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# TOTAL RETURN TRUSTS – THE BACKGROUND

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# TOTAL RETURN TRUSTS – THE BACKGROUND[1]

We estate planners constantly face change. Change in our clients' families, in their wealth, in the tax laws. And one of the most important changes is a potentially revolutionary approach to trust drafting and administration, explained in detail in several scholarly publications.[2] However, although the Revised Uniform UPIA ("UPIA"), the Uniform Prudent Investor Act ("Prudent Investor Act"), the total return trust and the Final Regulations under Internal Revenue Code ("Code") §643(b) (the "Final Regulations"), each was designed to fix very real and pressing problems, each goes about it in ways that can be counterproductive. This article addresses these innovations, the problems they solve and those they create, and proposes an alternative approach to these problems.[3]

## I. Modern Portfolio Theory and the Restatement (Third) of Trusts.

### A. Modern Portfolio Theory.

To understand the impetus behind the Prudent Investor Act, the UPIA the total return trust and the Final Regulations, an estate planner must first understand modern portfolio theory and the Restatement (Third) of Trusts ("Restatement"). Although the "prudent investing" concept began over 150 years with a Massachusetts decision,[4] it changed significantly with the publication of the Restatement in 1992. Under old state trust investing rules, investments were viewed in isolation, rather than as part of a portfolio, and some assets were automatically considered prudent or imprudent. Academics, trustees and advisors sought to eliminate these rules in favor of "modern portfolio theory."[5]

Although this author is unable to speak to all the intricacies of modern portfolio theory, two crucial concepts clearly emerge from it. The first is the concept of the two

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[1] Portions of these materials are derived from Cline, "Prudent Investing, Reallocating Income and Total Returns: The Curmudgeon's View" 28 Tax Management Estates, Gifts and Trusts Journal 62 (May/June 2003), reproduced with the permission of Tax Management, Inc., a subsidiary of the Bureau of National Affairs, Inc., Washington, D.C. All Rights Reserved. An expanded version of these materials will be published as part of the future edition of TM 861, "Trustee Investments," published by Tax Management, Inc., a subsidiary of the Bureau of National Affairs, Inc, Washington, D.C. All Rights Reserved.

[2] See, e.g., Hoisington, Modern Trust Design: New Paradigms for the 21st Century, 31st Annual Phillip E. Heckling Institute on Estate Planning, Ch. 6 (1997); Horn, Prudent Investor Rule, Modern Portfolio Theory and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust, 33 Real Property, Probate & Trust Journal 1 (Spring 1998); Wolf, Total Return Trusts—Can Your Clients Afford Anything Less?, 33 Real Property, Probate & Trust Journal 131 (Spring 1998).

[3] Some of the ideas in this article were presaged by that pioneering curmudgeon, Jeffrey A. Dennis-Strathmeyer, in his article, "You're Not Writing Noncharitable Unitrusts? Neither Am I" 21 CEB Est Plan R 160 (June 2000).

[4] Harvard College v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830), that held that trustees should invest in the same manner that "men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as probable safety of the capital to be invested."

[5] See, e.g., Macey, An Introduction to Modern Financial Theory (2d ed. (1998); Malkiel, A Random Walk Down Wall Street (6th Ed. 1996).

types of risk: Market risk, which deals with market volatility (e.g., the stock market); and non-market risk, which deals with the volatility of a particular asset (e.g., a company that may go bankrupt). An investor should obtain higher returns by accepting greater market risk (i.e, investments in stocks are riskier than in bonds, so as market risk increases so should the return on investment). On the other hand, non-market risk generates no additional return because an investor can avoid it by diversifying her investments. An investor should take at least two steps to deal with these risks. First, she should determine the level of volatility she is willing to accept in exchange for the return she hopes to receive. This will determine the level of market risk she assumes. Second, she should diversify her portfolio in accordance with her chosen level of market risk to avoid non-market risk.

