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Unitrusts: The Liberation of Trust Assets From Their Traditional Fixed Income Focus

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We all have witnessed, with frustration, trusts that comply with all the requirements of the Internal Revenue code and that address all the rules about trust law the drafting attorney has learned in law school only to find, in the end, that the language of this beautifully crafted document requires the trust assets to be invested in fixed income investments. How can such a well-intentioned, carefully crafted document force the fiduciary to be so ineffective in managing the trust's assets? The reason why trustees cannot optimize the total return on the assets in which they have been entrusted is that the language in most of today's trust documents – rooted in agricultural 19th century, when most trust documents involved land rather than money – remains obsessed with a very narrow constrictive view of income and principal. The old trust paradigm of the past 500 years has served its purposes well, and although in its more recent tax-driven incarnation in 1939 which reduces wealth transfer tax, manages income tax and avoids generation skipping tax, it has failed to provide a forward-looking concern for the operation of the trust after its execution and funding. Today's frustrated trustees find that after factoring in taxes and expenses, they must invest as much as 95% of a trust's assets in fixed income vehicles just to generate a 5% income stream to their beneficiaries, thus denying the trustee the opportunity to truly be a good steward of the assets held in the trust. Clearly, a new form of trust is required which will allow assets to be invested in a manner consistent with modern portfolio theory, modern trust law and the human needs and desires of both the grantor and the beneficiary.

THE OLD TRUST PARADIGM OF THE PAST 500 YEARS HAS SERVED ITS PURPOSES WELL, AND ALTHOUGH IN ITS MORE RECENT TAX-DRIVEN INCARNATION IN 1939 WHICH REDUCES WEALTH TRANSFER TAX, MANAGES INCOME TAX AND AVOIDS GENERATION SKIPPING TAX, IT HAS FAILED TO PROVIDE A FORWARD-LOOKING CONCERN FOR THE OPERATION OF THE TRUST AFTER ITS EXECUTION AND FUNDING

The structure of all trusts is basically the same with minor variations: "The trustee shall hold the trust corpus and pay income therefrom to the income beneficiary during their lifetime. Upon the beneficiary's death, the trustee shall divide the trust among the principle beneficiaries." The model is someone receiving something now, typically income, and a different or additional person receiving something, typically principal, later. Thus, the solution in creating a modern trust today lies in how we define wealth, income and principal.

The concept of principal and income arose in 15th century England when wealth was represented by land. The fruit of the land – the crops – could be consumed or traded away, while the land remained to produce another crop. The land was "principal," and the crops were "income." The distinction was easy to make. However, in this century the nature of wealth began to change, crop rotation became asset allocation. Significant assets were created in financial capital like stocks, bonds and cash. Because of the 500-year influence of the agrarian model, we moved to the concept that these financial assets could be rented. That is, we could rent our money to General Motors by buying some of its shares. In return, we received dividends. We call the value of the shares "principal," and we call the dividends "income." In the world of trusts, these two elements of principal and income are considered two different things, yet today at the end of the 20th century, we know the ancient distinction between principal and income is artificial. Property is property, but money is fungible. It makes no difference whether one receives dividends and interest or capital gains; they are both cash payments with no inherent characteristic of cash that would distinguish one from the other. Thus, since wealth in the 20th century is now represented largely by financial capital rather than real property, we must move away from the artificial distinction between income and principal. We must move to a new model for trust assets that is driven by total return. It should make no difference in what form the return should take – accounting for either income or the appreciation of

principal. The distinction between income and principal has blurred, if not disappeared. Yet, most personal trusts and associated investment strategies do not reflect the reality of the changing definition of wealth and capital in the 20th century. Thus, the resulting investment problems manifested in the traditional way of drafting trust documents with income and principal provisions are not easy to resolve by virtue of the language of the trust document.

The trustee is required to act impartially concerning the needs of the current beneficiaries and the anticipated needs of future beneficiaries, yet the artificial distinction between income and principal clearly favors one class of beneficiaries – either the current income recipients or the remaindermen – over the other. Currently with one set of beneficiaries getting the income and another getting the principal – the greater the income needs of the current beneficiaries, the less able the trustee in addressing the needs of the future beneficiaries. This is the primary reason why bank trust units have had such a poor reputation in managing assets. The beneficiaries are invariably disappointed with the impartiality of the trustees in managing trust assets. Income beneficiaries feel that the income produced is inadequate while the remaindermen feel the trustees have not produced growth which is consistent with the broader indices. The solution is trustees must move to the new total return investment paradigm and the trust documents under which they serve must facilitate, not impede, this new investment methodology. This new form of total return trust is popularly call the unitrust.

