TRU or false

An introduction to the total return unitrust

BY BARRY L. KOHLER

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FOR THOSE OF US WORKING in that arena where the worlds of law, estate planning, and investing intersect, a new development is beginning to take hold: one which combines current investment realities with a way to resolve the perennial trust problem of providing adequately and fairly for both the income beneficiaries and the remainder beneficiaries of a trust. This development is of interest to those who serve as trustees as well as attorneys who draft trusts.

In particular, the hope is that, going forward, practitioners will begin drafting trust instruments using a total return unitrust (TRU) approach, rather than the traditional "income and principal" approach. Moreover, the TRU approach may offer a solution to resolving (should all parties agree) present controversies between the income and remainder beneficiaries about how a trust "should" be invested.

The Problem

THE CRUX OF THE PROBLEM ARISES from the attempt to reconcile the following two principles: (a) A trustee's investment strategy must comply with appropriate fiduciary standards; and (b) A trustee has a fiduciary obligation to provide for both the income beneficiaries and the remainder beneficiaries.

A. A trustee's investment strategy must comply with appropriate fiduciary standards. The law of fiduciary responsibility continues to evolve, but slowly. Historically, the law of fiduciary duty concerning investments has lagged significantly behind the best thinking in the investment world and changing investment realities. To review the history briefly, the first fiduciary investing standard was that each individual investment must meet the prudent investor rule.[1]

But the essence of modern portfolio theory is that proper diversification and allocation across asset classes will yield comparable or better results with less volatility. Sometime after Nobel Prizes were awarded to the progenitors of this economic theory, the legal standard made a giant leap to the portfolio standard for the fiduciary. That is, the legal standard became that the fiduciary should invest so that the portfolio, considered as a whole, was appropriately invested.[2]

The significance of this development was to allow a trustee (or, more accurately, the trustee's investment advisor) to utilize a much broader range of investment choices than the former standard, which required each investment to meet the standard. Thus the trust portfolio could now be constructed like a typical investment portfolio to include some aggressive investments with higher risk, some more conservative investments with lower risk, and a range of moderate investments.

B. A trustee has a fiduciary obligation to provide for both the income beneficiaries and the remainder beneficiaries. Mindful of the foregoing principles, this issue was always one of the most troublesome for the fiduciary. Typically—at least in "old think"—one invested either for current income or for appreciation of capital. The former favored the income beneficiaries, of course; the latter, the remainder beneficiaries.

The problem, of course, is that the trustee was compelled to decide between higher yielding fixed-income investments, where neither the income nor principal is likely to grow over the life of the trust, or equity securities (stocks or mutual funds) with much lower current yields but much greater long term returns both in principal and in income. Fixed-income investments historically have yielded dramatically less in total return than equity investments over long periods of time.

Unfortunately, income beneficiaries measure trust performance by the amount of income received, and remaindermen measure performance by the appreciation of the value of the corpus (principal). Consequently, *both* are often disappointed,

"[l]eading to the conclusion that trust funds do not do well, almost as if they were a separate form of investment itself. As a result of the fact that beneficiaries have these expectations, which are divergent and contradictory from the point of view of the trustee, their expectations are often disappointed and this, rather than any absolute performance standard will be the measure of the success of the trust in the eyes of the income beneficiary and the remaindermen."[3]

Consequently, someone was usually unhappy with whatever balance the trustee tried to strike. Income was produced (typically) at the expense of the growth of the corpus—which is where the remainder beneficiaries' gaze was focused. And vice versa.

One of my favorite Will Rogers quotes is: "It ain't what we don't know that gives us trouble, it's what we do know that ain't so." There is much "old think" from the investment world that causes mischief. Perhaps the prime example relevant here is "Don't spend principal." This was feasible when investors could earn 8 percent to 10 percent each year from high-grade corporate bonds or dividends from blue chip corporations. But with today's lower interest and dividend rates, a disproportionate amount of principal would have to be invested for income, at the sacrifice of long-term growth.[4]

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The customary solution to this problem was for the fiduciary to invest a portion of the trust assets in income-producing investments, and the balance in investments intended to appreciate in value. The difficult issue, of course, was how to allocate (say, by percentage) the portion of the corpus invested for income and the portion invested for growth. Moreover, even the issue of determining how much income the trustee was obligated to produce had no easy answer. It was rare when the governing trust instrument would provide helpful guidance, such as whether the trustee was to consider the income beneficiary's needs (in light of the other income available to him or her), or would specify an amount (in dollars or by percentage) as to how much income was intended to be generated for the benefit of the income beneficiary.

