

FEATURE: BACK TO BASICS

By **Emily Brunner**

Investing for Trusts

A guide for trustees and their advisors

Asking the right questions is critical when investing trust assets. What's the time horizon of the trust? Are there any unusual tax characteristics? Why was it created? What are the beneficiaries' needs and desires?

The answers to these questions can lead to a diverse set of asset allocations. Here are some of the differentiating attributes of trusts that may lead to particular portfolio choices. Investment selection can dramatically leverage—or hinder—the value of a family's total wealth transfer, and thoughtful decisions are an important part of the trustee's job.

Grantor vs. Non-grantor Trusts

It's important to determine whether a trust is a grantor trust or a non-grantor trust. A grantor trust is considered to be the same as its grantor for income tax purposes. Its income, deductions, credits and other tax attributes are reported as part of the grantor's personal Form 1040. The grantor pays the related income taxes, without this payment being deemed a gift to the trust. This allows trust assets to grow free of the tax drag, which is why many trusts are drafted to be grantor trusts. A non-grantor trust is responsible for paying its own taxes.

Grantor trust status is governed by whether certain provisions are included in the trust agreement. The easiest way to figure out the trust status is to ask the drafting attorney. If a grantor is deceased, the trust is a non-grantor trust.



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Opportunities for Grantor Trusts

Investments for grantor trusts should account for the grantor's personal income tax situation.¹

Coordination of gain realization and/or loss harvesting. However, beware the wash sale rule! This rule generally disallows realized losses if paired with a purchase of a substantially identical security 30 days pre- or post-sale. Basis is rolled into the new security purchase. It's important for the grantor and the trustee to stay in contact because a loss realized by the grantor can be matched with a purchase by the trust, and vice versa, to trigger the rule.

Weigh the benefits of tax-preferred investments. All else being equal, a grantor trust should be careful about purchasing tax-preferred investments. Consider municipal bonds, which typically provide lower yields because of the accompanying tax benefit. Depending on the respective after-tax returns, a grantor trust could be better served with a taxable bond. The taxable bond might result in a higher absolute return to the trust, with the taxes absorbed at the grantor level, reducing the taxable estate.

Asset location (income investments). Income is taxed to the grantor wherever the asset is located. It doesn't matter whether assets producing ordinary income are held by the grantor or the grantor trust. This isn't true of non-grantor trusts.

Strategic use of the power of substitution. Many grantor trusts allow the grantor to "reacquire" any trust property in her discretion, so long as assets of equivalent value are exchanged. Trust property not appreciating as hoped can be exchanged for property with better potential, so that the growth of the trust is accelerated and growth of the grantor's estate is slowed. This power can also be used to move low basis assets back to the grantor in anticipation of a step-up in basis.



Managing Non-Grantor Trusts

Weigh the benefits of tax-preferred investments. Non-grantor trusts reach the top income tax bracket at only \$12,500 of income in 2018. Therefore, trustees may be more interested in purchasing tax-preferred investments than if the trust were a grantor trust.

Asset location. If the grantor isn't a top-bracket taxpayer (because the trust likely is), it may make sense to hold income-producing assets personally rather than in the trust.

Trust residency. State income tax obligations can significantly drag trust performance. Examine the rules tying a trust to a particular taxing state. Can changes be made to move the trust residence elsewhere? For exam-

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ple, in some circumstances, having an in-state trustee resign may make a trust non-resident as to that state. In that case, the trust would be taxable only on income sourced to the state (for example, from in-state real estate) as opposed to all income (for example, passive income such as stock dividends).

Other Asset Location Issues

Beware of investment overlap. Trusts for the same beneficiary may have different trustees, be held at different institutions or simply be thought of as entirely separate pots. The result can be that a single asset class is over- or underexposed considering the overall assets held for a beneficiary. Regularly review trust portfolios in concert so that the wealth opportunities for beneficiaries are maximized. Relatedly, there's always the opportunity to ask if trusts can be consolidated to simplify the family's administration.

Basis. Keeping low basis assets in the grantor's estate preserves the possibility of a basis step-up at death. Assets gifted to the trust take a carryover basis instead, so consider higher basis assets.

Growth investments. Long-term growth investments inside the trust may leverage the gift tax exemption originally used, because the appreciation may escape additional transfer tax at the grantor's death. Conversely, holding such investments in the grantor's estate is less favorable. The step-up in basis at the grantor's death would produce only 23.8 percent in federal savings under current law (capital gains and net investment income taxes) but create a marginal 40 percent federal estate tax rate.

Invest for Trust Goals

Long-term trusts. Capital appreciation may be more important than immediate income, and illiquid investments could be appropriate. You may be able to skew asset allocation more aggressively to equities. Long-term trusts, for example, those to which the donor's exemption from the generation-skipping transfer (GST) tax has been allocated, generally aren't intended to function as a beneficiary's primary source of income. This gives the trustee the flexibility to invest for the greatest income or growth overall, because the trust will be able to ride out temporary dips in the market.

