

Designing a trust for your family

Often, one of the objectives of a trust-based financial plan is to separate the benefits of property ownership into current and future portions. In a marital deduction trust, to take a routine example, a surviving spouse must have the right to all the trust income, paid at least annually, and in the future, after that spouse's death, the remainder beneficiaries (typically, the children or grandchildren) will receive what is left in the trust.

Measuring "income"

But that phrase "all the trust income" can be a source of surprising contention. Traditionally, trust income consists of dividends and interest. Capital gains and losses affect the amount of principal and, therefore, accrue to the beneficiaries. So, should the trustee invest for maximum growth, for maximum income or for some of each? When stock prices are shooting up, and dividends are not keeping pace (as happened in the

1990s), finding the right balance may be tricky. If you add to the mix the relatively low interest that we've experienced over the last few years, it becomes even harder to wring an income consistent with beneficiary expectations out of a portfolio.

In recent years new trust forms have emerged that try to reduce the potential for conflict between income and remainder beneficiaries over a trust's investment policy. Called a total return trust or a private unitrust, this approach calls for paying the income beneficiary a fixed percentage of the trust's value, determined annually. If stock prices move higher, the income beneficiary shares in that good fortune.

This approach frees the trustee to invest trust assets for total return, a direction that trustees have been encouraged to take by changes around the country in state laws governing fiduciary investing. IRS regulations recognize this approach as well.

What does a trust beneficiary receive?

Trust approach	Definition of income
Traditional trust	Interest and dividends
Total return trust	Fixed percentage of assets, determined annually
Indexed payout trust	Fixed dollar amount, adjusted for inflation each year
No-drop unitrust	Fixed percentage of trust assets, with a floor to protect income beneficiaries
Capped unitrust	Fixed percentage of trust assets, with a ceiling to protect remainder beneficiaries
Fully discretionary trust	Trustee decides annually what is best for beneficiaries, taking into account their circumstances and financial market conditions

The question of flexibility

There isn't as much flexibility in setting the payout rate for a total return trust as one might surmise. Set the rate too low, and the income beneficiary won't have enough to live on. Set it too high, and there is a real risk that the trust will be depleted, leaving nothing for the remaindermen. That's why some planners are uncomfortable with the inflexibility of the total return format. Volatile financial markets can have unwanted effects on fixed formulas. For that reason several alternative approaches also have been developed for balancing the needs and meeting the expectations of beneficiaries from multiple generations. The table below briefly summarizes some of the many strategies that have emerged to balance the interests of current and future beneficiaries. We would be glad to discuss your options for designing a family trust. Please contact us at any time.

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