

Total Return Trusts

In many trusts, if not most of them, the goal of the Trustor (creator) is to provide benefits for the income beneficiary – whether that is a spouse, a child or other persons. To achieve that goal, a typical trust may provide for income to be paid to the income beneficiary for his or her life. But what does that really mean?

What is Income?

The term "income" traditionally includes dividends from stock, interest on cash accounts, net income from real property rentals and leases, and similar receipts. It generally does not include profits from sales of appreciated property. When dividends and interest rates are high, the income beneficiary profits. When they are low, as in recent times, the beneficiary may not be receiving as much as the Trustor envisioned when the trust was created.

The Trustee has a duty to treat all trust beneficiaries fairly -- both the income beneficiary and the remainder persons (the persons who take the property after the income beneficiary's death). It isn't proper for the Trustee to invest in high income assets that provide no long-term protection from inflation, since that would unfairly favor the income beneficiary over the interests of the remainder persons. If the Trustee invests in growth assets, that often means the income is less and the income beneficiary doesn't get as much income as he or she might otherwise receive.

The Total Return Solution

One solution to this dilemma is to specify the amount the income beneficiary will receive as a percentage of the value of the trust assets each year. For example, a trust with assets of \$1,000,000 might specify that the income beneficiary receive 5% of the trust value each year. In the first year, the income beneficiary would receive \$50,000 as his or her "income payment", even if the actual income is less. If the income is more than \$50,000, that excess may be paid to the income beneficiary, or it may be accumulated for the long term benefit of the remainder persons, depending on the terms of the trust.

A major benefit of this approach is that the Trustee can invest in assets that provide the best "total return" of both income and growth of principal, without jeopardizing the interests of either the income beneficiary or the remainder persons; hence the name, the "Total Return Trust".

Another benefit is that the income beneficiary typically has a more equalized income stream that is less subject to the vagaries of the economy from year to year. Figure 1 illustrates this concept by comparing the results over a 10-year period with a steady 2%

growth, but varying income returns in each year.

In reviewing the table, you can see that at the end of the ten-year period, the value of the principal remaining for the remainder persons is very close in each payment method. However, the distributions to the income beneficiary fluctuate wildly under the traditional income method, whereas they are very steady under the total return trust.

Although nearly all trusts allow the Trustee to invade principal to provide for support and health care for the income beneficiary if income is insufficient, in the traditional income method, the income beneficiary is dependent on the Trustee to be sympathetic to his or her needs.

Trustees appreciate the total return approach since it often reduces squabbles among the beneficiaries as to what is "necessary" for the income beneficiary.

Is Total Return Right for You?

In deciding whether the total return method is right for you and your beneficiaries, you need to recognize the risk that a long stretch of low overall returns can eat away at the principal remaining for the remainder persons. In addition, where the income beneficiary has significant other resources, it may not be the best approach to force payments to that person from a trust that may be exempt from transfer taxes at the income beneficiary's death. In that situation, a better arrangement is often to allow income to be "sprinkled" among all the family members or accumulated in the trust, so the Trustee can direct the income where it will do the most good for the family as a whole.

Year	Principal	Income %	Traditional Income		To Income Beneficiary	Principal at End of year
			Income Amount	Growth Amount		
1	1,000,000	2%	20,000	20,000	20,000	1,020,000
2	1,020,000	3%	30,600	20,400	30,600	1,040,400
3	1,040,400	5%	52,020	20,808	52,020	1,061,208
4	1,061,208	5%	53,060	21,224	53,060	1,082,432
5	1,082,432	4%	43,297	21,649	43,297	1,104,081
6	1,104,081	6%	66,245	22,082	66,245	1,126,162
7	1,126,162	8%	90,093	22,523	90,093	1,148,686
8	1,148,686	4%	45,947	22,974	45,947	1,171,659
9	1,171,659	6%	70,300	23,433	70,300	1,195,093
10	1,195,093	5%	59,755	23,902	59,755	1,218,994
			Total Return at 5%			
1	1,000,000	2%	20,000	20,000	50,000	990,000
2	990,000	3%	29,700	19,800	49,500	990,000
3	990,000	5%	49,500	19,800	49,500	1,009,800
4	1,009,800	5%	50,490	20,196	50,490	1,029,996
5	1,029,996	4%	41,200	20,600	51,500	1,040,296
6	1,040,296	6%	62,418	20,806	52,015	1,071,505
7	1,071,505	8%	85,720	21,430	53,575	1,125,080
8	1,125,080	4%	45,003	22,502	56,254	1,136,331
9	1,136,331	6%	68,180	22,727	56,817	1,170,421
10	1,170,421	5%	58,521	23,408	58,521	1,193,829

Figure 1

Another situation where the total return trust may not be appropriate is if the trust contains hard-to-value assets, such as real property or a family business. One of the requirements for a total return trust is that the trust assets must be valued each year in order to establish the amount of the payment in following years. For hard-to-value assets, the costs of having frequent appraisals may make the total return approach less attractive.

Conclusion

If you are interested in considering the total return approach for your planning, one of our attorneys would be happy to evaluate your estate and your planning and advise you if it would help to meet your goals.



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