Investment Planning Answer Book by Jay L. Shein, Total Return Trust

Click to open document in a browser

There are different portfolio requirements for individual investors and trusts than for institutional tax exempt investors such as college endowments. While some investors may prefer the growth of the value of their stock because capital gains would be taxed at a lower rate than ordinary dividend income, this would not be a concern for institutional tax exempt or tax deferred investors. Investment planning with trusts can run into various problems. For instance, with a revocable trust, the grantor has the ability to change the document to accommodate any investment needs of the portfolio. Irrevocable trusts can not be changed except under narrow court ordered circumstances or under the decanting statutes that may be allowed in various states. Typical decanting statutes which are currently only found in a small number of states give trustees the ability to appoint all or a portion of the trust assets from one irrevocable trust to another. Decanting statutes typically would not need court approval to implement and give the trustee significant authority to move assets from one trust to another. Decanting statutes would be used to move assets from one trust to another trust that has more favorable provisions. To avoid some of the problems that would require judicial modifications or decanting of a trust, more flexibility must be built into irrevocable trusts for purposes of portfolio management. Much of this flexibility can be found in the total return trust concept.

Investment Planning Answer Book by Jay L. Shein, Q 14:1, What is a Total Return Trust?

Click to open document in a browser

A Total Return Trust is a legal document that allows for the management of an investment portfolio with a focus on total return as opposed to separation of income and principal. Diversification, asset allocation, and the various investments used to implement investment policy should be coordinated with the benefits and concepts contained in a Total Return Trust. Historically, trust models have tended to pay all income to the current beneficiary and the balance to the remainder beneficiary or beneficiaries. Unfortunately, these types of trusts are still popular in many form books that drafters of trusts use which still contain these types of provisions. This is probably not the best approach since each trust that is drafted will have parties (e.g., current beneficiary or remainder beneficiary) that have different objectives, circumstances, and financial needs. A trust should reflect the diverse needs of the various parties and take advantages of the realties and benefits of the financial markets.

Investment Planning Answer Book by Jay L. Shein, Q 14:2, What should be the focus of a Total Return Trust?

Click to open document in a browser

The focus of the investment policies for a Total Return Trust should be to consistently achieve above average investment results over a long period of time. This focus would be best implemented with a Total Return Trust strategy.

Investment Planning Answer Book by Jay L. Shein, Q 14:3, What is an example of a major trust deficiency for many trusts?

Click to open document in a browser

A revocable trust typically becomes irrevocable at the death or incapacity of the grantor of the trust. Many times the income beneficiaries of a trust are the spouse or children of the grantor. These beneficiaries of the trust may be entitled to all the trust income or some form of discretionary income. Trust income is defined either in the document or governed by the applicable state principal income act. Usually, this income consists of dividends of stocks or mutual funds and interest on bonds but does not include realized capital gains, capital gains distributions from mutual funds, or unrealized capital gains. The remainder beneficiary or beneficiaries such as the children would typically receive the income stream when the current beneficiary dies. The remainder beneficiary or beneficiaries may not receive the trust principal (corpus) for many years.

The trustee of the trust has the obligation to be fair to the current beneficiary as well as to the remainder beneficiary or beneficiaries. The trustee's objective in this type of trust is to provide the current income beneficiary with a reasonable cash flow while investing the trust assets in a manner to preserve the purchasing power of those assets for the benefit of the remainder beneficiary or beneficiaries. In the past when dividends were very high, it was easier for a trustee to manage a trust portfolio and provide a reasonable income stream for the current income beneficiary and still have opportunity for growing principal for the benefit of the remainder beneficiary or beneficiaries. Yields on stocks generally have been reduced significantly. The traditional trust that pays all income to the current income beneficiary and holds the principal creates a conflict between income and remainder beneficiaries. The income beneficiary, of course, wants the highest income currently; while at the same time, the remainder beneficiary wants a higher growth potential for the future. With the introduction of Modern Portfolio Theory, Post-Modern Portfolio Theory, and other portfolio management strategies discussed in this publication, both current and remainder beneficiaries would be better served by a total return approach to building and managing an investment portfolio.

Investment Planning Answer Book by Jay L. Shein, Q 14:4, What is a problem with a pay all income trust?

Click to open document in a browser

When given rates of a stock are higher, it is easier for the trustee to construct the portfolio to provide a reasonable income for the current income beneficiary while still providing an opportunity for growth to eventually benefit the remainder beneficiary. But when current yields on stocks are low or are decreasing, the investment advisor and the trustee might be tempted to increase the allocation to fixed income assets in the portfolio such as bonds. If the future includes inflation, which would in turn increase interest rates, the purchasing power of the bond portfolio would be reduced with little possibility of portfolio growth. If the advisor extended the maturity of the fixed income portion of the portfolio, the portfolio could become more volatile. If the advisor and trustee invested in high yield fixed income securities, they would be exposed to greater loss of principal due to credit risks. Even if the advisor selects equities/stocks that have a high current yield, they may have little long-term growth potential. For instance, many utilities pay out most of their income in the form of dividends which restricts the opportunity for appreciation for these types of securities.

