

TRUSTS & ESTATES



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Unitrusts To the Rescue

Can they help reconcile your clients' competing financial goals?

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Sometimes, it can be incredibly useful to have another arrow in your planning quiver. Consider the following:

- A trust is set up to provide for your client's surviving spouse, her third husband. On his death, whatever assets remain in the trust pass to your client's children from her first marriage. There's a tension between your client's surviving husband who wants as much cash flow as possible, and the children who are razor focused on getting as much appreciation in the trust assets as possible, to maximize their inheritance. How can a trustee satisfy everyone (or perhaps equally and reasonably dissatisfy everyone)?
- Your client's ne'er-do-well son has never kept a job. She wants to leave him a trust but needs to make sure the trust will last for his lifetime which could be another 40+ years. How can the trustee distribute funds to him so that the well won't run dry? Is there an approach you can mandate so that her son can't unduly badger the trustee into giving more and thereby undermining his future financial security?

For both of these and other circumstances, a financial concept known as a unitrust might offer a practical solution to reconcile seemingly difficult competing financial goals.

Two Types of Beneficiaries

To understand the planning concept it is helpful to differentiate two types of beneficiaries:

- A current beneficiary (formerly known as "income beneficiary" because he historically was paid income).
- A remainder beneficiary who receives the trust assets after the current beneficiary's interest ends.

Example: A bypass trust is set up for your client's spouse. She receives income for life. On her death, the assets pass to your client's children as the remainder beneficiaries.

Total Return Investing

Historically, many investors invested for income and yield when they needed current cash flow. But that approach was shown to be quite deficient, increasing risk and not providing an adequate inflation hedge. Financial plans now tend to focus on investing for total return. That's the sum of current earnings, like interest and dividends, and capital gains (unrealized appreciation). This provides great flexibility to minimize risk, hedge against inflation and still generate cash flow. Such change in investment approach had a significant impact on investing trust assets and making distributions to trust beneficiaries. In the past, it was common to name an income beneficiary and a remainder beneficiary. Many old trusts were drafted exactly that way, as illustrated in the example above. If the investments for such a trust were changed from income to total return, what would the spouse in the above example get as a distribution? Investing for total return means greater reliance on equities than income oriented assets. The answer to this dilemma, which affects many existing trusts, is to make a unitrust election if permitted under the trust agreement or state law. In some instances, drafting a new trust incorporating this approach may be useful to achieve certain planning goals.

What is a Unitrust?

With a unitrust approach the trust distributes a fixed percentage, say 4 percent, of the fair value of the principal of the trust, to the current beneficiary. This permits the trust assets to be invested by using total return investment concepts because there's no requirement to generate income per se. The trustee can liquidate capital assets as needed to supplement actual income earned from dividend and interest to fund the unitrust payments. The goal of this approach is that the trust's remaining assets should then grow at a reasonable value for the remainder beneficiary. Great stuff in the right circumstances, but a unitrust distribution method isn't a panacea for all trusts. The reality is far more complicated.

Issues with Unitrusts

There are many issues that must be considered before opting for a unitrust approach:

- Family dynamics are critical to the impact of trusts. But family circumstances often change. For example, if a husband sets up an inter-vivos (living) qualified terminable interest property QTIP (marital) trust for his wife, and names his sister as trustee, the mandatory income payout may be fine to meet the marital deduction requirements. However if the marriage later ends in divorce, the now ex-wife will have to extract income payments from her antagonistic ex-sister-in-law. Converting the trust to a unitrust payout under state law, perhaps mandated as part of the divorce proceeding, could solve the problem. To protect and benefit children of different marriages, a unitrust payment may be an ideal way to eliminate much of the discretion and protect all interests.
- Asset protection from malpractice claims, lawsuits and other risks is a critical goal of almost every individual, especially professionals, business owners and the wealthy. The mandatory unitrust payout is potentially problematic if your client has asset protection concerns. Mandating a fixed payout creates a certain cash stream that a creditor could attach. It's preferable to have a discretionary trust, for which the trustee could determine the details of a distribution. A discretionary trust eliminates fixed distributions to the beneficiary in favor of discretionary distributions, which are more difficult for a claimant to attack.
- Fiduciaries can face a daunting task, even with the apparently simple and logical sounding discussion above. If a trust owns non-marketable assets, such as real estate, how can this be valued? Even many investment partnership interests are difficult to value. Applying the Principal and Income Act requires that these assets be fairly valued every year to determine a payout. Certain mechanisms might be provided in the trust to avoid complexity (for example, simplifying assumptions); undue cost (for example, value every other year) and adversity concerning the valuation process (for example, independent appraisal firm). This makes the use of the unitrust approach potentially costly and complex if the trust owns non-marketable assets.
- If your client decides that the right approach is to make an election under state law for a unitrust payment or an adjustment to principal or income, depending on your state law, should you have every beneficiary sign off? Even if the state law doesn't require this and provides a level of protection, would your client be comfortable making such a unilateral decision without the approval of the beneficiaries? If your client decides not to have them approve it, do you give them notice of the rationale behind your decision, or is it better to remain silent to avoid giving them ammunition to create a challenge?

Refining the Unitrust Approach

When structuring a unitrust payout, it can be further refined from the basic unitrust approach illustrated above. Significant swings in investment performance can create unreasonable payments to a current beneficiary versus a remainder beneficiary, or vice versa. Will significant changes over periods of time in the inflation or deflation rate have an adverse impact that needs to be counteracted? One approach to have a unitrust payment address these risks is to create “floors” and “caps” on the amounts to be paid to either the current or remainder beneficiary. Some advisors advocate incorporating inflation adjustments into the amount to be paid to the current beneficiary. When this is done, the calculations and definitions become complex. How does one define “inflation”? Which index should be used? What happens if that index is no longer published 20 years from now?

Reality Check

Many modern trusts include a spouse and beneficiaries (and even other additional individuals named as beneficiaries currently, some of whom perhaps will become remainder beneficiaries as well). When a modern trust drafting approach is used for the bypass trust in the above example, the surviving spouse and descendants may all be current beneficiaries of the bypass trust. The trust agreement may provide that your client’s spouse should be considered the primary beneficiary. But by including all descendants as current beneficiaries better asset protection will be achieved for your client’s spouse; the opportunity to shift trust income to the lowest tax bracket beneficiary will be created, which could provide annual income tax savings, and if your client’s spouse doesn’t need the distributions, making them to other family members may reduce her estate. On your client’s death, the trust may break up into separate trusts for each of your client’s children. This modern approach to planning provides far more flexibility but may affect the appropriateness or utility of adding the unitrust concept discussed above.

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