Simultaneously, in light of the new economic and investment realities, on the investment side a new development occurred: the notion of investing for total return.[5] That is, investment professionals began to think in terms of how the total portfolio is doing, taking into account both income (dividends, capital gains, and other distributions) and appreciation of principal. Alternately stated, the economic concept of "yield" now began to include capital appreciation. Thus, rather than focus on the distinction between income and growth, the issue became to evaluate the total performance of the portfolio.

As a consequence, investment professionals began to design portfolios aimed at producing a sustainable (and hopefully fairly stable) total return, and then distribute from the total account whatever dollar amount the owner required or was needed by the income beneficiary. It would not matter whether the distribution came from income or principal. In its simplest terms, we

know that historically the long term return on equities has been 10.5 percent. Therefore, we can take a specified percentage (say, 4 percent) of the value of the portfolio each year (as a spendable distribution), and still have the capital value appreciate.

Following their investment colleagues, legal thinkers are now beginning to advocate the same approach be used by trustees: invest to produce total return and pay a specified percentage of the value of the trust to the income beneficiaries. This approach is not without some drawbacks, but it definitely deserves further consideration.

The Solution

THE TOTAL RETURN UNITRUST (TRU). The concept of the TRU is immediately familiar to those who have some knowledge of Charitable Remainder Trusts (CRTs), especially the Charitable Remainder Unitrust.[6]

One might define the "Total Return UniTrust" as a trust designed to balance impartially the interests of the current beneficiary and the remainder beneficiary while enabling the trustee to pay out as much as possible to the current beneficiary. In essence, the TRU is an express noncharitable UniTrust. It requires a payout one or more times a year to the current beneficiary of a stated and fixed percentage of the fair market value of the trust's assets—as revalued each year on the same date, but averaged over a three-year period to smooth out market volatility. As a complex trust, a TRU is not required to distribute all income currently. So if, in a given year, income is greater than the percentage amount that is required to be distributed to the current beneficiary, it can be accumulated for the benefit of both current and remainder beneficiaries."[7] *[NOTE:* An exception applies in the case of marital trusts used in a typical estate plan: in order to qualify for the marital deduction, the trust must require that all income be distributed.]

Drawbacks (With Possible Solutions)

DESPITE THE ENTHUSIASM FOR TRUs (including my own), it must be noted that there are some potential problems.[8]

A. It is not clear if this approach would be authorized by the governing instrument. Most trusts, of course, written in days past, refer to "income and principal."

SOLUTION: This problem can, of course, be avoided for trusts currently being drafted. As for existing trusts, as noted at the outset, if all parties agree, a trust could be amended, or a binding agreement entered among the beneficiaries (income and remainder) and the trustee which would protect and indemnify the trustee from adopting a unitrust approach to investment and distributions.

B. The income received by the income beneficiary would fluctuate. As with most investors, this is usually not a problem if the fluctuation is upward—it is the inevitable downward fluctuation that causes concern. Assuming the value of the portfolio increases, the 4 percent received by the income beneficiary will be larger in real dollar terms. It is when the value does not increase, or even declines, that a problem is presented to the income beneficiary—especially if he or she is dependent on the trust income to meet living expenses. Again, history tells us that on average, one in three years in the market is a "down" year.

SOLUTION: Adopt of a "smoothing rule" to reduce the variability of the income recipient's payments and allow for more predictable income distributions. The literature suggests that a three-year rolling average will produce a smoother stream of distributions than will a simple annual payout, and has historically has not resulted in more years of declines that if a five- or ten-year rolling average were used. A ten-year rolling average, however, substantially lowered the payout to the beneficiary.[9, 10]

C. There may be different needs for different income beneficiaries. To take the simplest example, a surviving husband (who continues to receive his full pension), might need less income from a trust than does the surviving wife, whose share of her husband's pension may drop by as much as 50 percent after his death. Selecting too high a payout percentage risks depleting the trust.

SOLUTION: The income portion of the trust could be drafted so as to provide that the annual distribution would be a dollar amount or a percentage, whichever is greater. That is, a dollar amount "floor" could provide the necessary safety net. Also, desired flexibility could be achieved by the income beneficiary declining to take more than he needs or by the trustee having the discretion to invade principal for benefit of the income beneficiary.

D. The income beneficiary might need more income in

times of higher inflation rates to maintain purchasing power.