Mandatory income provisions. In light of the desires of the grantor and the circumstances of the current and future beneficiaries, should the trust be invested with an eye toward producing more, or less, distributable income? Investment choices can create flexibility when a trust agreement hasn't kept up with unanticipated events.

Grantor retained annuity trusts (GRATs). These are intended to transfer appreciation on an asset to desired beneficiaries, typically children. Recently, the interest rate the GRAT must exceed to succeed in its goal has been at historic lows (although it may be creeping up), and there have been periods of strong market performance. In light of this, some GRATs have been funded with marketable securities as a simple way to use the technique.

"Successful" GRATs pass assets to remainder beneficiaries while "failed" GRATs simply fail to do so (but have minimal negative impact to the family). Therefore, GRATs are good candidates for isolating asset classes and embracing volatility. However, when GRATs have already successfully appreciated in value, investing in stable assets may be a smart strategy to lock in the appreciation. It decreases the potential for values to drop

before assets are paid to the children.

Beneficiary needs and preferences. Understanding the beneficiary's anticipated distribution needs can guide investment choices and help determine when to convert illiquid investments to liquid ones. Also, whether the beneficiary has a formal role or not, taking her opinions into account can make for more harmonious trust administration.

Insurance Trusts

Many insurance trust agreements purport to relieve the trustee of responsibility for reviewing the strength of the policy, the issuing company or anything else. Insurance is a specific asset class that, in addition to providing a fixed or variable death benefit, can:

- last for different lengths of time;
- have premium payments over varying lengths of time;
- provide more or less exposure to the market, poten-

tially impacting death benefit or cash value; and

- have sub-optimal pricing based on changes in the insured's health since purchase.

A specific policy, or insurance as a general matter, may be a better or worse investment choice at any given time. Whatever the specific trust agreement may say, it's prudent to periodically review policy performance and pricing relative to current available options.

Conversely, trustees of trusts that weren't originally created to hold insurance might determine that purchasing it may be desirable to address changing circumstances and to complement other trust assets.

Charitable Trusts

Charitable remainder trusts (CRTs). CRTs are exempt from income tax. A grantor can contribute an asset and have the trust sell it, and the trust will pay no income tax on the realized gain. However, the tax characteristics don't disappear—they remain waiting inside the trust.

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As required annual payments to the grantor are made, they carry out the income tax consequences.

CRTs are subject to a “worst first” system. Ordinary income is carried out before capital gains, which are carried out before tax-exempt income, etc.


CRTs often have significant deferred capital gains because they’re frequently used to diversify concentrated positions. Consider carefully before investing in assets producing ordinary income. This will come out before any capital gains at all. Conversely, investments in assets like municipal bonds produce a lower return on invest-

ment in exchange for a tax preference that may never be realized by the grantor (because it isn’t distributed out) or the tax-exempt remainder charity (which isn’t subject to income tax at all).

Charitable lead trusts (CLTs). Testamentary CLTs pay a specified amount to charity over a term of years, with the remainder to designated recipients (typically children). They’re often designed to zero out some or all of the estate tax due. The hope is that sufficient appreciation will occur during the trust term so that something will be left for the children at the end.

Stable growth investments may be appropriate for charitable lead annuity trusts (CLATs), whose charitable obligations are fixed year on year and can be planned to be surmounted. Unlike the GRAT, its non-charitable cousin, volatility doesn’t necessarily favor a CLAT. If the investment drops in value, the charity’s annuity payment takes precedence over the remainder beneficiary. In a GRAT, the remainder beneficiary is similarly harmed, but the person receiving the annuity payments is the grantor.

Trust Goals

Considering a trust’s purpose, structure and tax characteristics can guide a trustee’s investments to better achieve the grantor’s intent. The portfolio choices aren’t a separate matter from the distributions, but work hand in hand. With a deeper understanding of the legal aspects of the trust, trustees and advisors are better able to spot opportunities, minimize inefficiencies and ensure that the trust is operating holistically to achieve its goals. 

Endnote

1. The trustee’s responsibility is to the trust beneficiaries, not to the grantor. However, managing trust investments to minimize grantor taxes can be appropriate for a number of reasons: (1) Often, the spouse is a trust beneficiary whose joint return with the grantor is impacted; (2) Minimizing the grantor’s taxes means that more overall wealth could pass to trust beneficiaries; and (3) Failure to consider the grantor’s tax burden may result in the grantor “turning off” grantor trust status, which would negatively impact the trust’s financial performance.

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SPOT LIGHT

Pedal Pushers

Meteor (designer unknown) sold for \$1,875 at Swann Auction Galleries’ recent Vintage Posters Featuring Highlights from the Gail Chisholm Collection auction in New York City on March 1, 2018. The poster is from the Julius Paul Collection.