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THE TOTAL RETURN TRUST

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Overview: One of the hottest developments in the area of estate planning is the "Total Return Trust". The Trustee of a Total Return Trust invests to maximize the overall return of the trust. This is in sharp contrast with the requirements placed on the trustees of standard "income" trusts to invest so as to provide a reasonable return for the income beneficiaries. The Total Return Trust removes the inherent conflict between the income beneficiary, who wants the trustee to invest for income production, and the trust remaindermen, who want the trustee to invest for growth. The Total Return Trust permits the trustee to maximize the value of the trust in a way that benefits all of the trust beneficiaries.

I/R Codes: 4450.06, 8000.03

The Problem

Recent market forces have served to accentuate the inherent conflict between the income beneficiaries and the remaindermen of multiple generation trusts (including trusts that provide income to spouse, remainder to children). The income beneficiaries obviously want the trustee to maximize income; the remaindermen want the trustees to invest for growth. As of November 1999, 30- year Treasury notes were yielding 6.16%. Average dividend yields have been reduced to 1.34%. This low dividend rate is exacerbated by the fact that the current best performing sector of the market (internet and technology issues) generally pays no dividends at all.

Trustees have a fiduciary duty to treat all of the trust beneficiaries impartially. This includes the duty to act impartially between the income and remainder beneficiaries. General practice, however, is for the trustees to determine the income needs of income beneficiaries, and to invest so as to attain the requisite income levels. Where the income beneficiary is a surviving spouse, an orphaned minor or a disabled or incapacitated individual, the income needs of the beneficiary are often significant in relation to the trust principal available for investment.

The greater the income need of the current beneficiaries, the greater the portion of the trust that must be invested in income producing assets that can provide the desired return. This effectively reduces the portion of the trust principal available for growth investment. As a result, it becomes difficult, if not impossible, for the trustee to grow the trust principal in excess of the rate of inflation. In order to protect trust principal from the ravages of inflation, the trustee must divert more trust principal to growth investments, thereby diminishing the production of current income. In essence, the standard income trust imposes upon the trustee a fiduciary duty to disappoint equally.

The Solution

The solution to this inherent conflict is the Total Return Trust. ,The Total Return Trust provides that the "current beneficiaries" receive a percentage of the value of the overall trust property, rather than an interest in the accounting income of the trust (and perhaps the ability to receive trust principal distributions in the discretion of the trustee). For example, the typical Income Trust would provide for distributions of "net income to my spouse, payable at least quarterly, for the remainder of his life." The Total Return Trust would instead provide as follows:

> "The trustees shall distribute to my spouse each year an amount equal to (4%) of the fair market value of the trust as of the close of the last business day of the prior calendar year. Such annual distribution shall be made in four equal quarterly installments."

The conceptual model for the Total Return Trust is the Charitable Remainder Unitrust. Each year the named beneficiaries receive a fixed percentage of the trust principal valued as of a particular date (usually December 31 of the prior calendar year). As the value of the trust assets rise or fall, the annual distribution to the beneficiary will follow. The value of this arrangement is that the interest of the current beneficiary or beneficiaries and the remaindermen are completely in sync; they each desire the trustee to maximize the trust's overall investment return, without regard to the nature of that increase in value.

One potential drawback with the Total Return Trust is the possibility of wide swings in the amount of a beneficiary's annual distributions. This potential risk can be reduced in the drafting process by structuring the "Trust" distribution as a percentage of the average value of trust principal over a two, three or five year period, rather than based upon the prior year-end value. Of course, in a rising market, using average values will delay distribution increases.

Advantages of the Total Return Trust

1) The concept of a fixed annual percentage payout is easily understandable to the trust beneficiaries, both current and remaindermen. This is in contrast to the often complex and controversial issue of what is income for trust accounting purposes.

2) There is less likely to be dissension between the beneficiaries.

3) Since there is a harmony in interest of all trust beneficiaries, the trustee is able to invest for maximum total return consistent with the level of risk acceptable to the trustee and beneficiaries.

4) The trustee is given clear and easily carried out directions for making distributions to trust beneficiaries. Note that the trust can provide for supplemental distributions to meet certain contingencies (discussed below). This is in contrast to a purely discretionary trust which may substantially increase the burdens of trusteeship.

5) The Trust feature provides a self-adjustment mechanism during times of volatility (up or down). Note again by using a measurement value averaged over more than one year, the current beneficiary will be protected from short-term volatility. The trust could provide a mechanism that allows the trustee to alter a distribution rate that is no longer appropriate as a result of a prolonged or permanent economic or financial change.

6) Beneficiaries can plan and budget more effectively since distribution amounts for

the entire year are computed at the beginning of the year.

