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Conflicted Families:
Best Practices for Investments

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Conflicted Families:

Best Practices for Design and Drafting

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Asset Allocations for Second Spouse (Case)

Dear Ms. Brown,

Thank you for sharing the investment account statements for the Johnson Living Trust from October 2007 to November 2018. I have reviewed the account activity for this period with the purpose of estimating the value of the assets that should have accumulated to the B Trust by November 30, 2018. Based on my analysis I feel it is worth pointing out a few observations:

1) The *asset allocation of the accounts was changed significantly* from the passing of Charlotte P. Johnson (see Appendix). As of August 31, 2008 (the statement date closest to Mrs. Johnson's passing), the accounts collectively were wholly invested in stocks but were changed to become more fixed income-oriented in subsequent years. While this adjustment increased dividends paid from the portfolio, it reduced overall performance (dividends plus capital appreciation) over time.
2) According to Section 16370(a) of the California Uniform Principal and Income Act, except otherwise ordered by the court, one-half of the regular investment management fees charged by the advisor should have been disbursed from the income to the A Trust beneficiaries. It appears these *deductions for one-half of the management fees were not made*; therefore, the entire cost was borne by the principal of the investments.
3) *Over the five-year period of 2011-2015, the beneficiaries of the A Trust extracted net $307k from the account* (see box highlighted in the graph below). Not only did this exceed earned income, it exceeded the portfolio's total gains. Consequently, the principal from the accounts was greatly reduced, thereby diminishing capital appreciation during those years. While additional cash was deposited back in 2017, the potential gains to be realized from prior years were already forgone.
4) The *1.5% investment management fee seems higher than normal* for a total account this size. One might normally expect to pay closer to 1% for a total investment amount of $500k - $1mm (Chart included in Appendix).

* Investments became much more income-oriented – these two accounts constituted 81% of the total invested assets at the end of 2011. Roughly half of the assets in account xxxx-xxxx went into preferreds and nearly all of the money in vvvv-vvvv went into mutual funds utilizing various income strategies.

Trust Longevity Planning

TIME HORIZON

INCOME/EXPENSES

INVESTMENTS

INFLATION

ASSETS/LIABILITIES

TAXES

TIME HORIZON

Age
Life Care Plan
Major Expenses
Trust Document

	Bridget Johnson
Date of Birth	1/1/1999 (Age 24)
Gender	
Marital Status	Single
Health Comments	Health Concerns, Special Needs
Retirement Age	18
Life Expectancy	84

INCOME / EXPENSES

Business Interests
Investments
Salary
Living Expenses
Medical
Administrative

Income

Add

Social Security	Starts	Annual Amount
Bridget's Social Security	At Retirement (Age 62 - 2061)	$0

Other Income	Starts	Annual Amount
Other Income	Active	$99,993

Expenses & Taxes

Add

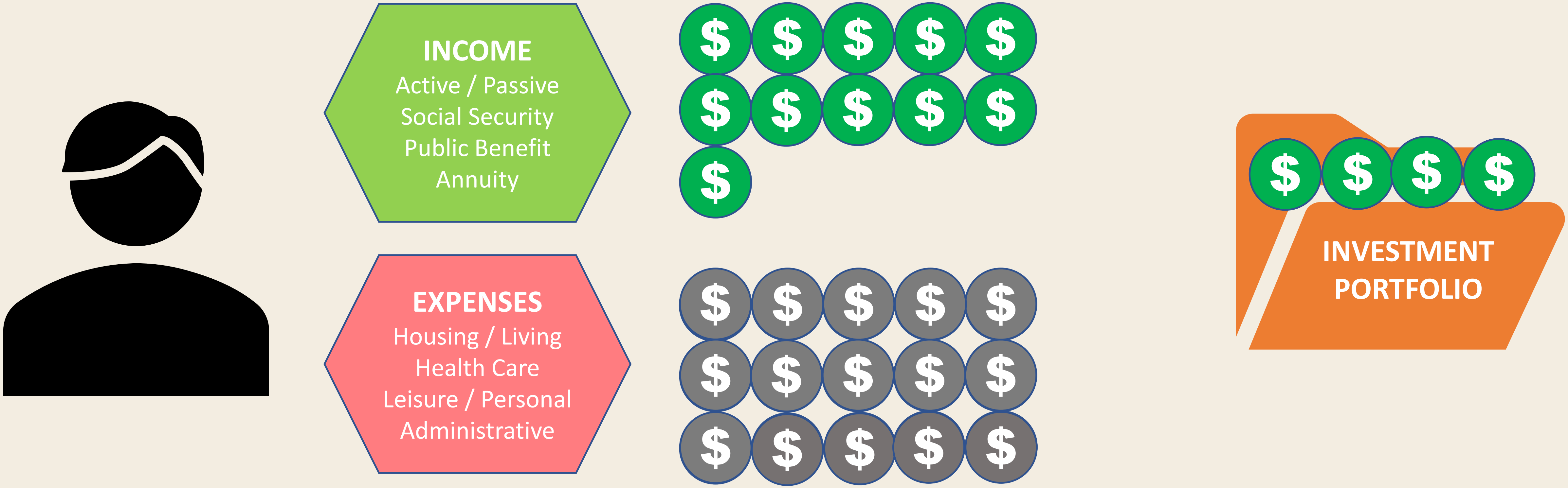
Living Expenses	Starts	Annual Amount
Current	Active	$36,000