The second concept, more controversial than that of risk, is that of market efficiency, which assumes that information about assets is disseminated efficiently and all assets are priced more or less correctly. If this is true, no investor should be able to consistently outperform the market. An investor's best strategy, in that case, is to invest passively, primarily through index funds, which should perform as the market does as a whole. Under the theory of market efficiency, active management (picking particular stocks, for example) is problematic because it generates additional management expense without a consistently higher return.

The question whether markets are actually efficient may not be as settled as modern portfolio theory implies. The equity value rollercoaster of the last five years has caused many to question the validity of the theory. For example, an alternate view of market valuation is that of behavioral finance, which takes into account the psychology of investing. Under behavioral finance, investor behavior is often the product of heuristic-driven bias. Heuristics can be defined as the "rules of thumb," often developed by trial and error, by which investors make decisions.[6] These biases can include representativeness (judgments based on stereotypes), overconfidence, conservatism (the inability to properly account for new information), aversion to ambiguity and emotional and cognitive problems.[7] Heuristic bias leads to "frame dependence," which means, in part, that decisions can be seriously influenced by such factors as loss aversion and regret for past decisions. Taken together, heuristic bias and frame dependence cause prices to stray from fundamental values, potentially for long periods of time, making markets inefficient.[8]

Behavioral finance principles, if true, can have several adverse consequences. Inexperienced investors tend to be more confident that they will beat the market than experienced investors (a fact that in hindsight should be self-evident, given all of the day-trading that went on five years ago). Further, different groups commit different errors: Wall Street strategists are more prone to gambler's fallacy, while individual investors are

[6] Shefrin, Beyond Greed and Fear, 13 (Harvard Business School Press, 2000). This book synthesizes the work of several academics in the area of behavioral finance.
[7] Id. at Ch. 2.
[8] Id. at 42.

more prone to betting on trends.[9] There is evidence that value investing is successful over the long term, and that there is simply not enough "smart money" (that is, investors free from heuristic-driven bias and frame dependence) to make the markets efficient. However, market inefficiency does not automatically imply that there is money to be made trying to "beat the market," and a steady investment in a well-diversified set of securities, for most investors, will produce better results.

Finally, investor psychology (both individual and professional) is not given adequate consideration, even if market efficiency theory, and not behavioral finance theory, can be proven correct. For example, John C. Bogle, founder and former chairman of the Vanguard Group, reviewed the history of the mutual fund over the past fifty years, and noted some remarkable changes.[10] In his view, the mutual fund industry has changed from one that stressed stewardship to one stressing salesmanship, in which "short term performance is the name of the game." As a result, fund managers turn over their portfolios at an annual rate of 110%, with an average holding period of stocks of just eleven months. This rapid turnover not only increases transaction cost, draining investor return, but it also makes speculators, rather than investors, out of fund managers. Fund investors, as a result, are penalized in two ways: increased fund cost (regardless of a fund's classification as "no-load"), and timing (both by investing too little early and too much too late).

The result of these penalties, according to Bogle, is staggering: although "the stock market provided an annual return of 13% during the past 20 years, and the average equity *fund* earned an annual return of 10%, the average fund *investor*, according to recent estimates, earned just 2% per year." In other words, even if the markets are efficient, and passive investment in index funds is the best approach, the average investor simply isn't following those rules.

This disparity between market return and investor return demonstrates a need for guidance not addressed by concepts like market efficiency. Think of all of the clients who have made a lot of money in managed funds. The idea that they know (or think they know) the person or institution managing their money gives them comfort and allows them to maintain their investment strategy more consistently, resulting in less turnover of investments and therefore higher returns. I'm not qualified to debate the merits of passive versus active management, but I do know the psychology of my clients.

