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Investing Irrevocable Trust Assets: Key Considerations

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Topics for Discussion

- Objectives for Today’s Session
- Part I: Investment Nuances of Irrevocable Trusts
- Part II: Standards of Trustee - Prudent Investor
- Part III: Investment Considerations
- Key Takeaways
- Disclosures

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Objectives for Today's Session

- Provide clarity on a complex topic
- Learn how the Uniform Prudent Investors Act (UPIA) of 1994 plays into investment decision-making
- What to be mindful of when managing irrevocable trust assets
- Share best practices
- Establish helpful resource guide

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Part I: Investment Nuances of Irrevocable Trusts

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Trusts: The Governing Document

- **Type of trust – revocable, irrevocable, CRT, CLT, GRAT**
- **Defines roles and responsibilities** of the trustee or co-trustee(s)
- **Identifies beneficiaries**, both current and remaindermen
- **Investment restrictions**
- **Investment authority:**
  - **Full**
  - **Shared**
    - Does not mean directed
    - Best practice: secure written approval prior to executing trades
    - If co-trustee wants to buy/sell and the corporate co-trustee executes, then assumed that the trustees agree and are responsible
    - Disagree: what does the trust state? Unanimous consent, majority rules, third party tie-breaker, etc. or silent => look to state statute
  - **Delegated**
  - **Directed** – explicit

Revocable vs. Irrevocable Trusts

- **Revocable**
  - – Typically, treat like an investment management or agency account
  - – Communicate and coordinate capital gains with grantor (i.e., settlor, donor), who pays taxes

- **Irrevocable**
  - – Trust pays the capital gains
  - – Current beneficiaries usually receive net income; remaindermen usually receive principal
  - – Fees typically taken from income and principal, equally, so fair to both sets of beneficiaries; may depend on state statue or governing document
  - – Important for the Portfolio Manager (PM) to know expected payouts and when the trust terminates
    - Work closely with Trust Advisor and beneficiaries
    - Ensure updated on distributions and financial changes with beneficiaries so can select and confirm that the investment objective and bond selection are appropriate

Asset Allocation Considerations

- **Investment objective:** typically Balanced or Growth, but depends on time horizon, distributions, unique circumstances, type of trust, and the underlying document
  – Consider both current and remainder beneficiaries
  – Potential for tension
  – Conflict => Balanced or consider Power to Adjust or Unitrust

- **Caution:**
  – 100% fixed income or 100% equities
    - Ensure appropriate and not favoring one set of beneficiaries over the other
    - Pull list and review

Principal vs. Income Accounting

- **Discretionary payment provisions**
  - Allowed by some trusts to current beneficiaries; approval process
  - Investment standpoint: Trust Advisors communicate timing and amounts to PM so can manage cash levels appropriately
- **Overdrafts**
  - PMs can't just cover an overdraft by transferring principal to income – considered principal distribution and document must allow for that; usually approved by a Trust Advisor and/or Committee
- **Unique or specialty assets** such as real estate, mineral interests, etc.
  - PMs should know cash needs for appraisals, insurance, property taxes or expected sales, etc.
  - PMs consider when allocating assets
- **Capital gain distributions, dividends, interest** <u>should not</u> be automatically reinvested if the beneficiary(ies) is receiving net income

Charitable Trusts

- **Charitable Remainder Trust** (CRT) and **Charitable Lead Trust** (CLT)
  - **CRT**: irrevocable trust where the grantor or named beneficiary receives income and thereafter, the trust distributes to one or more charities
  - **CLT**: irrevocable trust that provides payments to one or more charities and then distributes the remaining assets to the grantor or other beneficiary(ies)
    - Grantor CLT – know client's tax bracket to determine whether taxable or tax-exempt bonds makes sense
    - Non-grantor CLT – taxable bonds
  - **Annuity** (CRAT or CLAT) – fixed amount *or* **unitrust** (CRUT/CLUT) – fixed percentage of trust and revalued annually

- Charitable trusts and other irrevocable trusts should generally be **allocated separately** and not combined with other accounts; process in place to approve combining

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Part II: Standards of Trustee – Prudent Investor

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Uniform Prudent Investors Act (UPIA) of 1994

- Sought to unify how trustees should invest and manage trust assets
- Highlights of the Act:
  - **Section 1 – PRUDENT INVESTOR RULE**
  - **Section 2 – STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES**

    (a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

    (b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. [see Act for full language].

