TOTAL RETURN TRUST:
A WAY TO BALANCE THE
INTERESTS OF BENEFICIARIES

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A typical revocable trust is divided into two or three subtrusts on the first death. The first subtrust is the credit shelter (or "bypass") trust which uses the deceased spouse's lifetime exemption amount to reduce federal estate taxes. The second subtrust is the marital deduction or qualified terminable interest property trust (or "QTIP" trust) whose assets are subject to estate tax upon the survivor's demise.

The bypass trust often pays out all its "income" to the current beneficiary, who usually is the surviving spouse. Additionally, the trustee may be given the power to distribute some of the principal of the trust but only for limited purposes such as health, support and maintenance. The objectives are to provide the surviving spouse with funds to preserve an accustomed standard of living but also to have assets available to distribute to the children upon the death of the surviving spouse.

The terms of the QTIP trust must require the distribution of all trust "income" to the surviving spouse in order to qualify for the marital deduction. But there is no requirement that any principal must be distributed. Indeed, the intention is again to have a significant amount of assets, i.e. principal, left for the remainder beneficiaries who typically are the children of both spouses or, if there was a prior marriage, the children of the deceased spouse.

The dilemma arises because the "income beneficiaries" want the trustee to invest the principal so as to realize the greatest amount of income which will then be distributed to them. The "remainder beneficiaries," however, want the trustee to invest the funds in a manner that achieves the highest rate of return on the assets so that the principal will appreciate significantly over time.

The problem confronting the trustee is several fold. First, interest rates on bonds have always been much lower than the long term rates of growth realized by equity investments. When the lower returns on bonds are further reduced by taxes, expenses and inflation, the differences in annual returns over, for example, a twenty year period, between bonds and stocks becomes very significant. Between 1870 and 1925, the consumer price inflation averaged 6/10th of one percent. Today, we feel fortunate if inflation stays below 3%. Due to increased inflation, the dollars received upon maturity have significantly less purchasing power than the original dollars used to purchase the bond.

Another component of this problem is that dividend rates on stocks have declined over the last fifty years and a 100% equity portfolio will yield an unsatisfactory return to the income beneficiary. Also, this level of income probably is much less than what the decedent wanted for

the surviving spouse.

Added to these factors are the responsibilities imposed on a trustee under the Uniform Prudent Investor Act. For example, if a trust has two or more beneficiaries, the trustee has a duty to deal impartially with them and also must act impartially in investing and managing the trust property after taking into account the differing interests of the beneficiaries. This can be contrasted with the traditional favoring of the life income beneficiary to the potential detriment of the remainder beneficiary. Thus this duty of impartiality can create a great deal of consternation in the trustee who is trying to satisfy the interests (if not demands) of the current income beneficiary and the remainder beneficiary.

Finally, the trustee has a further duty to manage the assets as a prudent investor would and diversify the investments of the trust. Even if the trustee thought a 100% bond portfolio was appropriate to generate the highest income for the current beneficiary, such a concentrated portfolio would most likely be a breach of the duties to diversify and to be impartial.

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To solve this problem, the California Probate Code was amended in 2005 to allow for a "total return trust" or sometimes referred to as a "unitrust."

Under a "total return trust," the settlor directs the trustee to distribute to the current beneficiary, not the income of the trust assets, but a percentage of the value of the assets as of a specified date, typically January 1 of each year. This percentage must be no lower than 3% nor greater than 5%. Consequently, the trustee now makes an annual distribution of assets that equals the applicable percentage of the value of the trust assets, e.g. 4%. The assets or funds distributed may well be comprised of what might generally be viewed as income as well as principal. In making the distribution, the trustee now has the ability to sell some portion of the assets which may well have appreciated over the last several years. If the assets of the trust grow as a result of the investment strategy, then the value of the 4% will also increase, thus likely appeasing the income beneficiary. The remainder beneficiary sees the principal growing and is similarly satisfied.

This trust design responds to several important goals in determining how a settlor might instruct a trustee to make distributions from a modern trust:

- The trust must enable the trustees to invest for the highest total return consistent with the level of risk acceptable to the trust and its beneficiaries.
- If possible, the distribution rule should create an identity of interest between the current beneficiary, the trustee and the remainder beneficiaries relative to investment decisions.

- This distribution rule should allocate returns efficiently and fairly in all types of markets, even when there are times of unusual volatility, whether up or down.
- The flow of distributions to the current beneficiary should be as smooth as practicable while maintaining the identity of interest among the parties to the trust.
- The distribution rule should be simple and easily understood.

"this type of trust . . creates a consistent identity of interest between the current income beneficiary . . and the remainder beneficiary**"**

It can be reasonably stated that the "total return trust" (with a three year averaging rule as provided for in California) addresses all of the foregoing criteria. Very importantly, the greatest strength of this type of trust is the fact that it creates a consistent identity of interest between the current income beneficiary on the one hand and the remainder beneficiary on the other.

With this important development in the design and structure of trusts, we look forward to assisting and advising those clients who would like to learn more about converting an existing trust to a unitrust or revising a revocable trust so the subtrusts created in the future will be managed as "total return trusts."

If you would like to receive further information on total return trusts, please contact us at (619) 239-7777or BNDewan@mmpph.com.