And that psychology is often in direct conflict with the facts of the market. It is well accepted that investors cannot successfully "time" the market, selling right before a drop in prices and then buying right before an increase. It has been reported by Ibbotson Associates, and re-reported by everyone else,[11] that a dollar invested in the S&P 500 in 1926 would have grown to $1,114. However, if the same dollar was invested but the

[9] Id. at 52.
[10] All of Mr. Bogle's remarks are contained in "The Mutual Fund Industry in 2003: Back to the Future," delivered January 14, 2003, to the Harvard Business School Association of Boston. Transcript available at www.vanguard.com.
[11] See, e.g., Glassman, "The Secret Code of the Superior Investor," 121-122 (2001).

investor got out of the stock market during the 35 best months of the period (a total of 840 months), the dollar would have grown only to $10. Expressed differently, 99% of the growth during that period occurred during only 4% of the months in it. Miss those months, and you miss your appreciation.

Investors, in other words, have to hang around for 96 unproductive months, waiting for the big one. But many, if not most, investors don't have the stomach for it. Which is where handholding from investment advisors comes into play. Indeed, I would argue that even following the advice of a financial planner with a slightly second-rate actively managed portfolio, if done consistently, will generate higher returns on trust investments than following a passive mutual fund approach if the trustee gets skittish and pulls out of the market during one of those crucial months.

Further, if keeping down administrative costs is so crucial, then shouldn't the correct approach be for a trustee to seek the advice of a fee-for-service advisor only once, and then simply rebalance investments each quarter to remain consistent with that original advice? Yet I think paying those fees, even after the trust investments are "set," is crucial to achieving consistent returns, if only to keep the trustee in the market during prolonged downturns.

**B. The Restatement.**

Under the Restatement, a trustee "is under a duty . . . to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust." This standard requires "the exercise of reasonable care, skill, and caution." Further, it is to be applied "to investments not in isolation but in the context of the trust portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust."[12] Further, the trustee has a duty "to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so."[13] A trustee also has the powers expressly or impliedly granted by the terms of the trust.[14]

Trustees have the duty, "within a reasonable time after the creation of the trust, to review the contents of the trust estate and to implement decisions concerning the retention and disposition of original investments in order to conform to the requirements of **§§**227 and 228."[15] This duty requires the trustee, with the trust's investment objectives in mind, to "review the original investments, and, as necessary, formulate a plan for restructuring the portfolio to achieve a suitable level of risk and expected return with appropriate degrees of diversification and income productivity."[16] The trustee must determine whether any of the original assets are impermissible investments under local law and whether the trust terms direct retention or disposition of any of those assets.

[12] Restatement of the Law (Third) of Trusts, §227(a)(1992).
[13] *Id.* at 227(b).
[14] *Id.* at §228.
[15] *Id.* at **§**228.
[16] *Id.* at §229, Comments 118-119.

Transaction costs and the tax consequences of sale also are relevant factors to be considered. Further, the trustee's decision to retain or dispose of certain assets "may properly be influenced, even without trust terms expressly bearing on the decision, by the property's special relationship to some objective of the settlor that may be inferred from the circumstances, or by some special interest or value the property may have as part of the trust estate." Examples of such properties include "land used in a family farming operation, the assets or shares of a family business, or stock holdings that represent or influence control of a closely or publicly-held corporation."[17]

The Restatement addresses the place of actual trust language in directing trust investments: such directions are "legally permissible and are ordinarily binding on the trustee in managing the trust assets, thus often displacing the normal duty of prudence." However, the trustee may not be under a duty to "comply with a term of the trust if a court order directs or authorizes non-compliance when, as a result of circumstances not known or anticipated by the settlor, compliance would defeat or substantially impair the accomplishment of the purposes of the trust." Indeed, under such circumstances "the trustee may have a duty to apply to the court for permission to deviate" from the trust terms.[18] Further, if a trust agreement merely authorizes a particular investment, it is permissive only, and the trustee is not under a duty to retain permitted investments. It is not clear "the degree to which the trustee may have to give special consideration to specifically authorized investments, as against simply omitting them from serious consideration." What is clear, however, is that a permissive provision does not "remove the trustee of the fundamental duty to act with prudence."[19] Further, mere authorization with regard to an investment does not "constitute an exculpatory clause." Because these permissive provisions do not relieve the trustee of the duty to act prudently, and because diversification is a fundamental part of trustee investment requirements, "trust provisions are strictly construed against dispensing with that requirement altogether."[20]