Other Goals/Expenses	Starts	Annual Amount
Care Expenses	Active	$84,000

Tax Assumptions	Tax Rate
Federal Taxes	Form 1040
State Taxes	CO
Local Taxes	0.00%

Determine a Required Return

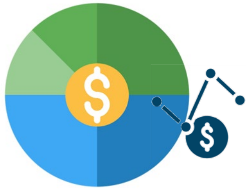
- Calculate how much money will need to be generated from the investment account to cover the shortfall difference between the income and expenses to support the overall needs of the trust.



- Design / tailor the investment portfolio to generate an expected return to match / cover the required return.

INVESTMENTS

Asset Allocation
Volatility
Expected Return
Reinvestment of Cash



Expected Return

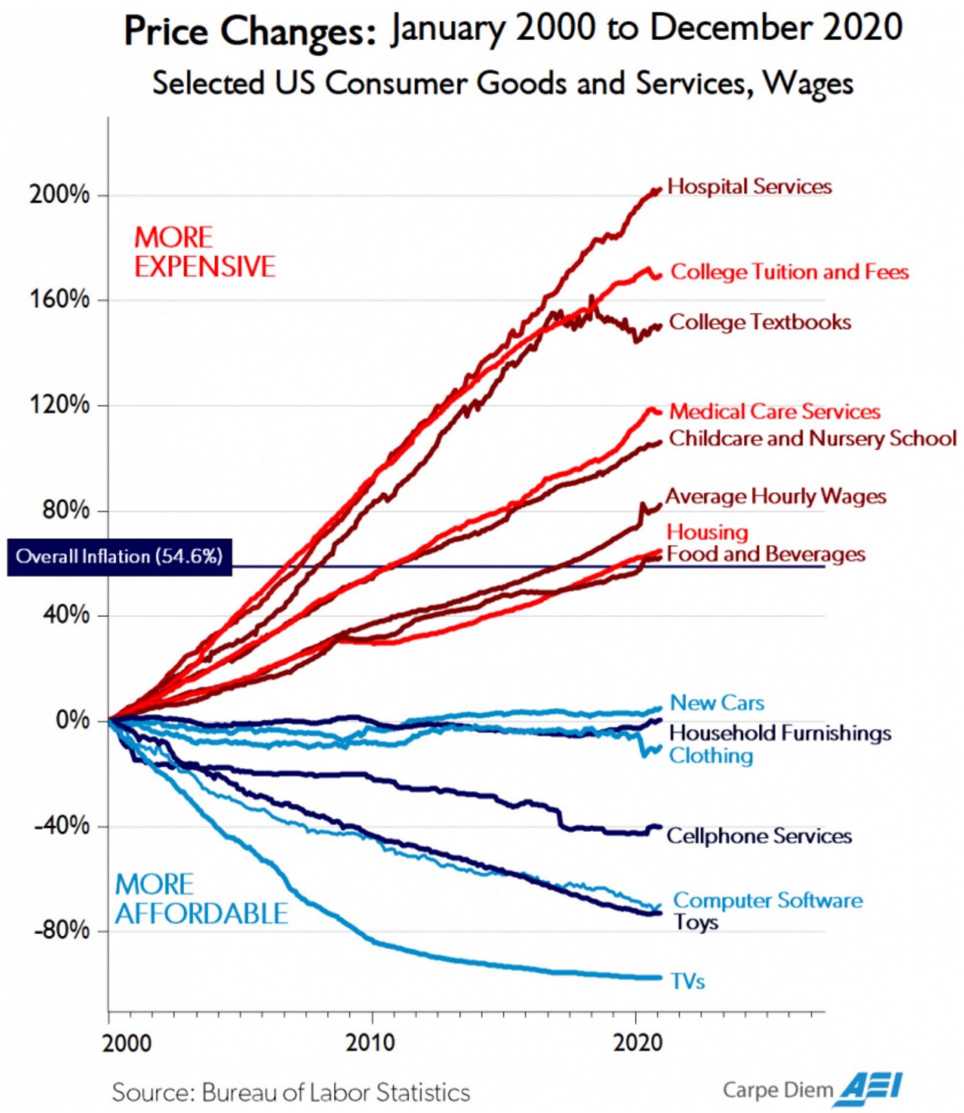
Assumptions: Equities 9% / Bonds 4%

Riskiness

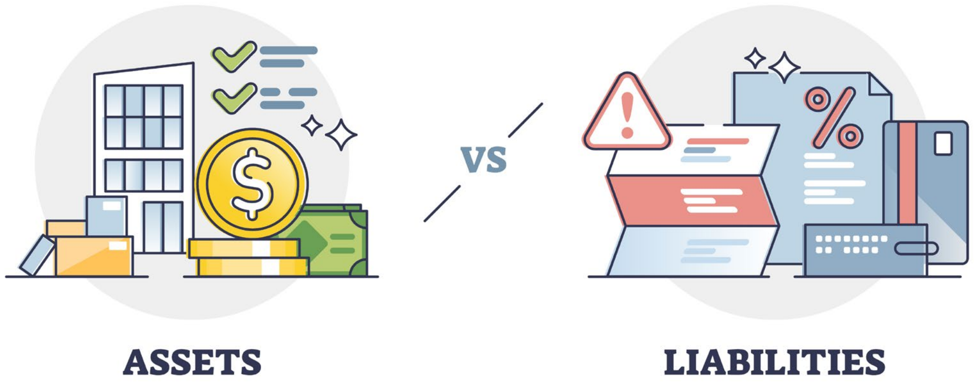
100% Equities	0% Bonds	9%
80% Equities	20% Bonds	8%
60% Equities	40% Bonds	7%
40% Equities	60% Bonds	6%
20% Equities	80% Bonds	5%
0% Equities	100% Bonds	4%

INFLATION

General Inflation
Income Inflation
Expense Inflation



ASSETS / LIABILITIES



Real Property
Liquid Assets
Mortgage / Loans

Liquidation Strategy

Strategy | Exclusion

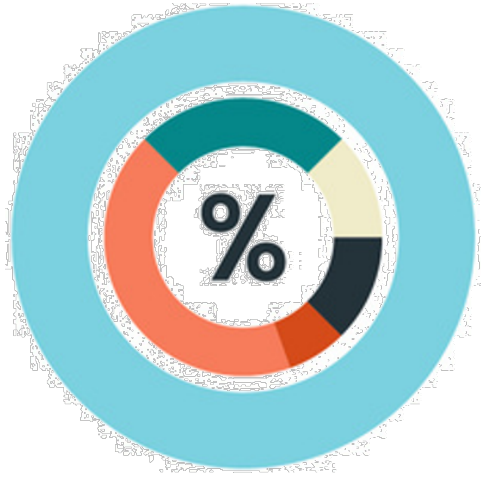
Liquidation Mode: Strategy

Current Strategy: By Type

Retirement Strategy: By Type

Qualified Spending Ratio:

TAXES



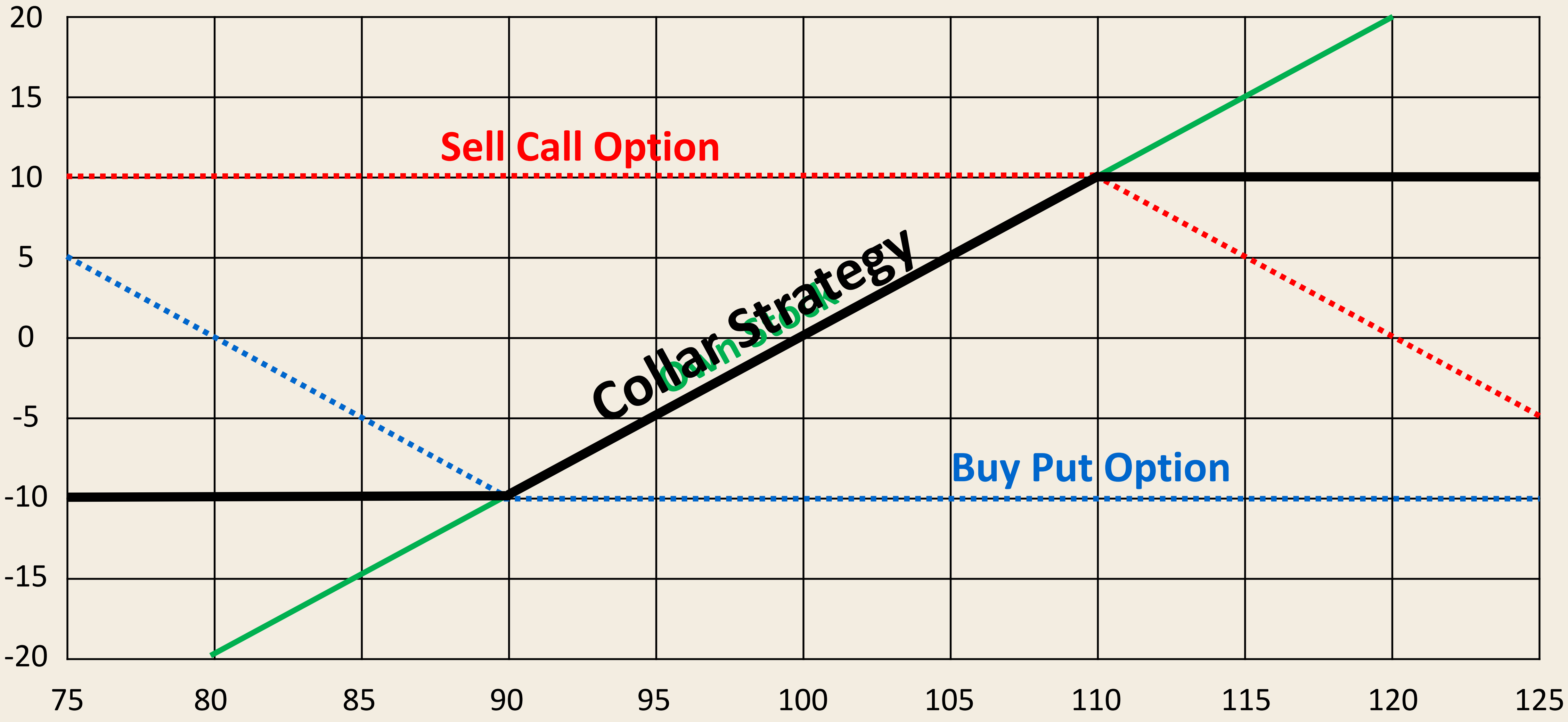
1st vs 3rd Party Trust

Tax-Exempt Income

Deductible Expenses

DNI

Concentrated Stock Positions – Option Collar



Diversification Concerns (Case)

Overview

Michael Lopez is currently serving as trustee over his family's trust and has asked Prudent Investors to analyze its current investment portfolio. The portfolio holds only 5 stock positions and Michael is concerned about whether the investments are sufficiently diversified. This brief memo will address the following three questions:

1. Are the investment holdings currently diversified?
2. Has diversification (or lack thereof) negatively impacted investment performance?
3. What options are available to improve portfolio diversification?