    - View portfolio holistically; opened door to a variety of new investments, which also created a more complex landscape for overseeing investments and ensuring that they are appropriate
    - Okay to invest in risky investments such as high yield bonds and private placements
    - Consider specialty assets

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Prudent Investor Highlights Continued

- **Section 3 – DIVERSIFICATION**
  - *A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.*
- **Section 4 – DUTIES AT INCEPTION OF TRUSTEESHIP**
  - *Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act].*
- **Section 5 – LOYALTY**
  - *A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.*

Prudent Investor Highlights Continued

- **Section 6 – IMPARTIALITY**
  - *If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.*
- **Section 7 - INVESTMENT COSTS**
  - *In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.*
- **Section 8 - REVIEWING COMPLIANCE**
  - *Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.*
- **Section 9 - DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS**
  - *A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. [see Act for full language].*

Part III: Investment Considerations

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Duty to Diversify

- Are there **special circumstances** that warrant not diversifying the portfolio?
- **Concentrations**
- **Educate trustees** and potentially, beneficiaries on risks
- **Consider gains** – create a divestiture plan as an option
- Is there **language in the trust** to address the position(s)?
- Can the trust be **combined with another trust** to dilute? Follow process to see if possible.

Delegation of Investment Management

- While able to delegate; trustee retains **duty to monitor**; not directed
- **Establish process** to approve and monitor delegations; umbrella delegation agreement helpful
- **Investment oversight:**
  - **Firm level** – due diligence consistent with how other external managers are monitored
  - **Account level** – allocation in-line with outside IPS, performance, concentrations
- Additional delegated manager fee on top of normal bank fee
- **Delegated Advisors tend to view the beneficiaries as the client vs. the Bank**
  - May be taking direction from the beneficiaries
  - Tend to combine irrevocable trust with other accounts they may be managing for the beneficiaries vs. treating the irrevocable trust as a stand-alone account

Private Placements

- **Less liquid investments**
  - Time horizon of trust – know when terminates or an estimate before investing in assets with lock-ups and potential side pockets
  - Liquidity – if making principal distributions, then the percent of less liquid investments likely to increase relative to liquid
- **Income**
  - Tend not to distribute income; consider power to adjust
- **Suitability**
  - AI/QP requirements
  - Just because AI/QP, doesn't mean the account is suitable
  - Best practice: establish process with approval checklist
- **Taxes**
  - K-1, comfortable filing an extension
  - PFIC likely if offshore LP – may pose accounting problems for charitable split interest trusts

Power to Adjust or Unitrust

- **What is it?**
  - Alternative to distributing only the net income of a trust to the current beneficiaries
  - Typically, applies to net income only trusts using a statutory power to either adjust principal to income or pay a fixed percentage of trust assets based on the governing law of the trust
  - Usually set at 3-4% of the trust's 12/31 market value

- **Investment Objective**
  - Usually, select a Growth-oriented investment objective
  - Work with Trust Advisor to evaluate if appropriate for specific trust/beneficiaries

- **Does it make sense in today's market environment?**
  - Interest rates have moved up after a long period of Fed accommodation
  - Best practice: review payout percentage annually

Key Takeaways

- An irrevocable trust should be **managed differently than an agency account**
- Trust Advisor and PM **communication is critical**
- When managing a new irrevocable trust, ensure all team members **understand** the **terms of the trust and investment parameters**
- Just because **UPIA** broadened the investment universe for trusts, **doesn't mean all investments are appropriate**
- If **delegating** investment management, even if your firm only has legacy exposure, ensure process in place to **monitor firms and underlying accounts**
- **Combining an irrevocable trust** with another account should be **an exception**; establish approval process

Disclosures

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