The Restatement incorporates the concept of risk discussed earlier,[21] distinguishing between market and non-market risk. The Restatement implies that a trustee may breach her fiduciary duty to preserve capital if she selects a level of return that allows inflation to erode the trust property's value. In other words, a trustee must accept a certain amount of market risk and avoid non-market risk by diversifying investments.[22]

The Restatement also adopts, to some extent, the efficient market theory.[23] Further, the Restatement specifically prohibits a trustee from incurring unreasonable costs in managing and investing trust assets.[24] At least one author reads these sections of the Restatement as implying that "a trustee that uses a strategy of active investment must

[17] *Id.* at 119.
[18] *Id.* at §228, Comment, Page 104-105.
[19] *Id.* at 106.
[20] *Id.* at 106-107.
[21] See, e.g., Restatement (Third) of Trusts, § 227, cmts (b)(h) (1992).
[22] Id. At § 227, cmt g.
[23] Restatement (Third) of Trusts, Ch. 7 (Introduction, pp. 6-7; Reporter's Notes, pp. 75-76) (1992).
[24] Id. At § 227(c)(3).

justify the increased costs in terms of an increase in expected returns."[25] In other words, the Restatement can be read for the proposition that passive asset management (for example, through the use of index funds) is generally a more prudent investment choice than active management.

In addition to the apparent bias in favor of passive investing, the Restatement also takes an ambivalent view of real estate, which makes up the bulk of many clients' wealth. The comments to §227 do allow real estate holdings as part of a balanced portfolio, but also point out several problems with them, and the special knowledge and care needed to manage them. The comments express no similar hesitation toward stocks, bonds and cash, however, even though managing stocks is viewed by many to be harder than passive real estate investments.

So the theoretical underpinning for the Prudent Investor Act, the UPIA and the total return trust is based in part on the idea that markets are efficient, and can be read for the proposition that managed funds are almost per se improper. (Many would call this an overstatement, but we all know that nothing is safe from the fertile minds of litigators.) These theories ignore the needs of the many clients who fund trusts with real estate or closely-held businesses and who intend to have the trustee maintain these assets. Reading the Restatement and its comments, it would seem that all trustees should be investing in publicly-traded securities. That clearly is not what many clients want, however.

## II. The Prudent Investor Act.

The Prefatory Note to the Prudent Investor Act indicates that it relies on the Restatement, and that it makes five fundamental alterations to prior prudent investing law. First, the prudence standard "is applied to any investment as part of the total portfolio, rather than to individual investments." Second, a trustee's central consideration in investing is the tradeoff "between risk and return." Third, all categorical restrictions on types of investments per se are eliminated; a trustee may "invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing." Fourth, investment diversification is integrated into the definition of prudent investing. Finally, trustees are now permitted to delegate investment and management functions, contrary to prior trust law forbidding the trustee to undertake such delegation.

Although the Prudent Investor Act is aimed primarily at private trusts, it also may apply to charitable and pension trusts, among others, and could even extend to "investment responsibilities of directors and officers of charitable corporations." In other words, the Prudent Investor Act could have effects far beyond private trusts.

### A. Analysis.

[25] Horn, supra at fn. 2, pg. 17.

Under Section 1 of the Prudent Investor Act, the prudent investor rule is a "default rule," which "may be expanded, restricted or eliminated by the trust terms. If the Prudent Investor Act is not overridden, the trustee owes a duty to the beneficiaries of the trust to comply with the prudent investor rule. Section 2 sets forth the trustee's standard of care: a trustee "shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust." The Prudent Investor Act does not adopt a single investment approach; rather, a trustee must consider particular needs of particular beneficiaries. Under Section 2(b), a trustee's investment choices are judged in the context of the trust portfolio as a whole and as a part of an overall strategy, after evaluating risk and return objectives. In other words, a trustee must develop an overall investment strategy. (For example, the comments point out that a trust "whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth.") Section 2(c) sets forth circumstances that a trustee should consider in investing and managing trust assets, including general economic conditions, inflation, expected tax consequences, the beneficiaries' other resources, beneficiary needs for liquidity and an asset's special relationship or special value, if any, to the trust purposes. Finally, Section 2(f) states that a trustee with special skills or expertise has a duty to use them.