7) The Total Return Trust may provide favorable income tax benefits to the current beneficiary. In a standard "income" trust, the beneficiaries generally receive the trust's net ordinary income, while the trust itself is taxable on trust capital gains. Although there are no IRS Rulings on point, it is assumed that distributions from a Total Return Trust will be taxed on a tier system, similar to the taxation of distributions from a Charitable Remainder Trust. Distributions from a Charitable Remainder Trust carry out trust income in the following order: ordinary income first, then short-term capital gains, long-term capital gains, tax exempt income and finally, return of basis.

   Therefore, depending upon the asset mix of the trust's investments, it is possible that a portion of the current beneficiary's distribution will be characterized as a long-term capital gain distribution. This would effectively increase the net after-tax value of the beneficiary's distribution. (Note, however, that distributions from a CRT carry out both current and accumulated taxable income, whereas distributions from a Total Return Trust would only carry out current taxable income.)

8) Economic modeling has shown that the overall investment rate of return and available distributions through the use of a Total Return Trust will outperform that available from standard income trusts during varying historic periods of market conditions.[2]

9) Total return investing with a fixed percentage payout facilitates the efficient regular pruning of the trust's equity investments. With a portfolio of primarily stocks, the Total Return Trust will invariably end up liquidating a small amount of stocks each year to enable the trustees to make distributions to the current beneficiary. This gives the trustees an opportunity to adjust the trust's portfolio. For example, within the typical portfolio there will be some stocks that have grown significantly (so-called "high flyers") and other stocks that have not performed as well.

   Through stock pruning the trustees can sell off a portion of the high flyers to decrease their overall size relative to the entire portfolio and therefore decrease the overall risk of the portfolio. Alternatively, the trustees have the opportunity to sell off the stocks that have not performed as well in order to potentially increase the future growth of the trust. Selling off the poor performers will also have an advantageous income tax impact on the current beneficiary. Since the assets sold will have minimal built in gain, the character of the distribution to the current beneficiary

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[2] Attorney Robert B. Wolf, of Pittsburgh, PA, in conjunction with PNC Bank, N.A., has been one of, if not the leading architect of the Total Return Trust movement. Wolf, working together with PNC Bank, N.A., has done extensive economic analysis and modeling of investment performance from 1925 to the present to support their position that Total Return Trusts effectively increase overall trust investment performance while maximizing the benefits and satisfaction of all levels of trust beneficiaries during all types of market conditions. See Bibliography following article.

will be primarily nontaxable return of principal.

Comparison with a Purely Discretionary Trust

Wouldn't a purely discretionary trust provide the same ability to invest for total return? Yes, in theory. The trustee could invest for total return, maintaining the trust principal primarily in equities, and use its discretion to provide trust beneficiaries with a reasonable rate of return on trust assets. The problem, however, is that the trustee has no clear guidance here as to how their discretion should be exercised. Should the trustee's discretion be based strictly on the beneficiaries' needs, or should the trustee provide the beneficiary with a fair return on trust investments.

Without clear guidance the trustee's decisions are subject to criticism, animosity and litigation. In a truly acrimonious situation the threat of litigation may be used as a tool to loosen the trustee's purse strings. Such a result is not surprising considering that the beneficiaries do not have a means to measure the appropriateness or reasonableness of their expectations.

It is also likely that without clear direction in the trust document, the trustees would not be able to characterize any of the distributions to current beneficiaries as capital gain distributions.[3] Without such direction, if distributions exceed the trust's net ordinary income, the trust rather than the beneficiary would be responsible for paying any capital gains taxes. This would increase the trust's overall cost of making the distribution, and reduce the trust's growth potential.

Comparison with an Indexed Annuity Trust

Another variation of a trust intended to replace the standard income trust is an "Indexed Annuity Trust". The Indexed Annuity Trust provides the beneficiary with an annuity amount that increases each year based upon a standard index, such as the Consumer Price Index. Such indexing will help to ensure that the beneficiary is able to maintain his or her standard of living, without exposing the beneficiary to investment risk.

The problem with this idea, according to Robert B. Wolf, is that the indexing trigger (e.g., the inflation rate or Consumer Price Index) is independent of the trust's rate of return, and may even be inversely correlated to it. He gives an example of the two-year period from 1973-74 when inflation increased by a total of 21%, while the total return for large cap stocks was –41.13%. An increase in the trust's payout as a result of the inflation adjustment would have forced the trust to liquidate a greater portion of the trust's stocks at a time when values were low, whereas a payout based upon asset values would have reduced the depletion of capital and produced positive dollar averaging.[4]

[3] This is because in standard income trusts capital gains are retained as principal, and are taxed to the trust. Even when the trustee exercises discretion to distribute principal, that distribution is received by the beneficiary income tax free; it does not carry out taxable capital gain income to the recipient beneficiary.

