Many happy returns
Total return unitrusts align beneficiaries' interests

At times, traditional trusts can create conflicts among beneficiaries, making it more difficult for your estate plan to achieve its objectives and placing your trustee in a difficult position. A total return unitrust (TRU) may offer a solution.

The problem

Consider Ted's dilemma: When his brother Zack died, Ted was named trustee of a trust for the benefit of Zack's wife, Chloe. The trust provides for Chloe to receive all of the trust's income for the rest of her life, after which the trust assets will be divided equally between Chloe and Zack's two children from a previous marriage, Rebecca and David.

As trustee, Ted has a fiduciary duty to treat all three beneficiaries impartially. But he soon finds this to be a thorny challenge. The problem is that it's in Chloe's best interests for Ted to place the trust assets in bonds or other fixed-income investments to help pay her living expenses. Rebecca and David, on the other hand, would prefer that Ted invest in growth stocks or other assets that will appreciate in value, thereby maximizing the amount they receive when the trust funds are distributed.

Suppose Zack leaves $1 million to the trust and that Chloe lives another seven years. If Ted invests it all in bonds that earn a 5% return, Chloe will receive $50,000 in income each year. When she dies, the trust principal will still be $1 million, but the value of Rebecca and David's shares will have been eroded by seven years of inflation.

If, on the other hand, Ted invests all the trust assets in a diversified portfolio of growth stocks that appreciate at a rate of 8% per year, the trust's value will grow to more than $1.7 million by the time Chloe dies. Rebecca and David may be happy with their inheritances, but there will be no current income to distribute to Chloe, who will therefore receive nothing. Either approach leaves someone dissatisfied and increases the chances of a dispute or litigation.

Like many trustees, Ted attempts to satisfy his duty to all beneficiaries by allocating the trust assets equally between stocks and bonds. Chloe receives income of $25,000 per year and the trust is worth about $1.35 million when it's time to distribute the funds. Not a bad compromise, but there may be a better solution.

A tried and TRU approach

With a TRU, instead of receiving all of the trust income, the current beneficiary receives a fixed percentage of the trust's value, recalculated annually. Because the current beneficiary enjoys a regular income stream regardless of the trust's actual earnings, the trustee is free to disregard traditional notions of income and principal and focus on maximizing the trust's total return.

Suppose that the trust in the previous example is structured as a TRU with a 3% annual unitrust payment to Chloe. Ted is relieved of the burden of generating current income for Chloe, so he can choose investments that maximize total returns — in this case, stocks that yield an 8% annual return.

The result: At the end of Year 1, Chloe receives a unitrust payment of $30,000, or 3% of the trust's value at the beginning of the year. Because the trust's value is recalculated annually, however, her payouts increase gradually over time, ending up at more than $40,000 in Year 7. In addition, even after making healthy distributions to Chloe, the trust's value grows to more than $1.4 million by the end of its term.

Handle with care

A TRU can be an effective tool for easing tensions between income and remainder beneficiaries, but it requires careful planning. Your trustee must select an appropriate unitrust payment and invest the trust assets wisely. If the trust's portfolio fails to outperform the payout rate, the trust won't meet your objectives.

One potential disadvantage of a TRU is that short-term swings in stock prices may cause unitrust payments to fluctuate significantly from year to year. To smooth payouts to current beneficiaries, some TRUs provide for asset values to be calculated based on a rolling three-year average.

It's also important to consult state law before establishing the trust. Not all states allow TRUs, though many empower trustees to make "equitable adjustments" of trust income and principal to ensure that all beneficiaries are treated fairly. This may allow trustees to achieve similar results. Even if you don't live in a state that authorizes TRUs, it may be possible to set up a trust in a state that permits them.

Most state TRU statutes establish a percentage for unitrust payments (4% is typical) or allow trustees to select from a range of unitrust rates (3% to 5%, for example).

In addition to checking state law, make sure a TRU is consistent with applicable federal tax laws and regulations. Federal law requires certain estate planning trusts to pay out all of their "income" to a specified beneficiary.

Tax-advantaged marital trusts, for example, must distribute all of their income, at least annually, to a surviving spouse. IRS regulations now provide that a marital trust structured as a TRU satisfies this requirement provided TRUs are authorized by state law and the unitrust amount is between 3% and 5%.

Whenever the validity or tax treatment of a trust depends on how or to whom it distributes “income,” it’s critical to review applicable laws and regulations to determine whether a TRU will qualify.

Get on the same page

Even in the strongest families, conflicting interests between income and remainder beneficiaries can create tension and turn the trustee’s job into a delicate balancing act. By aligning your beneficiaries’ interests, a TRU can relieve this tension and allow your trustee to concentrate on developing the most effective investment strategy.

Sidebar: Using TRUs for postmortem planning

Many state total return unitrust (TRU) statutes allow you to convert an existing trust into a TRU. This option provides some interesting post-mortem planning opportunities.

Typically, TRUs are used to maximize payments to the income beneficiary while preserving reasonable growth for the remainder beneficiaries. But in some circumstances, if state law permits, it may be desirable to use a TRU to minimize income payments.

In a recent private letter ruling, a husband who was the income beneficiary of his deceased wife’s credit shelter trust found that the trust was generating too much income and threatened to boost his own estate’s tax liability.

The IRS allowed the trustee to convert the trust into a TRU without adverse gift, estate, income or generation-skipping transfer tax consequences. This strategy minimized the husband’s income and preserved more of the trust assets for the remainder beneficiaries — his children.