Are the investment holdings currently diversified?

The investment account holds only five stocks along with $46,527.18 in cash (as of October 31, 2022). Microsoft (MSFT) and Home Depot (HD) alone make up nearly 90% of the total assets. The five positions collectively are invested in just three sectors: Technology (64%), Consumer Cyclical (32%), and Consumer Defensive (4%). While the positions themselves are generally non-correlated from one another, the large concentrated positions in Microsoft and Home Depot make the **portfolio generally non-diversified**.

All Holdings (?) EDIT HOLDINGS EXPORT HOLDINGS

Symbol	Name	Target Weight	Current Weight	Holding Drift	Price	% Change
MSFT	Microsoft Corp	53.08%	58.17%	5.09%	277.59	1.95%
HD	The Home Depot Inc	35.13%	30.48%	-4.65%	283.80	0.42%
$:CASH	Cash	5.99%	5.77%	-0.22%	1.00	0.00%
PG	Procter & Gamble Co	3.69%	3.40%	-0.29%	143.73	-0.18%
INTC	Intel Corp	2.08%	2.16%	0.08%	29.07	3.34%
KO	Coca-Cola Co	0.03%	0.02%	-0.00%	59.91	-0.23%

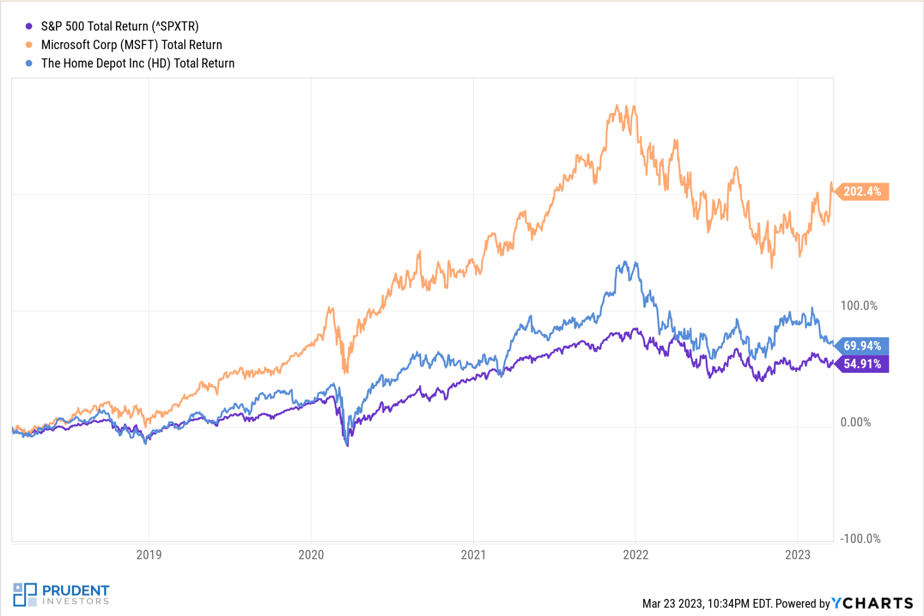
As of March 23, 2023

Diversification Concerns (Case) – Cont.

The portfolio currently holds 94% of its assets in stocks and just 6% in cash. The high allocation to stocks appears reasonable for its relatively young beneficiaries who do not currently need to spend the assets. The four beneficiaries are currently ages 42, 32, 21, and 19.

Has diversification (or lack thereof) negatively impacted investment performance?

The portfolio has performed very well since most of the positions were acquired through what appears to be a VWAP (volume-weighted average price) program on February 26, 2018. The portfolio, even when including cash, has significantly outperformed the S&P 500 since that date. Over roughly the last five years, **the lack of diversification has not negatively impacted performance**.



Diversification Concerns (Case) – Cont.

<u>What options are available to improve portfolio diversification?</u>
In evaluating the scope to rebalance the assets into a more diversified manner, we first need to consider the potential tax impact that could arise from selling existing positions to replace with new ones. The investments in the Lopez Family Trust are currently holding onto significant unrealized gains. The table below is based on the number of shares held in the account as of October 31, 2022 and is compared against stock market closes as of March 23, 2023.

