# MCF Private Trust

## Show Me The Money: Investing for Different Types of Trusts

Here we will examine fiduciary investing, its common law rules, expansion or limitation by the document, and changes under state law to glean insights into issues affecting the investment decisions, documentation, and areas of liability. Using the Uniform Prudent Investor Act as a guide, we will examine the thought process, considerations, documentation and ongoing review of challenging investment decisions, including, Concentrations, Initial assets, Delegation, and Factors to consider.

Investing is central to the role of a fiduciary. Regulation 9 defines fiduciary roles largely using the investment discretion as the central tenet. Without a fiduciary relationship, investments fall to the transactional, caveat emptor, brokerage model. Neither is better nor worse, but they are decidedly different, and that is the point.

Investing for trusts is similar to investing for people, in that people or charities are the beneficiaries of trusts and thus the objectives, risks, and taxation issues are similar, but NOT the same. Trusts are entity-like and potentially have multiple taxpayers, multiple, and sometimes conflicting interests complicating the objective, and are held to fiduciary standards of conduct far higher than an individual for their own account. Our focus here will be on Irrevocable trusts, not Revocable Living Trusts. A revocable trust, during the competent life of the grantor is much like an investment management account, considering only the needs of the present beneficiary, without regard to the future beneficiaries.

The grantor's intent with regard to the beneficiaries is paramount in the determination of the appropriate investment policy. It informs their property interests, the tax consequences of investments whether accumulated in the trust, or automatically distributed, as well as the enhancements proper investments play in enhancing the transfer tax side of the plan. All of this must be done with the care of a fiduciary, rather than one's own assets. It is fair to say that the fiduciary standard of care is a bit more conservative, like driving a friend's car rather than your own, or caring for a friend's child rather than your own. Always careful, but when another places their valuable asset in your care, we tend to make sure it is not put at risk beyond what is necessary.

There are essentially three elements to consider outside of the investment marketplace itself: Principal and Income accounting, Fiduciary Income Tax and Transfer Tax rules, and Fiduciary Responsibility.

Let's start with fiduciary accounting. The trust document dictates the relationship of the parties. The grantor creates the relationship and defines the role of the trustee as well as the manner in which they intend to benefit the beneficiaries. This creates a further relationship of the trustee in serving the needs of the beneficiaries within the boundaries of the document. Additionally, it establishes a relationship and ongoing need for communication between the trustee and beneficiaries as to goals and objectives, risk tolerance, distribution expectations, and total wealth and income picture in order to optimize the value of the trust in carrying out the grantor's objectives.

Whether the trust is required to pay income or not is central to determination of the need for cash flow and of the determination of who the tax payer will be: the trust or the beneficiary. Without this understanding, how could a trustee possibly invest properly? This dual set of beneficiaries also creates an unavoidable conflict in the irrevocable trust, no matter how subtle or pronounced: who is my client? Classically, the income beneficiary will want income and the remainder beneficiary will want growth. SO how do we invest? The language of the trust tells the trustee whether to pay "all income" annually, or whether income is discretionary. So, language as well as the needs of the beneficiary are central to every distribution, which in turn drives taxation of the income of the trust.

Fiduciary income taxation basically starts with the trust as the default taxpayer and shifts that burden to the beneficiary in certain situations, namely the required or actual distribution of funds. In general, up to the taxable income for the year, distributions carry out the income tax consequences of the trust. It is critical, then, that the trustee understand how to interpret the document terms, understand their implications, discuss in advance with the beneficiaries their expectation of distribution for the year, and invest accordingly. Even more dramatic is the "Grantor Trust" for income tax purposes wherein the trust is a disregarded entity for income tax purposes leading to all manner of potential benefits to the beneficiaries and the ability to legally pay their beneficiaries income taxes for them without it being considered a gift to them.

In addition to income taxation, many plans have multiple trusts, such as a bypass and marital trust, or an exempt and non-exempt trust for generation skipping transfer tax, which can be enhanced dramatically by appropriate allocation between multiple accounts for the same beneficiaries. Having a growth objective in one account and an income objective in another account may save the taxpayer a high level of estate tax at the death of the beneficiaries and even help determine from which trust it would make the most sense to take distributions. This ability to play the duality of investment professional with an understanding of the unique property law and tax law characteristics of trusts is critical. Without this, a competent investment advisor may invest in a very appropriate manner for the market, yet lose their gains to taxes, rather than for benefit of the beneficiary.

Finally, fiduciaries responsibilities provide certain special situations which are dealt with in the Uniform Prudent Investor Act. The Uniform Act puts clear emphasis on Modern Portfolio Theory, including the importance of diversification. There are also all the factors one would expect in investing criteria like, general economic conditions, the possible effect of inflation or deflation, expected tax consequences of investment decisions, the role each investment plays in the overall trust portfolio, the expected total return from income and appreciation of capital, and needs for liquidity, regularity of income, and preservation or appreciation of capital. Nonetheless, let me point out two that the Uniform Prudent Investor Act specifically mentions that may not come directly to mind for a fiduciary novice: other resources of the beneficiary, and an asset's special relationship or value to the purposes of the trust or the beneficiary.

Other resources are important in the fiduciary investment world because trusts often hold assets that are concentrated and may not appear properly diversified without the consideration of all assets available to the beneficiary. A family business, for example, may not appear the best investment when held in concentration, but in combination with outside wealth amassed by members of the family may make perfect sense. This issue also often informs the second point which is an asset's special relationship or value to the purposes of the trust or the beneficiary. Again, the desire to keep a family business in the family may be the very reason the trust was created in the first place. Or to use another example, a lake house or beach house may not appear the most appropriate investment to retain in a trust; however, its special relationship to the family as a gathering place and for lifestyle support may make its place in a trust portfolio completely justified.

Keeping in mind that the investment marketplace and the investment considerations are complex enough, add a fiduciary's insight and understanding and it raises fiduciary investing to a much more important and personal place. An investment advisor without deep knowledge of fiduciary accounts may invest perfectly well, but inappropriately for the type of account and cause unnecessary income tax or transfer tax, to say nothing of the proper administration of the trust to be diminished. Discuss this topic with your local professional trustees to learn more about fiduciary investing and how to best represent clients who need help in this area.

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