PERSPECTIVE

THE NEWSLETTER OF CHRISTIANA TRUST JANUARY 2012 VOL. 4 ISSUE 1

TO THINE OWN SELF, BE TRUE: TOTAL RETURN UNITRUSTS AND YOU

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In the beginning there were income-only trusts, and the trustee paid income such as dividends, interest or rents to the beneficiary named in the governing instrument. Upon the trust's termination, the trustee distributed whatever was left to the remaindermen, the trust's ultimate beneficiaries.

And from the beginning income-only trusts generated discord between the income beneficiaries and the remaindermen, as well as between the remaindermen and the trustee. The trustee necessarily invested in fixed-income investments to meet the needs of the income beneficiary; unfortunately, this minimized the growth of principal and reduced the amount that went to the remaindermen. Worry warts contemplated whether income-only investing might be considered as violating that part of the fiduciary code that requires the trustee to treat all beneficiaries impartially. Further complicating the situation, since the 1980s all states have passed prudent investor statutes requiring trustees to use total return investing.

Diminishing income, concern about breaches of trust, and the rise of the prudent investor rule posed serious problems for trustees. While there are a variety of solutions, this article focuses on two major approaches: Investing for total return and redefining "income." "Total return unitrusts" met the prudent investor challenge, while the trustee's ability to allocate between income and principal gave beneficiaries of income-only trusts a viable solution to declining income.

History of Total Return Unitrusts

Total return unitrusts can trace their origin to two developments. One is the development of a new type of trust, the charitable unitrust, and the other is the introduction of the "prudent investor" approach to investing.

Total return unitrusts (TRUs) for individuals appeared in the late 1960s when their cousins, charitable split-interest trusts, came on the scene. Initially split-interest trusts were divided into charitable and non-charitable interests. "Income" became an amount based on a percentage of the trust's principal, valued either once at the time of funding, or every year, on the same day as the anniversary of the trust's funding. What was new was that capital gains could be included as income if the account's yield was insufficient to fund the unitrust amount, whereas before, capital gains were always allocated to principal.

For example, if an individual created a $1,000,000 charitable annuity trust in which 5% of the trust's fair market value on the day of creation was to be distributed to him or her, he or she would receive $50,000 per year until the trust terminates after a period of years or at death, regardless of the actual income generated or the fair market value of the trust at the time of distribution. On the other hand, suppose an individual created a 5% charitable unitrust valued at $1,000,000 on the initial day of funding. He or she would receive $50,000 the first year; however, on the second anniversary of the trust's funding, the trust grows by l0%. Since its market value on the second year is $1,050,000, the individual would receive a unitrust amount of $52,500, and the balance would be added to principal.

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Based on modern portfolio theory, the "prudent investor" principle involved different measurements of risk that could be minimized through diversification. So-called "risky" investments such as small-cap equities may in fact increase the potential for higher return while lowering the over-all risk factor when combined with a diversified portfolio of equities and fixed-income investments.

The "prudent investor" rule radically changed the investing game for trustees. Trustees now had to invest the portfolio for total return, that is, the sum of the portfolio's yield, plus capital appreciation. Since equities traditionally have offered the potential for greater return, the asset allocation relied on a higher percentage of equities to fixed-income investments to achieve greater return.

But a funny thing happened on the way to the bank: Not only did income yields fall as equity exposure increased, but trust beneficiaries experienced an even greater challenge because of deteriorating market conditions that affected both income and principal returns. The markets peaked in October 2007 before beginning the long road down in 2008 and March 2009, causing companies to begin hoarding cash either by freezing or reducing their dividend payments. Although the S & P's dividend rate during the 1990s was 2.7%, from the period 2000-2008, the dividend rate fell to 1.7%. Fixed-income investments offered little relief. Nominal interest rates lowered yields across the spectrum as the Fed tried to stabilize the economy with low interest rates.

Principal returns have been jeopardized by unrelenting volatility that has been particularly evident currently. During the 1990s the S & P's total return was 18.1%, but for the period 2000-2008, the total return was -3.6%. Whatever the time frame, conflicts between income beneficiaries and remaindermen increased, as well as conflicts between beneficiaries and the trustee.