[4] Defeating the Duty to Disappoint Equally - the Total Return Trust, by Robert B. Wolf, Esq., 23 ACTEC Notes 46, at page 56 (1997).

Qualifying the Total Return Trust for the Marital Deduction

In order for a trust to qualify as a QTIP (Qualified Terminable Interest Property) Trust under IRC Section 2056(b)(7)(B)(ii), a trust must provide that the beneficiary spouse is entitled "to all the trust income from the property, payable annually or at more frequent intervals." Since it is possible that the income earned under some economic conditions may be greater than the specified payout for the spouse under the Total Return Trust, additional special trust provisions must be added to ensure that the beneficiary spouse receives the Trust payout amount or the trust's actual net income, whichever is greater.

The use of a Total Return Trust is particularly appropriate in a second marriage situation when there might be animosity between the surviving spouse and the remaindermen, who are children of a prior marriage. The Total Return Trust will help to ensure that the surviving spouse receives sufficient distributions to meet her living requirements while easing the burden of administration on the trustee. Use of a Total Return Trust takes away the trustee's need to pry into the surviving spouse's personal life to determine her income needs. The trust also eases the trustee's duty of impartiality since both the spouse and the remaindermen are interested in maximizing the value of the trust.

Other Safeguards Are Available

As was briefly mentioned above under Advantages of the Total Return Trust the trustee can be given the ability to change the Trust distribution rate if as a result of permanent or prolonged economic upheaval, such rate is no longer appropriate. Such a power should only be included in a trust with an independent trustee since such a power would not qualify as an ascertainable standard.

There are certainly other safeguards that can be built into the trust without the effect of causing the trust to more closely resemble a discretionary trust than a total return trust. For example, the trust could permit the trustees to make additional distributions to meet specified financial hardships or medical emergencies. This should adequately meet the needs of a trust for the benefit of the grantor's spouse with remainder to children. If the trust is intended to continue into the next generation or longer, it would be appropriate to add language that would permit the trustee to provide for trust beneficiaries' educational expenses, to assist them in starting a business or career, or the purchase of a personal residence (or the trust could purchase the home).

Other options are also available. The grantor can, with or without the assistance of the beneficiaries, determine a realistic spending plan over the lifetime of each beneficiary who receive "current" distributions. The grantor will first have to determine whether his or her intention is to maintain or enhance the beneficiary's standard of living. The grantor should also identify the beneficiary's likely periods of critical cash need. The grantor should also determine whether the anticipated investment returns will support the ability of the trustee to meet these additional anticipated distributions without adversely impacting the viability of the trust for the period of time the grantor desires it to remain in existence.

When Would a Total Return Trust Not Be Advantageous?

There are a number of situations when you would not want to use a Total Return Trust.

1) When the trust will hold hard to value assets. Since trust values are the basis for determining the amount of distributions to trust beneficiaries, placing hard to value assets into a Total Return Trust would cause an unacceptable level of uncertainty and risk. In fact, this would exacerbate one of the primary reasons why Total Return Trusts are such a great idea, the reduction or elimination of potential conflict amongst the trust beneficiaries, and between the beneficiaries and the trustees.

2) When the current beneficiary has sufficient assets for personal support and the receipt of distributions from the trust will only serve to increase the beneficiary's already taxable estate. An example here would be a non-marital trust (no marital deduction claimed) for the benefit of the grantor's spouse for life, remainder to the grantor's children. Another example would be a generation skipping trust primarily for the benefit of the grantors' grandchildren, but where the grantors' children are eligible beneficiaries of the trust in the discretion of the trustee.

3) When the trust is for the benefit of a disabled beneficiary, where distributions from the trust could disqualify the beneficiary from the receipt of other support benefits.

Summary

Like a Charitable Remainder Trust, the Total Return Trust provides for a distribution to the current trust beneficiaries of a fixed percentage of the value of the trust's assets. As a result of this distribution structure, the Total Return Trust unites the interests of the current trust beneficiaries, the trust remaindermen and the trustees in their desire to maximize the overall value of the trust. This permits the trustee to invest without regard to the classification or character of the investment returns as income or principal. The greater the value of the trust, the greater the value of the current beneficiary's distributions.

Economic modeling has shown that the use of a Total Return Trust will permit the trust to provide a greater benefit to all of the trust beneficiaries over differing economic conditions when compared with a standard income trust. While some of these same benefits could be provided with a solely discretionary trust, the Total Return Trust feature substantially reduces the potential for conflict amongst the trustees and the beneficiaries regarding the level of distributions. Safety valves can be inserted into the trust to permit the trustee to supplement distributions to meet specified needs of the beneficiaries.

The developing popularity of the Total Return Trust is not just a passing fad, but a fundamental shift in the way trusts can (and perhaps should) be invested.

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