Section 3 of the Prudent Investor Act states simply that a trustee shall diversify trust investments unless, because of special circumstances, the purposes of the trust are better served without diversifying. Such circumstances might include holding an undiversified block of low-basis securities that, if sold, would generate significant tax cost, or retaining a family business. Under Section 4, a trustee has a duty, within a reasonable time after accepting the trusteeship, to review the trust assets and decide whether they are appropriate investments in light of the purposes, terms, and other circumstances of the trust, and with the requirements of the Prudent Investor Act. In other words, a trustee cannot simply rely on the fact that her predecessor held these assets, even if her predecessor was the grantor.

Sections 5 and 6 reinforce the trustee's duty of loyalty to the beneficiaries and of impartiality among the beneficiaries. Section 7 states that a trustee may only incur costs in investing and managing trust assets that are appropriate and reasonable. As already noted, this duty, when read in conjunction with the Prudent Investor Act's implicit assumption that markets are efficient, could lead a trustee to conclude that passive investing in index funds is superior to investing even in mutual funds that are actively managed.

Section 8 is a crucial and a very beneficial change for trustees: compliance with the prudent investor rule "is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight." As the comments point out, "[t]rustees are not insurers * * * . Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard." Under Section 9, a trustee who properly delegates investment and management functions is not liable for the decisions or actions of the agent to whom the function was delegated. A trustee properly complies with this section if the trustee delegates investment and management functions "that a prudent trustee of comparable skills could properly delegate under the circumstances." In reversing the former trust law that imposed a rule of non-delegation, Section 9 of the Prudent Investor Act "is designed to strike the appropriate balance between the advantages and the hazards of delegation." Further, the duty to minimize costs, summarized in Section 7, applies to delegation as well. In deciding whether to delegate, "the trustee must balance the projected benefits against the likely costs." Additionally, "in deciding how to delegate, the trustee <u>must</u> take costs into account [emphasis added]." So, for example, if a trustee's regular compensation schedule assumes that the trustee will manage investments, "it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager."

## B. <u>Prudent Investor Litigation</u>.

A review of some of the litigation involving the concepts behind the Prudent Investor Act is helpful to a trustee attempting to administer a trust under the Act. Because the Prudent Investor Act has only recently been promulgated, there is little if any direct case law on its applicability. However, recent cases provide some guidance regarding a trustee's duty of investment and the appropriate level of damages following a breach of that duty. The courts in all these cases made their decisions after their states enacted the Act, but in each case, the trustee's actions were reviewed under prior law.

### 1. <u>How to Lose by Gaining</u>

In an Alabama case,[26] a decedent who was chairman of the board of the appellant bank, created a trust, naming the bank as trustee. The trust was funded 70% with the stock of the bank's own holding company. The beneficiaries argued that the bank breached its fiduciary duty to diversify and engaged in self-dealing by holding on to such a large concentration of its own stock. The bank argued that the terms of the trust modified the prudent person standard; the trust powers provided that the trustee had the power "to make new investments from time to time as it may deem necessary or desirable, regardless of any lack of diversification, risk or nonproductivity." The agreement also allowed the trustee to hold any assets originally received upon creation of the trust. The court, finding against the bank, held that the donor "did not intend to vest in the trustee Bank a power to diversify so little as to prejudice the interests of the beneficiaries."[27] The court also found that the bank "failed to provide a reasoned plan of investment calculated to accomplish the testator's purpose"[28] and that whatever plan it had was merely a justification for holding on to its own stock. This was due in part to the fact that the bank's own investment advisory service was recommending that no more than 5% of a portfolio consist of bank stocks.