Investment Planning Answer Book by Jay L. Shein, Q 14:5, Is there disconnect between investor objectives and actual portfolio management in a trust?

Click to open document in a browser

Many investors' objective is for their portfolio to grow for the benefit of their children or grandchildren. Many investors would be uncomfortable when made aware that the yields to the income beneficiaries could be very low if the optimum total portfolio objective is selected. Income beneficiaries, on the other hand, usually want to receive a much higher income stream than what would be available with the optimal portfolio implementation. Most income beneficiaries are not comfortable with the amount of income that they are receiving. Much of this concern comes from the fact that during many ten year periods, many portfolio values have grown greater than the income stream. For example, the trust portfolio may have increased 100 percent in value while at the same time the income stream only increased 30 percent.

Investment Planning Answer Book by Jay L. Shein, Q 14:6, What is an example of a trustee's dilemma?

Click to open document in a browser

Assume that the investment climate would suggest that a low interest and dividend rate are predicted while equity/stocks are expected to have a long-term rate of return of 8 percent. The investment advisor focusing on total portfolio return would typically want a larger allocation to stocks. For example, the advisor might choose an allocation of 30 percent in fixed income and 70 percent in equities with a million dollar trust portfolio. The following is an example portfolio:

Portfolio Example 1	*Projected $ Return*	
$300,000 fixed income (staggered maturities over a ten-year period), projected average annual income 4.0%	$12,000	
$700,000 equity portfolio, projected annual dividend income 2.0%	$14,000	
Total current income	$26,000	
Less half of projected trustee expense (assume 1% of total values for trustee fees, tax return preparation, etc.)	$5,000	
Net income to income beneficiary		**$21,000**

This portfolio is only providing 2.1 percent to the current income beneficiary or $21,000. If the portfolio mix was changed where 40 percent of the portfolio was in fixed income and 60 percent was in stocks, the income beneficiary would receive 2.3 percent which is $23,000 as shown in the following example.

Portfolio Example 2	*Projected $ Return*	
$400,000 fixed income (staggered maturities over a ten-year period), projected average annual income 4.0%	$16,000	
$600,000 equity portfolio, projected annual dividend income 2.0%	$12,000	
Total current income	$28,000	
Less half of projected trustee expense (assume 1% of total values for trustee fees, tax return preparation, etc.)	$5,000	
Net income to income beneficiary		**$23,000**

With a portfolio mix of 50 percent fixed income and 50 percent equity, the income beneficiary would receive 2.5 percent which is $25,000.

Portfolio Example 3	*Projected $ Return*	
$500,000 fixed income (staggered maturities over a ten-year period), projected average annual income 4.0%	$20,000	
$500,000 equity portfolio, projected annual dividend income 2.0%	$10,000	
Total current income	$30,000	
Less half of projected trustee expense (assume 1% of total values for trustee fees, tax return preparation, etc.)	$5,000	
Net income to income beneficiary		**$25,000**

We can see from these three examples that the investment advisor and trustee can attempt to produce higher yields for the current beneficiary by increasing the fixed income allocations, extending the bond maturities to receive a higher coupon, purchasing higher yielding lesser credit quality bonds, or selecting stocks with higher current yields. While these methods may produce higher yields for the current income beneficiary, they may not be the appropriate strategy for the current income beneficiary and/or remainder beneficiaries.

Investment Planning Answer Book by Jay L. Shein, Q 14:7, Do current state trust laws accommodate the total return concept of investing?

Click to open document in a browser

In the past, many principle and income statutes did not allow flexibility needed to take advantage of the total return concept, Modern Portfolio Theory, and the prudent investor rule. Most states today have adopted some form of the prudent investor act and are in the process or have adopted some form of the uniform principal and income act. While these updates to the statutes can help take care of the problems with existing irrevocable trusts, new trusts that are created can provide the appropriate language from the beginning to accommodate the Total Return Trust concept. To allow for proper management of an investment portfolio and to be fair to both the current income and remainder beneficiaries, trusts should be drafted from the beginning to accommodate these concepts.

Investment Planning Answer Book by Jay L. Shein, Q 14:8, Why not just use a discretionary trust?

Click to open document in a browser

Many trustees, especially individuals, prefer to have more specific guidance on trust distributions. Too much discretion does not solve a trustee's problem of how much and when to make a discretionary distribution. It has been argued that trustee discretion gives the trustee more flexibility to meet the needs of the income and remainder beneficiaries. The reality of the situation is that many trust departments, as opposed to individual trustees, may take too much time to make a discretionary distribution because of the need to consult with their legal and compliance departments regarding discretionary distributions. Many trust departments have indicated that they would prefer more specific guidance in regards to the timing and amount of distributions made to beneficiaries. Fully discretionary trusts may have some advantages compared to a credit shelter or dynasty trust. Combining a total return unit trust with a discretionary trust could also have some economic benefits that may be more flexible for a credit shelter or dynasty trust.