SOLUTION: The income portion of the trust could be drafted so as to provide that in any year in which inflation (as recorded by official government data) exceeds the specified payout percentage, the payout amount would then become the higher of the stated payout rate in the document, the stated official inflation rate, or the fixed dollar amount floor. Alternatively, the payout floor could be indexed to inflation. Finally, flexibility could be achieved by the trustee having the discretion to invade principal for the benefit of the income beneficiary.[11]

E. Accounting/Tax Standards are not quite ready for the TRU approach. The characterization of distributions from a TRU to the income beneficiary may give an accountant a headache. However, the current accounting issue is not insoluble; it just makes life more difficult when the time comes to file the trust tax return.

SOLUTION: The better news is that relief may be on the way in the form of the "new" Uniform Principal and Income Act (1997).[12] Albeit somewhat awkwardly, Section 104 of this Act (hereafter "UPIA") gives the trustee broad authority—subject to certain limitations—to make adjustments between principal and income. An even more direct legislative approaches (now being considered in Delaware, New York and other states) specifies (a) that the fiduciary's obligations may be satisfied if a payment is made to the "income beneficiary" of a fixed percentage of the value of the trust, valued annually, or (b) by simply presumptively defining "income" to mean a percentage of the trust and to eliminate the historical distinction between trust accounting income and principal.

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In the CRT world, the IRS has adopted a tier system which treats payouts as being taxable by the recipients rather than to the trust itself, and "orders" payouts as being made in the following sequence: from ordinary income, then short-term capital gains, then long-term capital gains, then a non-taxable return of principal. Hopefully, the Service will eventually issue a ruling that makes this principle applicable to TRUs. Yet, even if the IRS were not to adopt a comparable model and taxed all capital gains to the trust itself, at least one commentator believes the overall benefits (economic and otherwise) "remain essentially undiminished."[13]

F. The TRU approach is not right for all trusts. There are some trusts, such as those designed to care for minors or a beneficiary with special needs, where payments based on a percentage of assets would run counter to the purposes of those trusts.[14]

SOLUTION: Engage brain before blindly following any form.[15]

Conclusion

The Total Return Unitrust is a planning and drafting technique which will become increasingly important in the future. It accords fiduciary investing responsibility with the best investment thinking, helps balance the competing interests of the income and remainder beneficiaries, and if history is any guide, can produce "more" for each beneficiary. Oh, by the way: If the beneficiaries are happy with what each has received, claims against drafting attorneys, trustees, and investment advisors will decline as well.

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1. The so-called "Prudent Man Rule" was originally formulated in the Massachusetts case of *Harvard College v. Amory,* 9 Pick. (26 Mass.) 446 (1830). Note that the Harvard rule focused on conduct of the fiduciary, not performance, and reasonableness was measured by what other trustees similarly situated were doing. For an interesting modern history of the evolution of this rule, see Babson, "Preview of Trustee Investment Decision-Making in Accordance with the Uniform Prudent Investor Rule," *ALI-ABA Online CE Library* at http://www.ali-aba.org/aliaba/n457ch01p.htm. History buffs who want to trace the origins of these rules back to the earliest days of English common law should see the interesting discussion in the early sections of Edwards, "Trusts for the New Century: The Third Paradigm," (December 1999) at Professor Stephen R. Leimberg's Web site, www.leimberg.com, a treasure-trove of information on advanced estate planning topics. Leimberg is an adjunct professor in the masters of taxation program of Temple University School of Law.

2. The American Law Institute, in 1922, replaced the Prudent Man Rule (which had been adopted almost everywhere, with a "Prudent Investor Rule" in its Restatement (Third) of the Law of Trusts.

3. Patti S. Spencer, Esq. (with Adam R. Clark, Paralegal), "TOTAL RETURN TRUSTS: Trusts in the New Millennium," a presentation to the Pennsylvania Institute of Certified Public Accountants Estate & Personal Financial Planning Conference (November 11, 1999), also quoting Robert B. Wolf, "Defeating the Duty to Disappoint Equally—The Total Return Trust," *ACTEC Notes,* Volume 23, No. 1, Summer 1997, p. 47.

4. In November 1998, thirty-year Treasury notes were earning 5.15 percent (less than eighty-five basis points above the ninety-day T Bill rate of 4.32 percent) and average dividend yields were 1.48 percent. Robert B. Wolf & Stephen R. Leimberg, "Total Return Unitrusts: The (TRU) Shape of Things to Come," 10 RIA Est. Planner's Alert 15 (Dec. 1998).