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Essentially, the language in a unitrust document liberates the trustee to invest for maximum total return. The document may specify an annual dollar pay-out to the income beneficiary (an annual disbursement) as a percentage of assets, or even a pay-out indexed to inflation or some other reference point, or it may allocate the trust's actual investment growth each year on a 50/50 basis between the income beneficiaries who receive a cash payment and the remaindermen whose share would be reinvested in the trust's principal. How the trustee generates that pay-out – even if it means invading the principal – is up to them. Instead of tilting the asset allocation towards bonds when more income is needed for the income beneficiary, the unitrust lets the trustee make whatever asset allocation they think is most appropriate. Here a trust attorney who has focused his entire career solely on saving estate taxes must reshift his focus, thinking like an investment manager. This new asset management dynamic assures the successful on-going operations of the trust for the benefit of all beneficiaries.

For example, suppose the trust document requires the trustee to generate an annual 5% pay-out. Under the traditional income-only approach, they would have no choice but to invest 95% of the assets in fixed income to everyone's detriment. But with a unitrust they could invest virtually 100% of the assets in stocks and cap the principal for the necessary pay-out, confident that growth in principal would exceed the income disbursement. In effect, the unitrust model primarily distributes capital gains income each year rather than dividend or interest income. This approach also enjoys tax advantages since the 20% capital gains tax bite is currently lower than the tax on most beneficiary incomes. Most computer models which factor in trustee's fees, taxes and portfolio turnover into the equation conclude that a 5% pay-out with the old income-only approach would fail to keep pace with inflation over most time periods. Yet, an all equity portfolio could pay out 5% every year and still handily beat inflation. The added benefit of a unitrust pegged to a 5% or less pay-out is the value of the trust principal increases over the years, thus facilitating an increase in the actual dollar pay-out as well, greatly benefiting both the traditional income beneficiary and the principal beneficiary. Importantly, the unitrust creates a partnership among income beneficiaries, principal beneficiaries, trustees and attorneys who have traditionally been at odds with one another.

The problem is that virtually all existing trusts are of the traditional income and principal variety. This trust is irrevocable, and the grantor has been deceased for years. These trusts leave no room for the trustees to impartially maneuver for the benefit of the beneficiaries. The principal beneficiaries often see the growth in trust assets stunted by the income requirements of the income beneficiaries. One solution is that if all parties to the trust – the trustee, the income beneficiary and the remaindermen – want to switch to a unitrust they can seek the court's permission to reform the trust by signing a release which will hold the trustee harmless for potentially invading the principal of the trust. This can be both costly and unpredictable as the courts may be even more conservative than attorneys.

On the legislative front, the Uniform Prudent Investors Act leaves little doubt that trustees have broad authority to invest in a variety of styles, including total return investing. The Uniform Income and Principle Act also authorizes the trustee to recharacterize principal appreciation as income which would allow trustees to effectively comply with their duty of impartiality. These provisions have not been yet adopted by all states, and there is the opportunity for the state legislatures to amend their provisions. There is also the issue of the applicability of the law to existing instruments. Would the trustee be willing to make such appropriate adjustments in the presence of the traditional language in trust documents? If the trustee is given broad discretionary powers, there is no guidance as to how to execute it, and there is no framework for the beneficiary to build expectations. Thus, ultimately a unitrust payment formula must be incorporated in the trust document. Yet, the wheels of trust reform turn slowly. Legislators are unlikely to embrace unitrusts until attorneys do. Legislation will not

make sense as a solution until everyone gets on board, as it is hard to convince legislators to change laws concerning old trusts until they see attorneys writing new total return unitrusts.

But the challenge ultimately goes beyond the trust document itself. Every trust must have a trustee to assume the role of a fiduciary which fulfills all the obligations of the position, to include the investment of trust assets. The trustee must fulfill the wishes of the grantor which requires discretion in weighing intangible concepts such as the need, ability and maturity of the beneficiaries. By definition, this means some risk must be assumed by the fiduciary as there is no clear cut right or wrong judgment in the needs, ability and maturity of the beneficiaries. Sadly, the sensitivity that is required to be an effective fiduciary are not exhibited by today's corporate trustees. Although the unfulfilled expectations of today's trust beneficiaries can be somewhat attributed to antiquated trust documents, trustees bear some of that responsibility. Times have changed. Large corporate trustees no longer have trust departments; they have capital management divisions which reflects the corporate fiduciary's change in attitude toward the client. An emphasis on investment management and proprietary mutual funds has superceded trusteeship in the classical sense. This change in emphasis has made corporate trustees risk adverse in their actions, and hence they are often reluctant to exercise broad discretion in ways that rightly favor one beneficiary over another. To some extent, this is understandable. Trustee fees are kept low by a highly competitive market with the average fiduciary fee being no higher than that of an investment counselor who only manages investments. The trustee is not compensated for assuming the risk of dealing with contentious beneficiaries or antagonistic family members. Nor is the trustee compensated for the time spent teaching beneficiaries how to manage their inheritance. Yet, those services are integral parts of what the client wants from a trustee.

