finally dealing with the one thing the beneficiary REALLY cares about-what they will get. This needs based planning changes the dynamic of the estate planning process, putting the planner on the same side with both spouses and children.

The **third case study** pointed out that in setting a rate for a TRU, the asset allocation is critical to how much one can pay and still have a rational basis to believe that the real value of the trust will be preserved. A 2% payout TRU with a 50/50 stock and bond mix and a 4% payout all equity TRU for most of the period 1960-1998 would have traced very closely in market value, despite twice as high a payout for the all equity TRU. <u>Moral</u>: during many periods, you can pay out twice as much with twice the equity exposure (even though the accounting income may be only half as much)!

The **fourth case study** involved a second marriage situation where the second spouse demanded both a high payout from the trust assets and that it be indexed for inflation. Various approaches were taken to try to match these goals with limited success, at least when tested by the most difficult investment period for these goals--that is, starting in 1973. Various new types of trust designs were suggested and tested with computer modeling, including the "no-drop" unitrust, one in which the distribution never goes
down, an indexed payout trust (what was desired, but which didn't work in the worst case scenarios) and a new hybrid, the TRUCAP Index Trust. This is a trust which is an indexed payout, but with a cap so that if it pays out more than a set percentage (suggestion was 10%) it becomes a TRU, so as to avoid depletion of the trust, which would occur with a strict indexed payout. This hybrid seems the best solution for the difficult situation in which the payout is intended to be indexed for inflation, and illustrates that the process of inventing new types of trusts to respond to human (not just tax) needs, is just beginning.

The **fifth and last case study** illustrated one of the ways in which you can create a "virtual unitrust" to solve a problem. In that case, the problem was an overconcentration in international oil stocks with a relatively high yield). By using an existing withdrawal power, the family could essentially have the benefits of a unitrust, which could provide the tax advantaged cash-flow (much of the principal pruned to make the payout is a return of cost basis, and the rest is capital gain), without necessarily having to simply buy more bonds.

One more point: if people wonder what would be a good second career for trust lawyers if they really DID repeal the estate tax, how about drafting trusts to meet human needs!

Several questions were posed as to when the total return unitrust is contraindicated, and the answers were:

1. Whenever the beneficiary may not need any income from the trust.

2. When the assets of the trust are composed of other than typical financial assets. Real estate, closely held entities, FLP's, LLC's LLP's etc. don't fit in since illiquid assets, or ones where you have control over how much the income is, are better held by fully discretionary trusts.

3. Credit shelter trusts and GST Exempt trusts, to the extent that the grantor doesn't care about how much is going to be distributed to the beneficiary or to the extent that the beneficiary doesn't need anything from the trust, work better with fully discretionary trusts.

As an aside, one of the most useful combinations is to use a TRU in tandem with the fully discretionary trust. By having a concrete payout from the TRU, often this gives the beneficiary more confidence to accept a fully discretionary trust for the tax advantaged trust, because the TRU has satisfied their need for income.

That's it for Report #8.
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