The considerations when structuring an estate plan are so numerous that it is difficult for an advisor to narrow a client’s focus to the truly important issues. Every issue can be addressed with enough creativity to paralyze the process. Creativity, especially in regard to distribution provisions, creates risks that a trust or estate will be subject to incompetent or ineffective administration because a fiduciary must interpret the intent of the grantor or decedent. A total return unitrust may be the perfect option for minimizing these risks. A total return unitrust is a trust that requires distributions to be made each year (or other period) of a particular percentage of trust assets. By limiting trustee discretion, the total return unitrust reduces the likelihood of incompetent or ineffective administration.

The Chicken or the Egg: Trustees and Distributions

Two of the most important issues addressed in estate planning are: 1) who will be responsible for managing and distributing assets; and 2) how those assets will be distributed. While answers to those questions are independent considerations, they are undeniably linked. For instance, a decision as to how to distribute assets may directly impact the client’s decision about who will distribute the assets. Alternatively, the client’s options for who will distribute the assets (i.e., trustee) may impact the client’s decision about how to distribute the assets. A total return unitrust, while traditionally viewed as a trust investment strategy, may dictate the selection of a trustee. On the other hand, a client’s list of quality candidates (or lack thereof) to serve as trustee may dictate the use of a total return unitrust.

Selecting the Trustee: A Long-Term Proposition

Trustee selection has always been a crucial aspect of any estate plan. After all, the trustee will oversee the management and distribution of assets for spouses, children, grandchildren, and charity. For the client with an “I Love You” will (a simple will in which each spouse leaves assets to the other spouse outright and free of trust) and trust for children under age 21, the impact of the trustee decision is greatly reduced by the fact that the trustee may never be called upon to serve, and even if the trustee does serve, the assignment will be short-lived.

Estate planning has changed over the years and views of trust purposes have changed as well. The purpose of a trust used to be to protect a beneficiary from himself or herself; protecting the beneficiary from the beneficiary’s whims was a primary goal. If a trust lasted until age 21, 25, or 30, the beneficiary would be past the age of concern. Today, most advisors view trusts as protection from the outside world—creditors, spouses, estate taxes, etc.—that may never go away. This results in more trusts that last for the lifetimes of children, grandchildren, and more remote descendants. The short-term trust that terminates when a child turns 21, 25, or 30 is becoming a thing of the past because once that trust terminates the assets are exposed.

As long-term trusts have become more common in estate planning, trustee selection has become more important. But the trustee selection process is not necessarily getting proper consideration.
beneficiaries. With regard to trust assets, trustees must put the interests of the beneficiaries above their own interests.

2. The duty of impartiality includes balancing the interests of life beneficiaries and remaindermen, showing impartiality to all beneficiaries. This does not necessarily mean treating all beneficiaries equally, because a trustee must adhere to the trust provisions. For example, if the trust provisions instruct a trustee to favor one beneficiary over another, the trustee would not violate the duty of impartiality in doing so.

3. The duty to keep records of actions taken with regard to trust administration and, generally, to make those records available to beneficiaries. The trustee must keep documentation of distributions, assets, and liabilities. The trustee generally is required to send annual accounts to distributees and must furnish records to beneficiaries upon request. Trust provisions may modify these duties and a trustee should always look to the trust provisions for guidance.

The Winner Is …

The most common person selected as trustee is “Uncle Joe.” Uncle Joe probably has an advanced degree and/or is in business for himself or is established with a larger company; he is viewed in the family as responsible and is generally respected; he (outwardly) is “good with money.”

Uncle Joe falls short, however, in his knowledge of modern portfolio theory, the twin UPIAs (Uniform Principal and Income Act and the Uniform Prudent Investor Act), trust accounting, and income tax planning. Nor does Uncle Joe know the difference between a discretionary distribution standard and a HEMS (health, education, maintenance, and support) standard; or whether other resources may be taken into account when making distributions to a beneficiary or if other resources shall be taken into account. Uncle Joe may be intelligent, organized, respected, and “good with money,” but he may not be qualified to serve as trustee. In fact, the challenge in trustee selection is that most people are not qualified to serve as trustee. Furthermore, even if Uncle Joe is qualified, are Uncle Joe’s successors qualified?