Concluding that one trust will work for all situations would be a great error. Even those in favor of the fully discretionary trust will find many people do not have enough confidence in the trustee to invest all that power in the trustee. A total return trust could include some discretionary provisions, especially in the case of a trust set up for minors or incapacitated persons.

Investment Planning Answer Book by Jay L. Shein, Q 14:9, What are typical grantor concerns?

Click to open document in a browser

Many grantors want assets held in trusts for their children to be invested in a portfolio to grow for their benefit while focusing on providing high current income for their spouse or other current income beneficiaries. Clients would be shocked to learn that yields to income beneficiaries may be between two and four percent if the optimal total return portfolio was implemented. If income beneficiaries were polled, the advisor would find that their expectations were much greater: probably the minimum income expectation would range from five to six percent. High expectations by the income beneficiary are not possible without sacrificing opportunity for principal growth. It would be unusual to find a beneficiary of a trust that is content with the amount of income that they receive. This discontent probably comes from lack of sophistication or an unwillingness to give recognition to the trustee's duty to the remainder beneficiaries.

Investment Planning Answer Book by Jay L. Shein, Q 14:10, Is there an inherent conflict between income and remainder beneficiaries?

Click to open document in a browser

The conflict between income and remainder beneficiaries is more of a quagmire if the beneficiary is a trustee. Many would suggest that a truly independent trustee, whether an individual, bank, or trust company, should be able to discharge their investment responsibility fairly to both the income and remainder beneficiaries. Also, all beneficiaries would ideally be cognizant of this effort and acknowledge and agree to it. This is not how it usually works. Income beneficiaries do not like to hear that yields are low and that a trustee has a duty also to the remainder beneficiary. If the income beneficiary does not like the result and has the power to do so, they may desire to change the trustee or take action against the trustee. In other words, they may want to kill the messenger.

Trustees do have some responsibilities here. Trustees may hide behind the terms of the trust. The trustee may say that there is nothing they can do because the current beneficiary is receiving all of the income. Sometimes the trust document appears to give guidance to the trustee. For example, the trust document could state, "It is my intention that the needs of my wife for income be given paramount importance and the needs of my children as remainder beneficiaries are secondary." This type of statement can send a mixed message to a trustee in regards to designing a suitable investment portfolio. Over long periods of time, if inflation erodes the purchasing power of this income stream and there was not sufficient growth in the portfolio, the question becomes whether the long-term needs of the income beneficiary has been given proper attention. The Total Return Trust is a strategy to help solve the problem that causes conflict between current beneficiaries, remainder beneficiaries, trustees, and investment advisors.

Investment Planning Answer Book by Jay L. Shein, Q 14:11, What is the role of the prudent investor rule?

Click to open document in a browser

Under the past "prudent man rule," individual investments were considered separately when determining if the trustee was acting prudently. With this rule, trustees could be held liable for investment losses in one investment even though another investment made money. Under the prudent investor rule, which has been adopted in most states, trustees have a duty to beneficiaries to manage funds as a prudent investor would. This requires a reasonable skill, care, and caution on the part of the trustee or delegation to someone who has such skill to manage the investments of the trust. Typically, the trust portfolio must be designed to stay ahead of inflation. The prudent investor rule states that the investment portfolio should be diversified, and as such, the investor can no longer play it safe and invest the entire portfolio in very safe assets such as treasury bills. With a total return approach complimented by the prudent investor rule, no investment by itself would be considered imprudent. The total portfolio must be attended to. With this in mind, trustees are free to invest as they feel appropriate as long as they adhere to the terms contained in the trust. Trustees should opt for an overall investment strategy that considers general economic conditions, inflation, tax consequences, requirements of the beneficiary, the term of the trust, and the portfolio as a whole. Concepts embedded in Modern Portfolio Theory and Post-Modern Portfolio Theory, such as diversification, the degree of diversification, the extent to how much individual assets are correlated, and strategic, tactical, and macro allocation strategies will be used more frequently.

Investment Planning Answer Book by Jay L. Shein, Q 14:12, What are some types of total return trusts?

Click to open document in a browser

Total return trusts assist in providing solutions to some of the problems that cause conflict between current and remainder beneficiaries. Much of the current trust design seems to be biased in favor of the current beneficiary. Because of this, various types of total return trusts should be considered. Some of these are the Total Return UniTrust (TRU), the Total Return Annuity Trust (TRA), the Total Return Income Trust (TRIT), and the Total Return QTIP Trust.

Investment Planning Answer Book by Jay L. Shein, Q 14:13, What is a Total Return UniTrust?

