

## **HOW TO HAVE YOUR CAKE AND EAT IT TOO!**

### **THE TOTAL RETURN TRUST: A NEW WAY TO MAKE THE TRUST WORK FOR YOU AND THE KIDS**

by Charles L Stanley CFP® ChFC AIF® and Bradord N Dewan MBA, JD.

Most consumers trust the advice and implementation of their attorney when creating their Trusts as part of their estate plan. After all, the attorney is the professional, why should I as a consumer question what was done for me? Well, generally, you shouldn't have to. However, there can be a lot of inertia in the profession and "new" ways of doing things don't always catch on quickly and it could be costly to you, the consumer.

Typically, after the first spouse dies, a revocable trust will break up into two or three subtrusts or "buckets" to hold the decedent's assets and the surviving spouse's assets in a way that will take advantage of the tax law. The first of these buckets is the credit shelter (or "bypass") trust, often referred to as the "B" Trust. This trust will be funded with the deceased spouse's assets in order to use the deceased spouse's applicable exclusion amount (\$2,000,000 under current law in 2007) to reduce federal estate taxes (a good thing). The second bucket may hold the rest of the deceased spouse's half of the community property, and any separately owned property; it is commonly referred to as the "QTIP" trust. Because the primary beneficiary of the QTIP trust is the surviving spouse, the transfer of assets into the trust will qualify for the marital deduction.

The credit shelter bucket, or "B" Trust, is usually structured to require the payment of "income" to the surviving spouse. In addition, the trustee may be given the power to distribute some of the principal of the trust but only for limited purposes such as health, welfare and support. The objectives are to provide the surviving spouse with sufficient income to maintain the lifestyle they are used to and also to have assets available to distribute to the children upon the death of the surviving spouse. This distribution to the children will be from the remaining principal of the trust.

The terms of the QTIP bucket must require the distribution of the "income" to the surviving spouse. But there is no requirement that any principal be distributed. Often the distribution rules for the principal are limited. The intention is to have a significant amount of assets left for the remainder beneficiaries who typically are the children of both spouses or, if there was a prior marriage, the deceased spouse.

But here is the dilemma. The "income beneficiary" (the surviving spouse) wants the trustee to invest the funds of the trust in order to realize the greatest amount of income which will then be distributed to him or her. The "remainder beneficiaries," (the kids and grandkids) 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 so they will have a larger inheritance.

Now, the Trustee has a problem. First, interest rates on bonds have always been much lower than the long term rates of growth realized by stocks. 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. It is interesting to note that between 1870 and 1925, the consumer price inflation averaged on 6/10th of 1 %. Today, we feel fortunate if the inflation rate stays at 3% or below. As a result of this increased inflation rate, the dollars received when a bond is repaid has significantly less purchasing power than the original dollars used to purchase the bond.

Dividends on stocks have also greatly declined over the last fifty plus years. Thus, trying to satisfy the income beneficiary only with the dividends received on a 100% equity portfolio is not likely to succeed. And this level of income may well be much less than what the decedent wanted for the surviving spouse.

Trustees are required to fulfill their responsibilities under the California Uniform Principal and Income Act and the Uniform Prudent Investor Act, which can make their job difficult. For example, if a trust has two or more beneficiaries (one who is entitled currently to the income and one who receives the principal only upon the death of the first beneficiary), 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. Traditionally, Trustees favored the income beneficiary to the potential detriment of the remainder beneficiary (Mom gets lots of income and too bad for the kids later). 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 (Mom) and the remainder beneficiary (the kids).

On top of that, the trustee has a duty to manage the assets as a prudent investor would and to diversify the investments of the trust. So, even if the trustee thought that a 100% bond portfolio was appropriate in order to generate the most income for the current beneficiary, this single asset class portfolio would most likely be a breach of the duty to diversify and the duty to be impartial.

Picture a teeter-totter, one end is "income" the other end is "growth of capital". When one end is up the other is down. In other words, if a Trustee invests for income, they will get little if any capital growth and vice-versa, if they invest for capital growth they will get little income.

But fortunately for the trustee, the law is catching up with modern investment reality. Indeed, provisions allowing for this solution were only

added to the California Probate Code in 2005. The answer is a "total return trust" or sometimes referred to as a "unitrust."

Under a "total return trust," Mom and Dad direct 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 chosen percentage of the value of the trust assets, say, 4%. The funds distributed will probably be made up of income as well as principal. Thus the trustee, in order to make the distribution, now has the ability to sell some portion of the assets which hopefully will 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, so Mom will get a raise each year that the value of the Trust goes up. The kids see the principal growing and will also be happy campers.

This "modern" trust design responds to several important goals in determining how Mom and Dad 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 be in the best interest of 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 income beneficiary should be as smooth as practicable while maintaining the opportunity for capital growth for the kids.
- The distribution rule should be simple and easily understood.

The "total return trust" (with a three year averaging rule as provided for in California law) addresses all of the foregoing criteria. Very importantly, the greatest strength of this type of trust is the fact that it treats both the income beneficiary and the remainder beneficiary impartially.

California law now allows you to convert your current "income" trust to a "unitrust." Should you? That is a good discussion for you to have with your Investment Advisor and your attorney. Not everyone will want this kind of distribution pattern, but our experience has shown that most income

beneficiaries want all the income they can get from the Trust and yet the Trustee is required to treat the income beneficiary and the remainder beneficiaries impartially (they can't favor one over the other). Modern investment theory has resolved the problem from the investment perspective but Trust language has to also be "modern". If you aren't sure, give us a call and let's discuss your situation.

*Co-authored by Charles L. Stanley CFP<sup>®</sup>, ChFC and Bradford N. Dewan, MBA, JD.*

*Charles L. Stanley CFP<sup>®</sup> ChFC AIF<sup>®</sup> In addition to many published articles and quotes in the financial press, Mr. Stanley regularly conducts continuing education classes for Attorneys and CPAs and is available for public speaking, seminars and private consultations. He is also a wealth manager with Capital Financial Advisors, LLC, a fee-only Wealth Management Firm in La Jolla, CA whose mission it is to provide Wealth Management to Successful Business Owners. Mr. Stanley can be reached at 858-395-8694 or [cls@charlesstanley.cc](mailto:cls@charlesstanley.cc) or [www.charlesstanley.cc](http://www.charlesstanley.cc)*

*Bradford N. Dewan is an attorney with Miller, Monson, Peshel, Polacek & Hoshaw in San Diego, California where he provides sophisticated estate and tax expertise for families and business owners with significant net worth seeking tax efficient methods for transferring wealth. He can be reached at 619-239-7777 or [bndewan@mmpph.com](mailto:bndewan@mmpph.com).*