5. The seminal article for the use of a non-charitable unitrust was "Defeating the Duty to Disappoint Equally—the Total Return Trust" by Robert B. Wolf, 32 Real Prop. Prob & Trust Law J. 45 (Spring 1997) and 23 *ACTEC Notes* 46 (Summer 1997). This lengthy, technical article expounds at great length both the investment theory underpinning this strategy as well as the legal setting in which the discussion occurs.

6. For general background on the CRT, see, e.g., my earlier article "Doing Well by Doing Good: The Many Uses of the Charitable Remainder Trust (A Primer for the General Practitioner)," 12:4 *Maine Bar Journal* 240 (July 1997).

7. Robert B. Wolf & Stephan R. Leimberg, "Total Return Unitrust: The (TRU) Shape of Things to Come," Estate Planner's Alert (December 1998).

8. This "enthusiasm" is beginning to be seen even in the popular press. See, e.g., Carrie Coolidge, "In Growth We Trust," *Forbes Magazine,* March 8, 1999.

9. See Robert B. Wolf, "Defeating the Duty to Disappoint Equally—The Total Return Trust," 23:1 *ACTEC Notes* (Summer 1997) at p. 57 ff.

10. The illustration provided by Spencer is helpful; see Supra, Note 3. "Assume trust created seventy-one years ago—with same returns as S&P 500, with assumed 5 percent payout. If 5 percent payout is simply 5 percent of fair market value at end of year, there are twenty-three years in which there is a reduction in the distribution and fourteen years in which the reduction was over 10 percent. A beginning market value of $100,000 grew to $4,800,464. Three-year rolling average produces a smoother stream of distributions. There are only thirteen years in which there is a reduction in the distribution and only seven with a decline greater than 7 percent.

Market value at the end is $5,217,253. A five-year rolling average did not produce fewer years with a decline. A ten-year rolling average did not produce fewer years with a decline and substantially lowered the payout to the beneficiary."

11. This problem, and the solution, as well as other financial modeling, come from Frank Croke, "Total Chaos," *Financial Planning Magazine,* May 2000 at pp. 95, 98.

12. The 1997 Act was approved by the National Conference of Commissioners on Uniform State Laws on July 31, 1997, and by the American Bar Association in February, 1998. The full text of this Act may be found at <http://www.law.upenn.edu/bll/ulc/upaia/upaia97.htm>.

13. See Robert B. Wolf & Stephan R. Leimberg [Supra at note 7]. Also as noted therein, Reg. Sec. 1.643(a)-3(a), which states that a gain from the sale or exchange of a capital asset is ordinarily excluded from DNI (distributable net income)—unless such gains are allocated to income under either the terms of the governing instrument or local law, or they are allocated to principal and actually paid out to the trust's beneficiary during the taxable year, or utilized under the terms of the governing instrument or the practice followed by the fiduciary in determining the amount which is distributed or required to be distributed. There is some question as to whether or not a "specific event" or "economic substance" test is required to be satisfied to give an ordering rule effect. However, an express allocation of the necessary gains to income by the governing instrument should have the expected effect. Author Wolf intends to obtain a ruling to this effect. See also PLR 8728001 and Robert J. Rosepink, "The Total Return Trust—Where and How to Tax Capital Gains," *Trusts & Estates,* Oct. 1998, Pg. 12.

14. Marsha A. Flippin, "The Total Return Unitrust: An Innovative Approach to Efficient Trust Design," 1:4 *Estate Planning News and Views,* the newsletter of the Estate Planning Section of the Society of Financial Service Professionals (1999).

15. Maybe my proposed solution is too flip. As noted in Mark B. Edwards' article, "Trusts for the New Century: The Third Paradigm," there are four other types of trusts which are not well-suited to the unitrust form of payout: (1) A credit shelter trust where the surviving spouse is the beneficiary and is alive. Any mandatory distributions would remove assets from the shelter of the trust and subject any unspent portion to tax in the estate of the surviving spouse. (2) A generation-skipping trust which provides for distributions to a non-skip person for life and then to the skip beneficiaries. The mandatory unitrust formula would be contrary to good tax planning, for any unspent portion of the mandatory distributions to non-skip persons would be taxed earlier than necessary. (3) A spendthrift trust designed to protect assets from the claims of creditors. A mandatory unitrust interest would be reachable by creditors under the laws of most states. (4) A trust funded largely with non-financial assets such as real property or with non-liquid assets such as interests in a closely-held business. The unitrust formula would produce an inappropriate result of requiring payments in kind or requiring forced sale of some of the assets. [BK Note: alternatively, you could simply include such assets in the trust, but exclude them from the calculation of the payout amount.] ◗

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