Click to open document in a browser

A popular type of total return trust is Total Return UniTrust (TRU). With this type of trust, a payout to the current beneficiary occurs one or more times per year of an amount equal to a fixed percentage of the fair market value of the assets valued once each year. If the income component of the trust portfolio is greater than that which is required to be distributed in any one year, then the excess can be accumulated for the future benefit of both the current and remainder beneficiaries. This strategy allows for the possibility that all the parties involved, the current beneficiaries and the future remainder beneficiaries will possibly receive more income or principal benefit in the future. Trustees and investment advisors appreciate this flexibility as it allows them to use the concepts embedded in modern asset allocation and portfolio management.

Investment Planning Answer Book by Jay L. Shein, Q 14:14, How does a Total Return UniTrust work?

Click to open document in a browser

Assume that a trust begins with a principal value of $2,000,000 and is required to pay out 5 percent of the portfolio value based on the value of the trust assets January 1st of each year. The first payout, assuming the value of the trust is $2,000,000, would be $100,000. In the second year, if the value of the trust was $2,200,000, the payout would be $110,000. If the trust declined in the third year to $1,800,000, the payout would be $90,000.

Year	*Trust Value*	*Payout*
January 1, 2005	$2,000,000	$100,000
January 1, 2006	$2,200,000	$110,000
January 1, 2007	$1,800,000	$90,000

Over time, the current income beneficiary has a better chance of receiving a higher income as the value of the trust grows. There is no guarantee that growth of the trust corpus will occur. This is the challenge of managing a portfolio for both the current and the remainder beneficiaries. This structure does allow the current beneficiary to know what her distribution is going to be as of January 1st of each year. Because there can be so much volatility from year to year, the drafter of the trust may consider a smoothing provision to reduce the effects of the year to year fluctuations in market values. For example, the trust could be worded in the following manner to define the UniTrust payout and smoothing provision: "The trustee shall pay to my spouse in each year of the trust during her life a UniTrust amount equal to 4 percent of the fair market value of the trust at the close of the first business day of the trust year (or the date of the first funding for the first trust year) and the two previous trust years (or the smaller number of trust years that are available for the trust for the first two years of the trust). If there is short tax year, the UniTrust amount will be calculated based on the pro-rated portion of the UniTrust amount comparing the number of days in the short trust year to the number of days in the calendar year of which the short trust year is a part." This is just an example, and attorneys versed in the drafting of total return trusts should be used for appropriate language, preparing trust documents, and consulting with the client. This example is for a three year smoothing rule and could be expanded to include more years such as five years.

The following chart is an example that uses the three year smoothing rule on a 5 percent UniTrust. Typically, the trust document would state that the payout in year one would be based on 5 percent of the trust value, the payout of year two would be based on 5 percent of the average trust value for year one and two, and the payout of year three would be based on 5 percent of the average trust value for years one, two, and three. Subsequent year payouts would be based on the average trust value for the three preceding years.

Year	*Trust Value*	*Payout*
January 1, 2003	$2,000,000	$100,000
January 1, 2004	$2,200,000	$105,000
January 1, 2005	$1,900,000	$101,667
January 1, 2006	$2,050,000	$102,500
January 1, 2007	$2,300,000	$104,166

This example demonstrates the effect and benefit of using a smoothing rule. If you did not have the three year smoothing rule as in this example, the payout would simply be 5 percent of the trust value for that year.

Smoothing provisions do not completely shelter the beneficiary from stock market conditions such as those that existed from 1973-1974, 2000-2002, and 2008. They do reduce the variability of the payout amount. A longer smoothing rule should reduce the fluctuations in payout amounts. Even with smoothing rules, beneficiaries may not receive inflation adjusted payouts that they expect or that was the intent of the grantor of the trust.

Investment Planning Answer Book by Jay L. Shein, Q 14:15, How can the potential disadvantages of the variability of Total Return UniTrust payouts be addressed?

Click to open document in a browser

Some flexibility can be drafted into the Total Return UniTrust to help overcome some of the problems with the payout variability. Some examples of these provisions that can be included in the trust document are as follows:

- The payout could be any percentage of the value of trust assets even less than 5 percent unless restricted by some state statutes.
- The beneficiary could receive the greater of the trust income (as defined by the trust or state statutes) or the UniTrust amount.
- There could be a floor or ceiling on the UniTrust payout amount. For example, the payout could be 5 percent but never more than $100,000.
- There could be a provision for invading the principal in addition to the UniTrust amount. The UniTrust could be increased or decreased during the duration of the trust. For example, a child could receive a 4 percent UniTrust payout amount until age 40, 5 percent until age 45, and 6 percent until age 60.
- The trust could be drafted in a manner that applies the UniTrust payout amount only to certain assets and not to others. For example, the UniTrust amount might apply only to cash equivalents and marketable securities but not to a closely held business or real estate.
- Assets contained in the trust that do not have a readily ascertainable value would have a valuation method or formula specified.
- Total return trust could contain a provision that would increase the UniTrust payout amount to current beneficiaries as the cost of living increases.

