When a Unitrust Makes Sense

When advising LNW clients on trust strategies, a key issue we discuss at length is distributions: How much should the trust pay out, to whom and when? Especially for people and families with significant multigenerational wealth, a trust structure known as a "unitrust" may be able to resolve a variety of issues.

A unitrust can be especially advantageous if the people and organizations you want the trust to support have different and potentially conflicting needs: say a spouse, children/grandchildren/stepchildren, other relatives or a favorite nonprofit.

Below, I delve into the world of unitrusts to show how a unitrust works, the major advantages and also the pitfalls. Each family situation is unique, so this is intended as general information to give you an idea of what is possible.

What is a unitrust? Unitrusts get their name from the fact that they distribute a fixed "unitary" percentage of their net asset value annually to the "primary beneficiaries" (the PBs), which are the first in line to receive trust distributions. Distributions are made for a set number of years – either the PBs' lifetime or a fixed period of time.

The operative word here is fixed. If LNW is the trustee, we would not have discretion to make additional distributions. At the end of the period specified, the trust assets would go to the "remainder beneficiaries" (the RBs) who can be anyone the grantor chooses: other family members, friends, a nonprofit, etc.

For Example: Ryan has appreciated stock worth $5 million he transfers to an irrevocable unitrust, naming his wife Miranda (second marriage) as the PB to receive 4% of the trust's net assets annually for the rest of her life. After Miranda passes, whatever is in the trust (including any appreciation) goes to the children and grandchildren from Ryan's first marriage (the RBs).

Taxes: Ryan can choose to make this a "grantor" trust. During his lifetime, he would then pay any taxes the trust owes, thereby allowing the assets to grow tax-free. Properly structured, trust assets and their appreciation would be outside Ryan's estate, potentially reducing or eliminating estate taxes.

Unitrust Who's Who

Grantor: Person setting up and funding the trust.

The PBs – Primary Beneficiaries: First to receive distributions (over their lifetime or up to 20 years)

The RBs – Remainder Beneficiaries: Final recipients of trust assets (people or organizations), after the PBs.

NOTE: If a charity or nonprofit is the RB, the unitrust is known as a Charitable Remainder Trust (CRT). When the charity is the PB, it is a Charitable Lead Trust (CLT).

Why a Unitrust

There are numerous advantages to unitrusts, both financial and life-enhancing.

Reduces conflict between the priorities of the primary (PBs) and remainder beneficiaries (RBs). Because the payout to the PBs is a fixed percentage of assets, this can reassure the RBs that the trust assets are less likely to be depleted by the time the trust pays out to them.

Encourages the PBs to live well within a fixed budget. With a unitrust, the PBs cannot ask the trustee for higher payouts. This can make them more responsible with what they receive from the trust, including saving and investing the distributions to fund their goals.

Potentially less variance in distribution amounts. With a standard trust, the annual income can vary greatly depending on the markets, dividend and interest rate levels. The fixed percentage from a unitrust would also vary depending on those variables but possibly not as much if investments are diversified and well-managed.

For Example: Say the PB is the much-younger spouse of the grantor, and the children from the first marriage are the RBs. If not a unitrust, the trustee would have incentive to maximize income payouts to the spouse, since discretionary trusts have compressed income tax brackets. (How Trusts are Taxed). The children might feel cheated.

What's more, with a discretionary trust the spouse could ask the trustee for additional distributions (discretionary principal). The children might become even more resentful, fearing that the trust will be greatly depleted by the time they inherit. With a unitrust, the risk of the spouse spending down trust assets through discretionary requests is virtually eliminated.

Unitrusts can work well when charities are the remainder beneficiaries (RBs). If charities are the RBs, the grantor may be eligible for an upfront tax deduction. And if the grantor relinquishes control of the trust and is not a beneficiary (a "non-grantor" trust), the assets in the trust are excluded from the taxable estate, although not always at the state level.

Another benefit: Charitable trusts have tax-exempt status. Therefore, funding such trusts with highly appreciated assets can be advantageous since any income or capital gains they generate is not taxable at the trust level. Trust beneficiaries, however, are still required to pay federal (and sometimes state) taxes on distributions. *On the following page is an example of how a unitrust can work in the sale of a business.*

Three Main Types of Unitrusts

Standard Unitrust. Pays out a fixed percentage of trust assets annually (based on net asset value at a certain point in the year, typically the first business day of the year).

Net Income Unitrust. Each year, the trust can pay out *the lesser of* (1) a fixed percentage; OR 2) the net income the trust generates. Say the grantors who are also the primary beneficiaries are a couple with teenage children (the RBs). The couple do not need income from the trust, so the trustee can focus on investing for capital growth. If the couple eventually retire, the trustee can focus on investing for higher income.

Flip Unitrust. A flip trust can start as a net income unitrust (see above) and at a future date (often when the assets are sold) switch to a standard unitrust paying out a fixed percentage of assets. This may be a good option if there is an illiquid asset in the trust that does not produce income, say a highly appreciated vacation home or closely held stock (see example on next page). It can also work well for people near retirement whose "flip date" is when they stop working.

Note: *The "flip date" once set must be outside the control of the trustee or beneficiaries, ensuring fairness and preventing manipulation.*

For Example: *Business Exit with Charitable Remainder Unit Trust (CRUT)*

Issue: Angela is retiring and selling her fully owned online retailer founded 20 years ago.
Her goal: Provide income for herself, her two grown children, and the nonprofit she founded.

Solution: Two "flip" Charitable Remainder Unitrusts (CRUTs) are created. 10% of the company shares go into each trust. Angela is the grantor and the primary beneficiary (PB) of each trust.

