Getting More Out of Trusts: The Total Return Unitrust

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Trusts have become a basic tool in estate planning. Virtually every trust provides for the distribution of income to the current beneficiary, either mandatory or in the trustee's discretion. The reasons for this vary. In a trust for a surviving spouse (marital trust), distribution of income is required to qualify for the marital deduction, and distributions generally carry out trust income to the beneficiary, thus are subject to less punitive income tax rates. But for most clients, income is intended to provide a source of regular funds to the beneficiary, particularly where the beneficiary is the surviving spouse. For many clients, however, the significant decline in interest rates and the limited returns generated by fixed income investments generally, the last 15 years has made the benefit for many trusts modest at best.

A simple example illustrates the shift. Assume a marital trust under a will with $1 million conservatively invested in 10 year treasury notes:

- In January 1990, the rate for these notes was 8.21 percent, generating annual pre-tax income of roughly $82,000 for the surviving spouse.
- In January 2014, the rate for these notes was 2.85 percent, generating annual pre-tax income of roughly $28,000 for the surviving spouse.

This reduction is obviously dramatic and highlights a basic challenge for trustees - how to invest in a way to provide income for the current beneficiary and not abandon some appreciation for the residual beneficiaries in light of their fiduciary obligations to each. Traditionally, trustees have responded by taking a conservative approach when investing trust assets, driven by concerns that more aggressive investments to generate higher returns pose greater risks and exposure to fiduciary claims by current and/or residual beneficiaries.

The evolution in total return and modern portfolio theory has led to a new approach to accommodate competing responsibilities of trustees and grantors of trusts, giving them the ability to reclassify income and principal to adjust payments to the current income beneficiary.

Under Virginia's version of the concept, the trustees of a trust (generally those who are not "interested trustees," but in certain cases, interested trustees can elect to convert) have the ability to convert a trust which provides for payment of income to a beneficiary to a total return unitrust. In a total return unitrust, the amount payable to the beneficiary is based on a percentage of the fair market value of the trust at the time, rather than the income that those assets generate. Moreover, clients creating trusts have the ability to either establish or authorize use of total return unitrusts at the time of creation (or amendment) of their trusts.

The permissible range for the unitrust amount in Virginia is 3 percent to 5 percent of the fair market value of the trust assets. This range dovetails with certain IRS rules for how income can be defined for federal income tax purposes

The ability to either convert a trust to a total return unitrust or build it into new or existing trusts can be a useful tool that many clients will find appealing if they – as grantor or trustees – want to offer a more meaningful current benefit to income beneficiaries under their trusts.