The investment advisor, in conjunction with the client's attorney and tax advisor, should be creative in the design of a Total Return Trust as there is a lot of flexibility in this area.

Investment Planning Answer Book by Jay L. Shein, Q 14:16, What is a Total Return Annuity Trust (TRA)?

Click to open document in a browser

A TRA provides a more predictable payment stream than a Total Return UniTrust. The Total Return Annuity Trust provides a specific dollar amount that remains constant regardless of the fluctuation in trust value. For example, the distribution may be set as $100,000 on an initial trust value of $2,000,000. Regardless of how much the trust value fluctuates over time, the trust will pay out $100,000.

Investment Planning Answer Book by Jay L. Shein, Q 14:17, How does a Total Return Annuity Trust compare to a Total Return UniTrust?

Click to open document in a browser

An advantage of the UniTrust over the TRA is that the UniTrust would not run out of funds where the annuity trust has the potential to do so. The UniTrust will have something left over for the remainder beneficiary whereas the annuity trust may or may not. Whether to use a TRA or a UniTrust depends on the particular circumstances involved. For a surviving spouse in a long-term marriage situation, the annuity trust can provide a more predictable income stream for the surviving spouse. However, a disadvantage of the TRA is that it can erode the corpus and the remainder beneficiary will suffer. When there is little concern for the remainder beneficiary, a TRA may be more appropriate. Another approach could be to have two trusts, one being a UniTrust and the other being a TRA.

Investment Planning Answer Book by Jay L. Shein, Q 14:18, What is a Total Return Income Trust (TRIT)?

Click to open document in a browser

Because market values are unpredictable and uncontrollable, Total Return UniTrusts (TRU) have received some criticism. TRUs are like a bet on the future market values. Those that are proponents of TRUs are usually optimistic and assume a relatively stable rising security portfolio value to provide for the needs of the current and remainder beneficiaries. For instance, a TRU may provide just enough income for a surviving spouse to live comfortably. In a bear market, the income level may drop below the threshold required by the surviving spouse. In this case, the trustee is in the difficult position of having to tell the surviving spouse that due to the way the trust was drafted, the income has been reduced because the value of the portfolio is dropping significantly. Very large declines in the capital markets will not alleviate all the problems even with the smoothing strategies mentioned in this chapter. Three or five year smoothing rules will not reduce the negative effects of some of the past historical declines in the capital markets.

One way to approach this problem is using a Total Return Income Trust (TRIT). The trust document could spell out a planned income stream in current dollars. This income stream could then be increased by inflation or some stated amount at the time the trust is created or funded in the future. For example, the trust document could specify that the surviving spouse would receive $80,000 per year increased by inflation as measured by the Consumer Price Index (CPI). If the grantor of the trust were to pass away ten years after the creation of the trust document with an assumption of a 3 percent annual CPI, then at the time of the grantor's death, the surviving spouse would receive $107,513 per year. This was calculated as follows:

Future Value = Present Value × $(1 + \text{inflation rate})^n$

Where n = number of years

Future Value = $\$80,000 \times (1 + 0.03)^{10} = \$107,513$

This payout amount would then continue to be increased annually by an amount dictated by the CPI as seen in the following table.

$80,000 trust payout adjusted by CPI (assuming 3%)	*Payout*
Year 1	$ 80,000
Year 2	$ 82,400
Year 5	$ 92,742
Year 10	$107,513
Year 20	$144,488

Investment Planning Answer Book by Jay L. Shein, Q 14:19, Why is the Total Return Income Trust (TRIT) beneficial for the grantor and the beneficiaries?

Click to open document in a browser

The TRIT gives a more reliable income stream adjusted by inflation which provides a more stable payout in real dollars. Many grantors and beneficiaries prefer this concept. Another approach would be for the grantor to provide in the trust document an income stream in today's dollars and increase it by a percentage point such as 4 percent per year and state that if inflation is greater than 4 percent as recorded by an official data source such as a CPI, then the higher figure would be used. This would make the TRIT more flexible.

Investment Planning Answer Book by Jay L. Shein, Q 14:20, How can the Total Return UniTrust, Total Return Annuity Trust, and Total Return Income Trust be made more flexible?

Click to open document in a browser

Some grantors may want even more flexibility for the trustee and investment advisor than has been discussed in this chapter. The drafter of the trust can be creative such as giving a specific discretionary amount to distribute. For example, a trust funded with $2,000,000 could allow for discretion to distribute up to $100,000 or 5 percent of the trust value for health, education, maintenance, or support (HEMS). In addition to the amounts distributable by a Total Return UniTrust, Total Return Annuity Trust, and Total Return Income Trust, the trust document could additionally allow for a percentage of the return in any one year to be distributed. In other words, the distribution of a Total Return UniTrust could be 5 percent of the corpus or 60 percent of the total return of the portfolio.