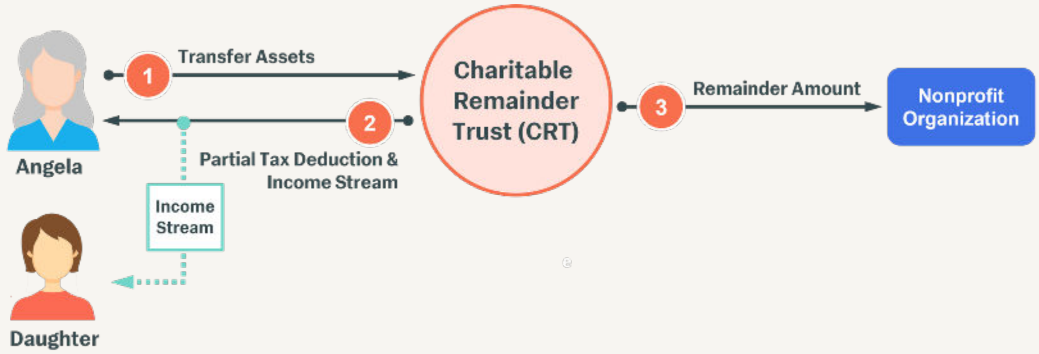
Before Company Sale

- **Upfront income tax deduction** for the asset transfer made to each trust.
- **No extra taxes generated.** Angela initially receives no income from the trusts because they hold only non-dividend paying stock (flip trusts allow for the lesser of what the trust generates or 4%).
- **Company shares are valued at a discount** because they are held by more than one owner (Angela and the two CRUTs). So when she passes away, her heirs will inherit the shares held outside the trusts at a discounted value, thereby potentially reducing estate taxes payable upon Angela's death.

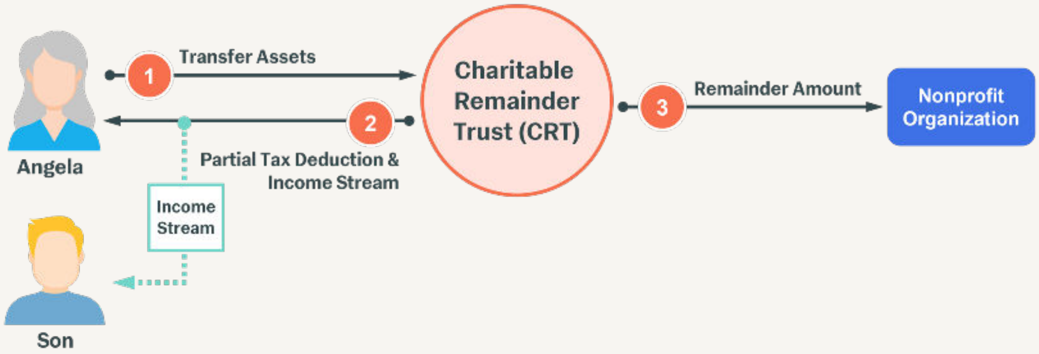
After Company Sale

- Angela's company is sold for $50 million after-tax, of which the CRUTs each get 10% ($5 million each).
- **Income.** Angela receives 4% of net assets in the two trusts annually (roughly $400,000 the first year), which is taxed to her for the rest of her life; upon her death, each CRUT's income stream will then be paid to her children.
- **Flexibility.** The trust terms give Angela flexibility. Each trust specifies that Angela can change the charity that is the remainder beneficiary.

CRUT #1 for Daughter



CRUT #2 for Son



Vulnerabilities of Unitrusts

While unitrusts can work well for a variety of family situations, they are not for everyone, and we are careful to point out the major pitfalls to our clients up front, including:

- **Changing needs of the grantor.** Unitrusts are irrevocable; the assets are not available for the grantor's use during their lifetime and the terms of the trust cannot (easily) be changed once it is established.
- **Changing needs of the primary beneficiaries (PBs).** Life is unpredictable and the PBs of a trust over time may have strong legitimate reasons for wanting higher trust distributions.
- **The state where a unitrust is located is very important.** Because of the volatility of life, states that make it easier to change the terms of a trust from unitary to standard are probably better places to set up a trust. Also, because of the regular fixed payouts from a unitrust, creditors could come after the income stream from a unitary trust more easily. States that offer more asset protection on trusts, such as South Dakota, are preferable.
- **Good asset management is critical.** The role of the asset manager is magnified with unitrusts because there is more leeway to invest for long-term growth, as well as income. As trustee and trust asset manager, LNW invests assets to last for the anticipated time horizon.
- **Issues with Charitable Remainder Trusts.** When a charity is the remainder beneficiary, it receives the assets at the end of the specified period, even though future generations may still have great need for support. One solution would be to also create an ILIT (Irrevocable Life Insurance Trust). The ILIT would hold a life insurance policy that upon death of the grantor would pay to the PBs an amount that approximates the value of the assets eventually going to charity (the RB of the CRT). If done properly, the value of the life insurance policy would not be included in the grantor's taxable estate.

Final Thoughts

The right trust structure for you and your family is something that takes time to figure out and is driven by many different factors: assets, capabilities and even personalities. This is why we get to know our clients and their family members well before advising on one type of trust vs. another. Then as trustees or co-trustees, LNW can make sure the purpose behind each trust is carried out, often over many generations.

ABOUT THE AUTHOR

Diana Shiner, JD, CTFA is passionate about developing and implementing comprehensive strategies for wealth management that align with the goals of each client and their family, including administration of trusts at LNW. Diana utilizes her wide-ranging experience in private banking, estate planning/settlement, business formation/governance, real estate and family law to tailor sophisticated solutions for high-net-worth individuals and families with complex finances and asset holdings.

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