<u>Delaware Total Return Unitrust Legislation (12 Del C §61-106 et seq.)</u>
On June 21, 2001, Delaware became the first state to pass total return unitrust conversion statutes, and these became the model for many other states that passed similar legislation. The statutes were amended in 2004 to take advantage of a new IRC definition of income, as well as in 2009 and 2010. As an additional inducement, the legislature extended the state's TRU advantages "to any trust, including a trust initially converted to a total return unitrust under the laws of another jurisdiction that is administered in Delaware or to any trust, regardless of its place of administration, whose governing instrument provides that Delaware law governs matters of construction," with some minor exceptions.

The hallmark of Delaware's trust legislation is simplicity and flexibility. Trustees can change from income-only trusts to total return unitrusts, and back again, by notifying named parties in writing, provided no one objects within a 30-day period but without seeking court approval. Trustees may design the trust as they deem best, provided that the beneficiaries agree.

After choosing the unitrust form, the trustee must decide upon a statutory percentage ranging from 3% to 5% per year. The trustee, upon proper notification to and no objection from the interested parties, can change the percentage from year to year within this range without court approval. Being able to pick a percentage from the 3-5% "safe harbor" rates is an improvement over current market yields, with the opportunity for the income beneficiary to receive even more through the 5.0% option.

Self-settled trusts known as asset protection trusts (APT) are eligible for unitrust treatment. Delaware permits the transferor (creator) of an APT to receive each year "a percentage (not to exceed 5 percent) specified in the governing instrument of the initial value of the trust assets (which may be described either as a percentage or a fixed amount) or their value determined from time to time pursuant to the governing instrument," without losing asset protection.

The trustee determines whether the trust is an income-only trust or a unitrust; the percentage, timing, and method used to determine the unitrust amount; and which assets may be excluded in the calculation such as a personal residence. These decisions and the rationale behind them must be contained in a written investment policy that must be sent to the settlor, if living; all living persons who currently receive or who are eligible to receive income or principal; remaindermen; and all persons acting as an adviser or trust protector. At least one of each class of beneficiaries must be legally competent.

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Delaware law differentiates between "trustees" and "interested trustees." "Interested trustees" are those to whom income and principal can be distributed currently or at the termination of the trust; trustees who can be removed and replaced; or those individual trustees who have a legal obligation to support a beneficiary. "Interested trustees" must use a "disinterested person," that is, someone who is not a "related or subordinate party" as defined in Section 672 of the IRS Code, like Christiana Trust, to determine the unitrust's percentage, timing, excluded assets, etc.

Delaware unitrust legislation contains an "ordering rule" determining the order in which income is distributed and taxed that is similar to the ordering rule that applies to charitable trusts. Unitrust payments are considered to be paid first from trust accounting income as if the trust were not a unitrust, and secondly, from ordinary income not allocable to net accounting income. Next, the trustee uses short-term capital gains to fund the unitrust amount, then from long-term capital gains if short-term gains are exhausted. Principal is the final component distributed. Not surprisingly, the first income out — trust accounting income, ordinary income, and short-term capital gains –potentially may be subject to the highest personal income tax rates, depending on the tax bracket of the recipient, while long-term capital gains are tax-favored at lower rates, and no income tax is due upon the return of capital.

When Total Return Unitrusts Are Not Recommended

Some commentators do not recommend total return investing in the following circumstances:

- Spendthrift trusts because once the unitrust amount is distributed, creditors can attach it
- Trusts funded with illiquid or non- or low-incoming producing assets like real estate or closely-held corporations because raising cash is difficult
- Generation-skipping trusts because distributing principal can waste the GST exemption
- Trusts with a short duration like a trust that terminates when the income beneficiary turns 21 years old, and the beneficiary is already 19 years old

Power to Adjust (12 Del C §§61-104 and 105)

Total return unitrusts do not work in all situations. For those trusts that must remain income-only trusts, Delaware passed legislation permitting the trustee to adjust between income and principal.