[26] *First Ala. Bank of Huntsville v. Spragins*, 515 So. 2d 962 (1987).
[27] *Id.* at 964.
[28] *Id.*

The bank argued in the alternative that, even if a breach occurred, there were no damages, because the trust suffered no loss. The lower court held, and the Supreme Court of Alabama agreed, that, although the value of the trust property had increased from the date of the trust creation to the date of trial, the amount of the gain was much less than what would have been achieved through active management. The beneficiaries' witness stated that the appropriate measure of damages was the amount the trust property would have grown to had the bank invested in a mix of the S&P 500 index and fixed income treasury bills. The bank argued that approach was speculative and done in mere hindsight. The court sided with the beneficiaries' witness and also awarded interest.

This case stands for two of the most important points of fiduciary investing. First, neither the trust drafter nor a trustee should rely on boilerplate language if the intent of the trustor is to allow the trustee to hold large undiversified concentrations of anything. The drafter should include very specific language, worded very strongly, if this is the testator's intent. A trustee, in the absence of such strong language, should seek either the consent of all the beneficiaries or instructions from the court authorizing an investment strategy that does not include diversification. Second, any investment strategy should be part of a plan that is well thought out from the beginning and communicated in some fashion to the beneficiaries.

In a second case, the Washington Court of Appeals[29] held that a trustee's duty of investment is analyzed on the basis not only of the overall return obtained by the trustee, but also of the mix of the trustee's investments. The decedent left half of her property in trust for the benefit of her husband. The trust required payment of income to the husband and distribution of the trust principal to the decedent's children after the husband's death. Although the husband started a probate proceeding, he took no further steps to conclude that proceeding until an action was filed, and continued to manage the estate assets as his own. One significant estate asset was stock in a closely held company, which the husband sold for a large profit after the decedent's death. Taking into account this profit, the husband's overall return exceeded the total return that the corporate co-trustee would have obtained had the trust assets been invested with that trustee.

The husband argued that his performance should be evaluated based on the performance of the trust as a whole. The court noted that common stocks represented 13% of the trust's marketable securities, while bonds and bond equivalents represented the balance. Although overall trust performance "is a factor in evaluating the performance of the trustee," the court found that the husband "did not weigh his investment and income-producing securities against his investment in [the closely held corporation]. The overall trust performance was boosted dramatically by the sale of the [closely held stock] in 1983. But Mr. Cooper's investment strategy could not have anticipated the gain from the sale of the stock before it occurred." Furthermore, the court found that, following the sale of stock, the husband invested "estate assets almost exclusively in marketable securities, 87% in bonds, favoring again the income beneficiary—him."[30]

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[29] *In the Matter of the Estate of Cooper*, 81 Wash. App. 79; 913 P.2d 393 (1996).
[30] *Id*. at 90.

However, the "no harm, no foul" rule is not dead. In Ohio, [31] the beneficiary of a trust created in 1972 sued the trustee bank for breach of the duty to diversify. The trustee held stock in The Limited, Inc., which constituted about 11 percent of the trust's assets in 1981, and performed exceptionally well over the next sixteen years, splitting five times. By February, 1992 the stock represented 66.6 percent of the trust's assets and was valued at $28.88 per share. In accordance with its policy that a trust could not hold more than 10 percent of its assets in one stock, the trustee began a program in 1983 to reduce its holdings in Limited stock, but the program's effectiveness was frustrated by the frequent stock splits. The beneficiary asserted that the bank's failure to diversity the trust's assets by reducing its holdings in Limited stock to 10 percent resulted in a significant decline in the value of the trust. The appellate court affirmed summary judgment in favor of the trustee bank on the grounds that the beneficiary failed to state any damages. It relied on the affidavit of a trustee's expert witness stating the Limited stock overall performed more than twice as well as a similar investment in the S & P 500 and that under the beneficiary's theory of recovery pretax funds available for distribution would have been reduced from roughly $1.24 million to $362,000. The beneficiary did not submit any expert testimony regarding damages, maintaining that calculation of damages required only a simple mathematical computation. The court relied on the Second Restatement of Trusts, not the Third Restatement or the Prudent Investor Act, stating that "[i]f the trustee fails to sell trust property which it is his duty to sell, and the property subsequently appreciates in value, so that no loss results, the trustee is subject to no pecuniary liability."[32] Given that the court relied, essentially, on old law, this case is of limited usefulness.