Baskies and Samuels [Baskies, Jeffrey A., and Brian J. Samuels. "The Marital Unitrust: A New Planning Strategy for the Remarried Spouse." *Estate Planning*, Vol. 27, No. 10, Dec. 2000, 480-485] termed a Total Return Qualified Terminable Interest Property (QTIP) trust a Marital UniTrust (MUT). Similar to the Total Return UniTrust concept, the purpose of the MUT is to balance the needs of the surviving spouse with the interest of the remainder beneficiaries. The MUT may be useful for all QTIP type planning but is definitely an important situation in second or third marriage situations.

An example of how a MUT might be drafted is the MUT could state that all income or a percentage of the value of the trust such as 5 percent as valued annually could be paid out. By structuring it this way, some of the pressure can be reduced on the investment advisor and trustee by relieving the friction that is common between the needs and wants of the income beneficiaries versus the remainder beneficiaries. The MUT has the advantages and disadvantages of a Total Return UniTrust (TRU). The same strategies that are used with a Total Return UnitTrust can be used with a QTIP trust as long as the surviving spouse is entitled for all income for their life payable at least annually. Sometimes the trustee may not have to distribute income from the QTIP trust in order to retain its character as qualified terminal interest property. If the spouse can demand the distribution of all income but does not take it, the trust should still qualify. In Revenue Ruling 2000-2, [2000-3 IRB 305] the Internal Revenue Service held that the spouse must be given the right to compel the trustee to make distributions. There may be times when the QTIP trust may want to accumulate income. Accumulating this income would allow the investment advisor to the trust more flexibility in managing the portfolio. The undistributed income could then be added to the corpus.

Investment Planning Answer Book by Jay L. Shein, Q 14:21, What are some examples of Total Return Trust strategies?

Click to open document in a browser

EXAMPLE 14-1

Mr. X created a UniTrust which had a $2,000,000 value. The trust provided for a 5% payout rate which would be equal to $100,000. If the trust increased in value to $4,000,000, the payout would be $200,000. Because of the payout method, there is less of an opportunity for surviving children to criticize their trustee who may be a sibling. The trust could still have an invasion of principal provision, but it could be more restrictive than if the trust had been an income only trust. This allows for the portfolio to be managed using a total return approach to investing. While a charitable trust has restrictions on how small the percentage payout can be, there is no such restriction on a noncharitable UniTrust. The beneficiary can receive the greater of the trust income or the UniTrust amount. Additionally, the trust could provide for a floor on the UniTrust payout amount.

EXAMPLE 14-2

Mrs. Y is 69 years old and the beneficiary of a $2,000,000 UniTrust. The UniTrust pays out 6 percent per year as valued annually, but Mrs. Y can never receive less than $120,000 per year. The $120,000 minimum payout would be considered the floor of the UniTrust since Mrs. Y can never receive less than that amount. Remember that there can be an invasion of principal provision in addition to the UniTrust amount. This UniTrust could also allow for payments to be increased or decreased during the term subject to the provision of the document and the creativity of the drafter.

EXAMPLE 14-3

Little X-ey, who is 25 years old, is the beneficiary of a $2,000,000 UniTrust that has a 7 percent payout. The trust document states that Little X-ey is entitled to receive the greater of $140,000, the current UniTrust amount, or a dollar amount adjusted by the Consumer Price Index every years. The UniTrust amount does not have to be adjusted annually but can be adjusted periodically such as every three, five, or ten or more years. This strategy can also be applied to a QTIP trust. If this strategy is properly explained to a surviving spouse who is the beneficiary of a QTIP trust, it should not force the trustee to invest for the highest possible current income.

EXAMPLE 14-4

Mr. and Mrs. Z created a UniTrust with $2,000,000 that provides the surviving spouse with the greater of the trust's net income or a 4 percent UniTrust payment. Mr. Z passed away in a car accident the year after the trust was created. The trust is currently generating an income of 3 percent. The trust stated that Mrs. Z, the surviving spouse, would receive the greater of the net income or 4 percent of the trust value as valued annually. In this case, Mrs. Z would receive $80,000, which is 4 percent of the trust value, as opposed to $60,000, which is 3 percent of the income amount. The grantors of the trust should explain the advantages of this formula over time as it will usually produce a better overall result. A caveat to remember is that a UniTrust in a rising market can be beneficial to the current and remainder beneficiaries but some income issues may arise in a declining market.

EXAMPLE 14-5

A Qualified Terminal Interest Property (QTIP) trust can produce a dilemma. A QTIP trust provides a lifetime income to the surviving spouse and can have the power to invade principal during their lifetime which will qualify the trust for the marital deduction. The grantor's spouse can specify how the remaining assets are to be disposed of at the death of the donee's spouse. The value of the property at the death of the donee's spouse is includable in the gross estate of the surviving spouse. Many in our society are taught to live off of income. While portfolios should be invested for total return, there could be pressure applied to the trustee by the surviving spouse to increase the fixed income portion of the portfolio which would sacrifice the possibility of growing the principal. A UniTrust concept can overcome some of this dilemma.