Delaware legislation authorizing a trustee's power to adjust, enacted in 2005, permits a trustee to adjust between income and principal and vice versa if the trustee "invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in §61-103(a) of this title, that the trustee is otherwise unable to comply with §61-103(a) of this title."

Before making adjustments, the trustee must take into consideration many factors, among them, the nature of the trust; settlor' s intent; current and future anticipated market conditions; anticipated tax consequences; the trustee's ability to invade principal or accumulate and capitalize income; and the specific event that triggered the need.

Among factors that prohibit the trustee from exercising its adjustment power are whether adjusting jeopardizes a trust's marital deduction; reduces existing unitrust or annuity trust amounts; causes an individual trustee to be treated as owner of all or a part of the trust for income tax or transfer tax purposes; or if the trustee is a beneficiary of the trust or would benefit from the adjustment. A trustee may release the power to adjust.

Federal Income Tax Consequences of Distributions

Redefining trust income affects many aspects of fiduciary administration. "Trust accounting income" is used to determine the relative interests of income beneficiaries and remaindermen, and to allocate items of income, expenses, and disbursements between the parties according to rules that were codified into each state's Income and Principal Act. For the most part, the interests of the income beneficiary and remaindermen are harmonious except in trusts that pay income to a second spouse, with remainder to the issue of the first spouse.

Prior to the passage of IRC §643 that became effective January 2, 2004, the "gain or loss realized from the conversion of property into cash … is treated as income or as loss sustained." IRC §643 changed everything. The regulations clarified that capital gains can be included in a trust's distributable net income (DNI) to the extent they are allocated to income under local law or the terms of the governing instrument.

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The IRC regulations stated further that a "state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust."

Conclusion

In the pursuit of greater income and to allocate returns more equitably between the current income beneficiary and the remaindermen, fiduciary administration developed new tools: total return unitrusts and a trustee's power to adjust. Together, they offer the possibility to correct unintended but unfortunate circumstances, especially in older irrevocable trusts.

Total return investing unites the investment interests of income beneficiaries, remaindermen, and trustees, a positive development that will continue through any market cycle. Income beneficiaries are no longer stuck with the S& P dividend yield of 2.16% or the 10-year Treasury bond yield of 1.94% available in late November 2011.

Critics may debate the advantages of modern portfolio theory, yet by emphasizing the importance of diversification, it introduced the concept of less volatile returns. Risk management through an analysis of standard deviation is another important contribution, as is the effect of disparate investment classes on total return.

Under favorable circumstances, income beneficiaries and remaindermen participate in the account's growth, but the flip side is that both also share equally in the account's decline, not that anyone anticipated an extended down market. At the time, proponents of TRUs had every reason for optimism: For the period 1950-2008, the S & P Historical Return was 10.8%, clearly higher than the actual dividend yield for the period of 2%-3.0%. In 2008, a series of national and international financial crises caused the S & P's historic average return to fall to 3.01% for the period 1999-2009.

Utilizing the trustee's power to adjust is equally important but complex. Total return unitrusts are much simpler to comprehend and administer than the power to adjust. One commentator suggests that trustees are reluctant to undertake the continuing responsibility of adjusting income and principal for the duration of the trust, despite the protection afforded the trustee in making its decisions.

We at Christiana Trust stand ready to offer our assistance to you and your clients in evaluating whether TRUs or the power to adjust is something you or they should consider.

If you or your clients would like to learn more about trust investment choices or any other personal trust service, we invite you to contact Amy Brown at 302.888.7740 or abrown@christianatrust.com. For information on our corporate trust services, please speak with Lou Geibel at 302.888.7424 or lgeibel@christianatrust.com.

Clients in the western United States are invited to contact Doris Krick in our Nevada office at 702.732.9734 or dkrick@christianatrust.com to hear more about the benefits and services we can provide through Christiana's Nevada-based location.

We encourage those interested in learning more about the benefits of Delaware or Nevada as a trust situs to visit our Web site at christianatrust.com.

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