The obvious responsibilities of a trustee are fairly straightforward: Invest the trust assets, distribute the assets to beneficiaries, and make sure a tax return is prepared and filed. The not so obvious responsibilities are: Investing for tax efficiency, obtaining knowledge of a beneficiary’s current standard of living, being impartial to current and remainder beneficiaries (unless partiality is allowed), preparing trust accounting (not just accounting for a trust), handling conflicts with beneficiaries, voting stock of closely held companies, preparing withdrawal notices, and on and on. Most people named as trustees do not handle such responsibilities for themselves very well, let alone for someone else’s assets. I ask my clients the following questions when discussing trustees:

Does Uncle Joe have a CPA? Does Uncle Joe use a financial advisor? Has Uncle Joe completed his estate planning? These questions force clients to evaluate Uncle Joe, not in the light of a family member, but as a trustee. If Uncle Joe does not do these things for himself, why would the client expect him to do these things for the client’s children?

Clients with few trustee options or who want professional trust administration often will opt for a corporate trustee. Corporate trustees come in many shapes and sizes, from the very large (e.g., Northern Trust, US Trust) to the smaller and more local (e.g., “State Bank and Trust”). Some manage trust assets as part of their services; others provide only administration services and delegate the asset management. A corporate trustee’s job is to be a trustee, unlike Uncle Joe, who likely is managing the assets out of responsibility or interest. Corporate trustees often are viewed by clients in a negative light; however, many opinions are based on third-hand experiences or the rumor mill. Corporate trustees generally are viewed as too expensive, too conservative, and too out-of-touch with beneficiaries. However, corporate trustees’ fees generally are comparable to investment advisor fees, with possibly a few extra basis points for the additional administration and liability assumed. The Uniform Prudent Investor Act mandates that a trustee has a duty to diversify investments, so trustees cannot invest assets as conservatively as they once did. Corporate trustees usually aren’t able to have the same relationship with beneficiaries as Uncle Joe, but some clients see this as a positive because it eliminates personal judgments.

Regardless of the trustee (and successors) selected, the trustee will be charged with carrying out the various responsibilities of trust administration. The one responsibility that will have the most impact on beneficiaries and their relationship with the trustee is the responsibility of making distributions. The longer the term of the trust, the more scrutiny to which the trustee will be subject from current and remainder beneficiaries.

Traditional and Current Uses of Total Return Unitrusts

One form of trust that alleviates concern about discretionary distributions is the “all-income” trust. But just as short-term trusts are becoming a thing of the past, so are all-income trusts. All-income trusts generally involve distribution of all income to a beneficiary for life, with the remainder passing to other beneficiaries (usually income beneficiary’s children) upon the beneficiary’s death. The trustee has no discretion and essentially is relieved of that responsibility. Investment responsibility, though, becomes much more important. With smaller dividends and lower interest rates, it’s become more difficult for a trustee to make an income beneficiary happy (through larger income distributions) and remainder beneficiaries happy, too (through growth of principal). Indeed, the trustee is
in the unenviable position of implementing a portfolio strategy that will make everyone happy (or, actually, no one happy). The result is an investment mix that generates neither sufficient income nor sufficient growth. Thus a trustee with the best intentions ends up in the hot seat with all beneficiaries.

As of September 2009, 27 states had enacted legislation that allows an all-income trust to be converted to a total return unitrust. A total return unitrust directs the trustee, instead of paying all income to a beneficiary, to pay a stated percentage of the assets to the beneficiary (based upon initial or periodic asset value). The percentage is generally 3–5 percent and is established by the trustee based on the circumstances of the particular trust assets, terms of the trust, and the beneficiaries. The trustee then may invest the trust assets for overall total return, rather than focusing on generating sufficient income for the income beneficiary. Like the all-income trust, the distribution discretion is removed, but the trustee also has been relieved of the delicate process of investing for income and growth.