Based on the assumption that the trust does not have significant deductible expenses to offset the realization of gains, selling the positions could result in large tax liabilities. The trust has some options to consider in managing the portfolio's current lack of diversification:

Stock	No. Shares	Cost Basis	Market Value	Unrealized Gain/Loss
Home Depot (HD)	[illegible]	[illegible]	[illegible]	[illegible]
Intel (INTC)	[illegible]	[illegible]	[illegible]	[illegible]
Microsoft (MSFT)	[illegible]	[illegible]	[illegible]	[illegible]
Proctor & Gamble (PG)	[illegible]	[illegible]	[illegible]	[illegible]
The Coca-Cola Co. (KO)	[illegible]	[illegible]	[illegible]	[illegible]
			TOTAL	[illegible]

Options to Address Lack of Portfolio Diversification:

1. Liquidate entire portfolio and reinvest assets in a more diversified manner
   Pros: -This provides maximum flexibility in reinvesting the proceeds into a diversified portfolio
   -Liquidating the entire portfolio is simple and requires little additional analysis.
   Cons: -Selling all of the positions would result in a realized gain of over $417k, triggering large tax liabilities.

2. Obtain consent from the beneficiaries to leave investments as currently constituted
   Pros: -No tax liability would be incurred.
   -Holding onto existing investments is simple and would require little additional analysis.
   Cons: -Portfolio would remain undiversified and vulnerable to large shocks, particularly in the event of a significant selloff in Microsoft or Home Depot.

3. Gradually reduce core holdings over many years and reinvest in a more diversified manner
   Pros: -While tax liabilities would still likely be incurred, they could be reduced through slowly selling the positions over time.
   Cons: -Given the size of the unrealized gains, strategically selling the positions could take many years and still leave the portfolio exposed to significant selloffs in its core holdings for the foreseeable future.
   -Strategically selling parts of the positions would require extra tax planning and account management. Given the varied life situations of each of the beneficiaries, ideally the investments would to be split into four separate accounts and sold at different schedules depending on each beneficiary's circumstances.

4. Move concentrated stock positions into an exchange fund (pools concentrated stock positions of different shareholders to diversify exposure)
   Pros: -The concentrated stock positions could be converted into diversified holdings.
   -The transfer into an exchange fund could be done without realizing capital gains, which would avoid triggering tax liabilities.
   Cons: -Transferring the concentrated stock positions into an exchange fund would likely result in the trust bearing some additional costs. Typically annual management fees range between 1.50% - 2.00%. Additionally, exchange funds require a seven-year holding period and contribution minimums can range between ($500k - $1mm). [Source: Valur Library]
   -While the lack of diversification could be mitigated and tax liabilities can be deferred, the cost basis is not improved. This means that the sale of the new positions could still result in significant taxable gains.

The Blended Family: Incapacity

Patti Murphy

Peter S. Myers

P & P get married and buy a home

Home

50% TIC interest to Patti

50% TIC interest to Peter

California Purchase

50% interest

Murphy-Myers Children RLT – 3 kids each, equal beneficiaries

Here, assume we are planning for Peter's incapacity

The Blended Family: Incapacity

Patti Murphy

50% TIC interest to Patti

P & P get married and buy a home

Home

California Purchase

50% interest

Murphy-Myers Children RLT – 3 kids each, equal beneficiaries

Here, assume we are planning for Peter's incapacity

Peter S. Myers

50% TIC interest to Peter

Peter Incapacity Trust - IRRT

Life Insurance - $500K DB

The Blended Family: Incapacity

Patti Murphy

50% TIC interest to Patti

P & P get married and buy a home

Home

California Purchase

50% interest

Murphy-Myers Children RLT – 3 kids each, equal beneficiaries

Here, assume we are planning for Peter's incapacity

Peter S. Myers

50% TIC interest to Peter

Peter Incapacity Trust - IRRT

Life Insurance - $500K DB

-LTC Rider – reduces DB $ for $

-majority of bene's decide whether to access the policy

The Blended Family: Death

Patti Murphy

Peter S. Myers

P & P get married and buy a home

Home

50% TIC interest to Patti

50% TIC interest to Peter

California Purchase

50% interest

Murphy-Myers Children RLT – 3 kids each, equal beneficiaries

Here, assume we are planning for Peter's incapacity

Life Insurance - $500K DB

Peter Trust - IRRT

Life Insurance - $500K DB

The Hypo #1

Divorce

New Marriage

Divorce

Issues in planning:

CHARACTERIZATION OF PROPERTY

- Community Property

- Separate Property
  - Pre-marital property
  - Gifted, bequeathed or inherited property
  - “Rents, issues and profits” of such property

- QCP

CHARACTERIZATION OF PROPERTY

- Community Property

Each can bequeath 1/2

- Separate Property
  - Pre-marital property
  - Gifted, bequeathed or inherited property
  - "Rents, issues and profits" of such property

Owner/powerholder spouse can bequeath 100%

- QCP

Each can bequeath ½ (except out of state real estate acquired while out of state)

Drafting Considerations

- Client and spouse have different beneficiaries they ultimately want to benefit
- Surviving spouse and children of first marriage are in possible conflict
- Surviving spouse and children of first marriage are close to the same age
- Look to intent of parties - who do they want to benefit?
- Plan for adult and minor children as well as grandchildren - is a pot trust appropriate?

Using Three Trusts & CP SubTrusts at Death of First Spouse – SP Direct

Wife's SP Trust

Smith 2016 Trust

Husband's SP Trust

Survivor's Trust

"QTIP"

"Bypass"

Surviving Spouse

Children of first marriage

How does the plan protect deceased spouse's property?

For whose benefit?

Using Three Trusts & CP SubTrusts at Death of First Spouse – Pass CP Through SP

Smith 2016 Trust

Survivor's ½ CP

Wife's SP Trust (Revocable B4 Her Death)

Husband's SP Trust – Irrevocable at His Death

"QTIP"

"Bypass"

How does the plan protect deceased spouse's property?

For whose benefit?

Surviving Spouse

Children of first marriage

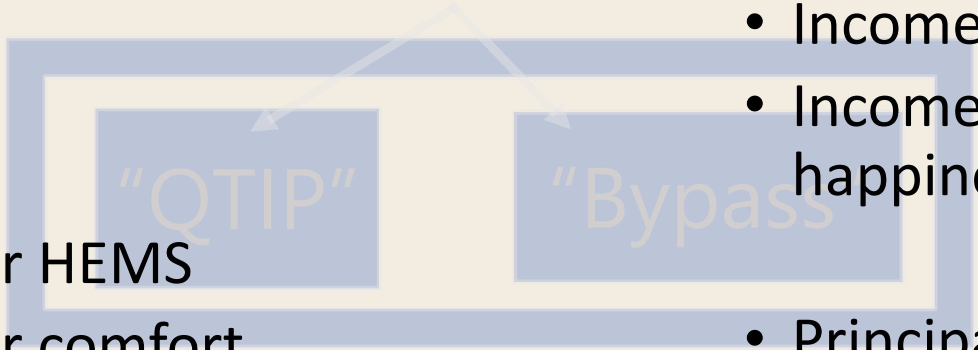
Watch For

- Simultaneous death
- Class gifts – especially “child/children” and “grandchild/grandchildren” Any class where kinship is necessary to define it – e.g., “my nieces”
  - Foster children and stepchildren may be included
  - Raised while a minor (started as a minor and continued throughout lifetimes)
  - Barrier to adoption – clear and convincing evidence that decedent would have adopted but for barrier
- “Descendants”
- Use disinheritance language?

	INCOME	PRINCIPAL
SURVIVING SPOUSE	MANDATORY? (QTIP IT?)	HEMS*?
CHILDREN OF 1ST M	DISCRETIONARY (BYPASS ONLY)	Discretionary (Bypass only)
ADULT CHILDREN OF 2ND M	DISCRETIONARY (BYPASS ONLY)	Discretionary (Bypass only)
MINOR CHILDREN OF 2ND M	Probably not relevant? (s/s has support obligation – if needed to satisfy)	Relevant?
CHILDREN BORN OUTSIDE THE MARRIAGE	Fix C/S obligation?	????