EXAMPLE 14-6

A trust that provides a surviving spouse from a second marriage all income with the remainder to the children of a first marriage can create another conflict. This framework gives the potential for the spouse to focus only on current income. If the beneficiary and the trustee are the same person, the conflict between the current and remainder beneficiaries becomes more complicated. This conflict could be created in a second marriage where the income beneficiary and trustee of the QTIP trust is the surviving spouse or if the children of the first marriage are the remainder beneficiaries and trustees of the QTIP trust for the surviving second spouse. These conflicts can make it difficult for the trustee who is also a beneficiary to act fairly and without partiality.

Investment Planning Answer Book by Jay L. Shein, Q 14:22, Can using an independent trustee such as a bank trust department allow for fairness to both the income and remainder beneficiaries?

Click to open document in a browser

Even with an independent trustee which we assume has a duty to discharge their investment responsibilities to both the income and remainder beneficiaries, this is often not the case. Even if the beneficiaries are aware of the independent trustee's responsibilities, the income beneficiary may not like the remainder beneficiary and may want to change the trustee. Independent trustees are not entirely to blame. It is easy for the independent trustee to hide behind the terms of the trust. The trust administrator may not be sufficiently versed in proper portfolio management. Language in some trust documents that is intended to take care of this conflict is as follows: "The grantor intends that the needs of the wife's income be given paramount importance, and that the needs of the grantor's children as remainder beneficiaries be secondary." This type of language can actually cause problems rather than solve them. The trustee has a dilemma as to whether or not they should invest mostly in high yield fixed income securities to provide the surviving spouse with a generous income. While this may be good in the short term, it will not be so in a long period of time, especially if inflation has eroded the purchasing power of the income stream and there has not been any growth in the value of the trust corpus. This demonstrates the additional problems an independent trustee has without the benefit of some of the concepts available through Total Return UniTrust, Total Return Annuity Trust, Total Return Income Trust, or a Marital UniTrust.

Investment Planning Answer Book by Jay L. Shein, Q 14:23, What can be done with revocable and irrevocable trusts?

Click to open document in a browser

Revocable trusts can simply be amended to provide for the total return concepts described in this chapter.
For irrevocable trusts, the problem is more complex. To amend the trust, it would require judicial approved modification or possible decanting of the trusts in those states that allow for this. It is prudent to draft trusts from the beginning using some of the total return trusts concepts in order to allow for the benefits that have been described in this chapter.

Investment Planning Answer Book by Jay L. Shein, Q 14:24, What are some of the tax considerations for total return trusts?

Click to open document in a browser

Prior to the Internal Revenue proposed regulations under Section 643, only the fiduciary income generated by the trust that was distributed or distributable to the income beneficiary was taxed at the beneficiary's income tax rate. Income and capital gains that were retained in the trusts were taxed at the trusts' income tax rates. The capital gains were taxed to the remainder beneficiary as they would eventually receive the principal net of tax. With the advent of Section 643 proposed regulations, the trustee can distribute all income generated by the trust and can take principal to meet the required distribution amount. The principal amount would attract capital gains taxation to the income beneficiary. Under previous tax doctrine, it would be a tax free distribution for the income beneficiary, and the remainder beneficiary would be responsible for the capital gains taxes. While one might conclude that the previous method was advantageous to the income beneficiary or the remainder beneficiary, consider the basic concept of a total return trust. Total return trusts are managed with the objective of providing the best possible total return without being limited to simply generating income from the fixed income component to provide for the current beneficiaries needs. The needs can now be met from income or principal. The potential for the after tax return for the remainder beneficiary is greater, even though they may have received some taxed distributed capital gains. This is not a comprehensive discussion of all the tax ramifications for a total return trust. There are many positive tax implications for all parties involved for this type of structure. The grantor or trustee should seek competent legal and tax advice for a better understanding and discussion of the income tax ramifications for this type of trust.

Investment Planning Answer Book by Jay L. Shein, Q 14:25, What is the best investment strategy for a total return trust?

Click to open document in a browser

There is no one best investment strategy for a total return trust. The investment advisor has many options. Some investment vehicles that might be considered are individual securities, exchange traded funds, and alternative investments. Strategies that may be considered are strategic asset allocation, tactical asset allocation, or a macro approach. Since many trusts provide a cash flow on a regular basis to a beneficiary, a major risk that is not typically addressed adequately is timing risk. For trustees that are just accumulating wealth for the future and are making no distributions, the problem is not significant. However, most trusts are making distributions. An example of the risk of taking funds out of a portfolio can be clearly demonstrated with the following example.