Most discussions or articles addressing total return unitrusts involve the conversion of all-income trusts to unitrusts; however, a total return unitrust can be implemented from the outset in a client’s estate plan. Unitrust provisions can be drafted into wills and trusts and can be administered for multiple generations. In fact, a unitrust percentage of 3–4 percent will result in trust assets being available to beneficiaries for several decades. This may be important to a client, depending upon the client’s view of money and its effect on family members.

Client Philosophy of Distributions
All estate planners should ask clients what they want their families to do with the assets they receive. Answers from my clients are broad, including medical needs, charity, emergencies, an easier life, starting a new business, “who cares—I’ll be dead;” buying a home, education, etc. Specific answers vary, but for most clients the philosophy behind the answers is similar and can be narrowed down to a common theme: The money should complement a lifestyle, not establish a lifestyle. The philosophy is easy to summarize, but how can a document possibly reflect that philosophy? We always include language of a client’s general intent for the trustee such as the following:

... the trustee shall not allow a beneficiary who reasonably should be expected to assist in securing his or her own economic support to become so financially dependent upon distributions from any trust that he or she loses an incentive to become productive ...

This language provides fairly generic direction of the client’s intent, which we often modify for a client’s specific intent. Whether generic direction, more specific direction, or no direction is included in a will or trust agreement, it is nearly impossible for the trustee to truly know the client’s intent. Furthermore, even if the trustee does know the client’s intent, that intent can be ignored and replaced with the trustee’s judgment. Other considerations for distributions, such as “the beneficiaries’ accustomed standard of living“ or “other income and resources reasonably available to the beneficiaries” may be beyond a trustee’s knowledge due to geography (across country from beneficiary), resources (no method to determine beneficiary’s accustomed standard of living), or the fact that the trustee does not want to put forth the effort to investigate. Again, distribution decisions still come down to trustee selection.

Can the Trustee Implement Client Philosophy?
If a client has the “perfect” trustee—i.e., one who understands and can competently exercise the responsibilities of trustee—the client may not have to worry about trustee discretion. The client can rely on a HEMS standard and know trust assets will be invested properly and distributions will be made in a responsible fashion. Everything will be fine; the beneficiary will never question the trustee’s judgment and will respect the trustee’s duties as carrying out the intent of the beneficiary’s parent or grandparent. Advisors who regularly work with trustees and/or beneficiaries know this situation almost never exists. Trustees are either too lax or too tight with the money and the beneficiary (whether the trustee is too lax or too tight with the money) always wants more. Additionally, beneficiaries often feel they are being kept “in the dark” regarding trust assets and generally feel that the trustee is either corrupt, dismissive, disinterested, or all of the above.

For many clients who have the “perfect” trustee and those who do not, it is appealing to reduce the discretion, decision-making, and potential conflict involved with decades of trust administration. Additionally, clients may want to limit trust distributions, which may reduce the impact of selecting the “wrong” trustee, an unfamiliar corporate trustee, or simply someone with whom the client does not have a close relationship. The total return unitrust alleviates concerns a client may have in selecting a trustee:

Investing trust assets. The trustee can hire an investment advisor, wealth manager, etc., who is familiar with investing for total return and providing appropriate investment management for making regular distributions.

Distributions. The discretion to make distributions has been removed from the trustee’s plate.

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Information disclosure. If the trustee has limited distribution discretion, and therefore will not be exposed to a beneficiary asking for more money, the trustee will more openly disclose trust information to the beneficiary.

Conflict with the beneficiaries. The inherent conflict between the trustee and beneficiaries will be reduced because of the eliminated discretion.

Income tax returns. The trustee will hire a CPA to prepare any necessary federal and state income tax returns regardless of trust structure.

Trust accounting. This must be performed (although rarely is) for all trusts. However, if the investment advisor is a trust company, the trustee may negotiate trust accounting as part of the investment advisory fee.

Conclusion

A total return unitrust can reduce the impact that an unqualified trustee can have on a trust. The client can reduce the impact even more by dictating the use of professional money management for trust assets. A total return unitrust will significantly affect distributions. But for the client who also wants to limit the effect distributions will have on family members, the total return unitrust may be the perfect solution.

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