Income and Principal Distributions

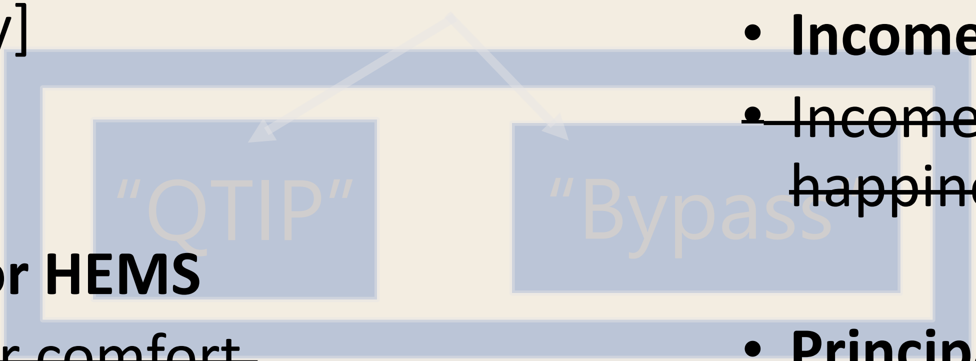
- Marital “**QTIP”**
  - All income or unitrust
  - Principal for HEMS
  - Principal for comfort, welfare and happiness
  - 5 & 5 power



- **“Bypass”** trust
  - All income or unitrust to spouse
  - Income for HEMS
  - Income for comfort, welfare and happiness
  - Principal for HEMS
  - Principal for comfort, welfare and happiness
  - 5 & 5 power

Income and Principal Distributions

- Marital "**QTIP**"
  - [All income or unitrust]
  - [mandatory]
  - **Principal for HEMS**
  - ~~Principal for comfort, welfare and happiness~~
  - ~~5 & 5 power~~



- **"Bypass"** trust
  - ~~All income or unitrust to spouse~~
  - **Income for HEMS**
  - ~~Income for comfort, welfare and happiness~~
  - **Principal for HEMS**
  - ~~Principal for comfort, welfare and happiness~~
  - ~~5 & 5 power~~

Discretionary Distributions

- "At any time or times, the trustee **SHALL** pay to or apply for the benefit of the surviving settlor so much of the net income and principal of the trust as the trustee deems proper to pay the reasonable expenses of the surviving settlor for his or her **HEALTH, EDUCATION, SUPPORT AND MAINTENANCE**. In exercising discretion, the trustee shall give the consideration that the trustee deems proper to **ALL OTHER INCOME AND RESOURCES THAT ARE THEN KNOWN TO THE TRUSTEE AND THAT ARE READILY AVAILABLE** to the surviving settlor for use for these purposes. All decisions of the trustee regarding payments under this subsection, if any, are within the trustee's discretion and shall **be FINAL AND INCONTESTABLE by anyone.** The trustee shall accumulate and add to principal any net income not distributed."

Other typical language – discretionary distributions

“Our **Independent Trustee [in its reasonable discretion?] may distribute** as much of the principal of the QTIP Trust to the surviving Grantor as our Independent Trustee **may determine *advisable for any purpose***. If no Independent Trustee is then serving, our Trustee [in its reasonable discretion?] **shall** distribute as much principal of the QTIP Trust to the surviving Grantor as our Trustee determines necessary or advisable for the surviving Grantor’s **health, education, maintenance or support.**

“Our Trustee, in its **reasonable discretion**, **may** consider the needs of the surviving Grantor and other income and resources available to the surviving Grantor.

Specific Discretionary Issues

- SHALL
- HEALTH, EDUCATION, SUPPORT AND MAINTENANCE
- ALL OTHER INCOME AND RESOURCES THAT ARE THEN KNOWN TO THE TRUSTEE AND THAT ARE READILY AVAILABLE
- FINAL AND INCONTESTABLE

Issues Related to Discretionary Distributions

- Shall v. May
- Control
- Identification of beneficiary
- Psychology of trustee
- Discretion to be used

Issues Related to Discretionary Distributions (cont.)

- HEMS definition
- Other resources
- Illiquid assets
- Exhaust marital and survivor’s trusts first
- Special trustee
- Tangible personal property

- Unitrust