EXAMPLE 14-7

The advisor can see how the ordering of returns in specific years can significantly affect the ending value of the portfolio in future years which would be for the benefit of the remainder beneficiaries. The table uses the returns of the S&P 500 to illustrate the effect of timing risk. Each of the three examples assumes the beginning value of the portfolio to be $2,000,000 with annual withdrawals of $160,000. The first example uses the returns of the S&P 500 from 1973 to 1982. The second example uses the same returns but in reverse order. The third example assumes a constant return that is equal to the compound return for the S&P 500 over the ten year period from 1973 to 1982.

	Example #1		***Example #2***		***Example #3***	
	Returns	***Value***	***Returns***	***Value***	***Returns***	***Value***
Year 1 - 1973	−14.7%	$1,546,000	21.4%	$2,268,000	6.7%	$1,974,000
Year 2 - 1974	−26.5%	$976,310	−4.9%	$1,996,868	6.7%	$1,946,258
Year 3 - 1975	37.2%	$1,179,498	32.4%	$2,483,854	6.7%	$1,916,658
Year 4 - 1976	23.8%	$1,300,218	18.4%	$2,780,882	6.7%	$1,885,074
Year 5 - 1977	−7.2%	$1,046,602	6.6%	$2,804,420	6.7%	$1,851,374
Year 6 - 1978	6.6%	$955,678	−7.2%	$2,442,502	6.7%	$1,815,416
Year 7 - 1979	18.4%	$971,522	23.8%	$2,863,818	6.7%	$1,777,048
Year 8 - 1980	32.4%	$1,126,296	37.2%	$3,769,158	6.7%	$1,736,110
Year 9 - 1981	−4.9%	$911,108	−26.5%	$2,610,332	6.7%	$1,692,430
Year 10 - 1982	21.4%	$946,084	−14.7%	$2,066,612	6.7%	$1,645,822
Compound Return		6.7%		6.7%		6.7%
Average Return		8.7%		8.7%		6.7%
Standard Deviation		21.3%		21.3%		0.0%

The above example illustrates the uncertainty in investing. Using probabilistic analysis such as Monte Carlo Simulation (MCS), the advisor can look at various effects of this timing risk over different time periods. Probabilistic forecasting, such as MCS, makes the undertaking unproblematic by explicitly dealing with the uncertainty in the future by showing the results in portfolio dollar values. Simulation methods should be considered when planning any trust distribution and especially in the case of a Total Return Trust. While these simulations can help understand a range of possibilities for a particular client they do not indicate what the future will actually be. The future may be very different than MCS suggests. MCS should not be used as an absolute result when looking forward into the future. MSC is just another tool to assist in planning.

Investment Planning Answer Book by Jay L. Shein, Q 14:26, What investment strategies should be considered for a Total Return Trust?

Click to open document in a browser

Total Return Trusts should consider a plethora of investment asset classes and strategies. Alternative investment strategies such as but not limited to hedge funds can be a valuable risk reducer in a Total Return Trust as they may have a low correlation to other asset classes in the trust portfolio with an objective to provide positive returns. Advisors should attempt to educate investors and trustees on the benefits of alternative investment strategies for the use in a Total Return Trust.

Many trustees and advisors do not consider all the strategies available because they do not understand them. Advisors should investigate available investments and recommend them in the appropriate circumstance. While all trustees and investors will not require, need, desire, or want alternative investment strategies, rewarding opportunities may be available for those who do understand them and realize their benefits.

Many other investment strategies, vehicles, and asset classes have been discussed in this publication. There is no perfect investment or investment vehicle. All investment strategies have caveats.

Investment Planning Answer Book by Jay L. Shein, Q 14:27, What is an investment vehicle that may be advantageous in a Total Return Trust?

Click to open document in a browser

Investment advisors may want to look at Exchange Traded Funds (ETFs) because of their tax-advantaged structure. Because the highest tax brackets and trusts are reached much earlier than an individual's tax bracket, ETFs tax-advantaged structure might be appropriate. Most but not all ETFs have little or no capital gains distributions. However, they do pay dividends based on the underlying securities which are subject to ordinary income taxes unless they are qualified dividends. The advisor should be cautious here and investigate totally the structure, holdings, and distribution methodology of each Exchange Traded Fund they are considering as some of them may not be tax efficient. Many leveraged ETFs can have large short-term capital gains or ordinary income distributions that could be subject to ordinary income tax.

Investment Planning Answer Book by Jay L. Shein, Q 14:28, Who should use a Total Return Trust?

Click to open document in a browser

Total Return Trusts may not be for every person or every situation. Each client and his or her personal situation can be different. Attorneys who draft trusts and investment advisors should be creative in providing adequate investment provisions and strategies for both current and remainder beneficiaries. In order to provide the appropriate trust design, it is important to understand the contemporary finance theory and the prudent investor rule and how they work in tandem with the Total Return Trust. Most investors will find that some version of a Total Return Trust can benefit all parties involved.