However, more recently, a federal district court [33] heard the case of trusts created by the plaintiff's grandparents for the lifetime benefit of the plaintiff's mother with a remainder interest to the plaintiff. The trust created by the plaintiff's grandfather, created in 1906, began with a value of approximately $122,000 and grew to only $518,000. The trust created by the grandmother, on the other hand, was started in 1924 with approximately $149,000, but grew to a value of over $2,500,000. Upon learning of this "apparent disparity in rates of growth" for the two trusts, the plaintiff filed an action against the corporate fiduciary charging that it breached its fiduciary duty and that it acted negligently in administering the grandfather's trust. The corporate fiduciary moved to dismiss both counts based on the fact that the plaintiff could not demonstrate that the trust suffered a loss. The District Court found that, under Pennsylvania law, parties in the situation of the plaintiff cannot prevail in a surcharge claim if they cannot show that there was a loss in the principal value of the trust. The court also noted a prior Pennsylvania decision that rejected the argument that the remainder beneficiary of a trust suffers a loss because the return on investments did not keep pace with "certain stock market indicators". This case is rather surprising; while it does not appear that the plaintiff provided much evidence of loss other than the disparity in return between the two trusts, the court did not look into the reasons for that disparity. For example, one explanation for

[31] *Pickerel v. Huntington National Bank*, No. 01AP-911, 2002 WL 416970, (Ohio Ct. App. 2002).
[32] *Id.* at 5.
[33] *Pitts v First Union Nat'l Bank*, 262 f2d 593 (USDC Md., 2003).

the difference in values might have been that the corporate fiduciary decided to invade principal more heavily for the plaintiff's mother out of one trust than the other. Rather, the court seems to make the blanket assertion that, so long as the principal value of the trust increases, the beneficiaries cannot maintain an action against the trustee for improper investments.

### 2. Janes and its Progeny: Measuring Damages

In another important decision, New York's highest court[34] addressed the problem of a trustee who failed to diversify. This case dealt with trusts created under the will of a decedent who died with an estate made up primarily of a $2,500,000 stock portfolio, 71% of which was made up of common stock in Eastman Kodak Company. The trustee sold only enough Kodak shares to pay administration expenses and retained the balance of the shares from the date of the decedent's death in May of 1973 to February of 1980. During this time, the shares' value dropped to approximately one-third of their value at the date of the decedent's death.

The court found that the trustee breached its fiduciary obligation in three ways. First, the trustee failed to consider the Kodak stock in relation to the entire investment portfolio. Second, the trustee "paid insufficient attention to the needs and interests of the testator's 72-year-old widow." Because the annual yield from the portfolio was only 1.7%, the high concentration of Kodak "jeopardized the interests of the primary income beneficiary of the estate."[35] Third, there was evidence that the petitioner failed to exercise due care "and the skill it held itself out as possessing as a corporate fiduciary."[36] As a result of these findings, the court affirmed liability.

The court then turned to the measure of damages. The trial court used a "lost profits" measure of damages and determined the trustee's liability to be what the proceeds of the Kodak stock would have yielded, to the time of trial, "had they been invested in [the trustee's] own diversified equity fund on August 9, 1973."[37] The *Janes* court overturned this trial court determination and instead found that the appropriate measure of damages was based on the value of the stock on the date it should have been sold (in this case, only a few months after the date of decedent's death), reduced by the proceeds from the actual sale of the stock. The court further held that interest could be awarded within the discretion of the trial court. In rejecting the "lost profits" measure of damages, the court found such relief was only appropriate where "the fiduciary's misconduct consisted of deliberate self-dealing and faithless transfers of trust property."[38]

Two New York Supreme Court cases[39] already have been decided in light of the *Janes* decision. Both cases were decided the same day, and both involve trustees who held IBM stock as virtually the sole trust asset, notwithstanding their duty to diversify. In

[34] *Matter of the Estate of Janes,* 90 N.Y.2d 41 (1997).
[35] *Id*. at 53-54.
[36] *Id*.
[37] *Id*. at 48.
[38] *Id*. at 55.
[39] *Estate of Saxton*, 712 N.Y.S.2d 225 (2000); and *Estate of Rowe,* 712 N.Y.S.2d 662 (2000).