It is rare that we find an individual who is involved in another's financial affairs and who possesses all the qualities of a good trustee in the requisite proportions. On the other hand, rarely do we find today a bank trust department possessing the personal strength and interests that clients seek. Yet each of those choices – individual or corporate trustee – has unique strengths and weaknesses which can together serve the client well. There are three primary responsibilities of the trustee: (1) the investment function, (2) the administrative function and (3) the counselor function. The first two – the investment of funds and recordkeeping – are areas in which corporate trustees excel. The third, acting as a family counselor, facilitator and advocate, is not the strength of the corporate fiduciary. Here, the individual trustee excels. The solution is perhaps to bifurcate the responsibilities of the trustee's office, giving clerical and investment functions to the corporate trustee, while giving a chosen individual discretionary powers over the trusts, its distributions and perhaps even its beneficiaries. While this can be done within individual co-trustees, the better solution may be that of the trust protector.

For many years legal practitioners in English Common Law jurisdictions have made regular use of a special trustee often call the trust protector. The role of the trust protector is to modify the terms of the trust when necessary to carry out the grantor's intent. The powers of the trust protector can be simple, such as the power to remove or replace trustees, or can be more complex such as the power to alter the beneficial enjoyment of the trust. There is no limit to the range of powers provided the trust protector, although the powers typically granted would include: (1) the power to amend the dispositive terms of the trust such as removing beneficiaries or changing the ages of distribution, (2) the power to amend administrative terms such as removal or replacing trustees, (3) the power to appoint one's successor as trust protector, (4) the power to exercise discretion as to the receipt, time, nature and amount of distributions from the trust itself and (5) the power to change the legal status of the trust.

Almost anyone can act as trust protector, other than the grantor, beneficiary or a direct family member. The grantor would defeat the purpose of the trust by retaining trust protector powers as the IRS would rule the trust assets as part of the grantor's estate. The beneficiary cannot act as trust protector as it may create a general power of appointment that would cause the trust assets and its income to be included in their estate and would cause income tax liability as well. A family member may not act as trust protector as the IRS would maintain a related party is merely an agent for the grantor with adverse tax consequences as well. Thus, it is best a third party act as trust protector.

Perhaps the ultimate solution to properly create and administer trusts that reflect the changing nature of wealth (real property to financial assets), the changing nature of trust administration (income and principle to total return) and the changing nature of the trustee (impersonal corporate trustees to more personal, individual trustees interested in impartially serving the best interests of the income and remainder beneficiaries) is to create a new trust paradigm better suited to their long-term administration. For most investors, banks are not even the third or fourth best option for investment and recordkeeping. Alternatively, investment management consultants are widely recognized as providing, by far, the highest level of professional investment counsel. Consultants explain how the capital markets work and create realistic performance expectations. Consultants perform an asset study to determine the risk, return, tax efficiency, liquidity and cost structure of the existing trust portfolio. They evaluate and diagnostically determine the right portfolio structure that would impartially serve the interests of the beneficiaries. They create a custom statement of investment policy for the trust against which they are measured and accountable. In essence, consultants play the important role of counselor that is essential in trust administration. Given the most important discipline in trust administration is investment management, perhaps the best solution for both the grantor and the beneficiaries of trust is to engage the services of an investment management consultant to manage the on-going administrative responsibilities of the trust. Working with the trust services division of their firm or with the trust services of a third-party trust company that would create a unitrust, the consultant is empowered to impartially administer the trust assets as a trust protector. The consultant clearly brings far better credentials, less conflicts of interest and more objectivity than the bank in the on-going management of the trust. Clearly, if we cannot rely on the corporate bank trustee to properly administer the trust and if an unrelated third party would best serve as a trust protector, then the objectivity, judgment and professional investment counsel of the investment management consultant is better suited to impartially addressing the complex administrative and asset management considerations in "total return" investing required in a total return unitrust. The consultant is accustomed to evaluating and at times replacing the third party administrative and recordkeeping services provided their institutional clients and the consultant is very comfortable in providing personal investment counsel, creating a custom statement of investment policy for each trust. None of these services can be objectively performed by the corporate trustee which has conflicts of interest with their proprietary asset management and their proprietary services.

Think of the billions of dollars that have been under trust over the last 18 years when the market has increased tenfold, and the only thing the corporate trustee has to show for their work is that the original principal balance has been preserved. The time has come for a change, and the professional investment counsel of the investment management consultant has never been better positioned to carry out the original intent of the trust while professionally balancing the income and principal interests of the beneficiaries. ■

Notes

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