*Saxton*, the decedent created a trust for the lifetime benefit of the spouse, with a remainder interest to his children. The trust was funded entirely with IBM stock. In 1960, two years after the trust was created, the trustee (a corporate fiduciary) sent an "Investment Direction Agreement," under which the trust beneficiaries agreed that the sole trust asset was IBM stock and that it was their desire for the trustee to continue to hold the stock rather than follow normal diversification procedures. The trustee did not discuss the agreement with the beneficiaries, nor did it discuss the risks associated with not diversifying.

For the next 19 years, the trustee did not communicate with the beneficiaries. In 1984, the beneficiaries began raising with the trustee the possibility of diversifying the trust assets. Despite the urgings of the beneficiaries, the trustee did not prepare or present any plans for diversification; it was the position of the trust officer in charge that holding one security alone was adequate so long as that security remained on the Bank's "buy" list. He took this position notwithstanding the Bank's own written investment policies that recognized that diversification was required under the "prudent person rule."[40] In 1992, the trustee finally implemented a diversification strategy, at which point the value of the stock had dropped by more than $4 million. Needless to say, the trustee was sued by the beneficiaries for breach of fiduciary duty. The trustee alleged that the agreement protected it from liability, and that the beneficiaries consented to the continued retention of the stock, in light of the several discussions that took place between the beneficiaries and the trust officer. The court found the trustee liable. It held that the trustee breached its duty in 1987, when the beneficiaries informed the trustee that it was under a continuing obligation to develop a diversification strategy. The court applied equitable, rather than contractual, standards in finding that the agreement afforded the trustee no protection. The court adopted the *Janes* method for determining damages.

The *Rowe* case dealt with the trustee of a charitable lead trust that was initially funded solely with IBM stock. As in *Saxton*, the corporate trustee had a written diversification policy, under which a single security should not constitute more than 10% of the total assets of a trust. Nevertheless, the trustee decided not to diversify because the IBM stock had dropped in value from the date of trust funding. Rather, the trustee decided to diversify "at a later time when the stock had reached a higher price." The first moves toward diversification were made two years after funding. However, five years after the date of funding, the trustee still held approximately two-thirds of its original IBM stake, during which period the value of the stock dropped from $3.5 million to $1.8 million. The trustees, of course, were sued for breach of fiduciary duty. The expert witness for the trust beneficiaries stated that the trustee's "tactic of waiting for the IBM stock to rise was based on 'wishful hoping' . . ."[41] The court found the trustee liable, and held that the amount of the surcharge should be determined in light of *Janes.*

The *Janes* conclusion regarding the measure of damages was also confirmed last year by a federal district court, which specifically rejected the S&P 500 measure of

[40] *Id.* at 228.
[41] 712 N.Y.S. 2d at 665.

damages.[42] (Funny how times change; for the last few years, applying S&P 500 damages would be equivalent to a defense verdict.)

A Maine case is a little friendlier to the idea, rejected in *Janes,* of a lost measure of profits.[43] The court again dealt with a surviving-fiduciary husband who did not properly fund a trust for his own benefit at the death of his spouse. In this case, the husband "retained some of the assets, sold others, and commingled both the assets and the proceeds with his own personal assets."[44] Following the husband's death, the personal representative of the husband's estate filed an accounting stating that the estate was liable to the successor trustee of the trust under the will of the predeceased wife for the value of the assets he did not transfer to the trust at the date of death. The successor trustee, on the other hand, asserted that "the damages should be determined not with reference to the increase in value of the inception assets but by reference to the value that would have been attained" in an S&P 500 Index Fund.[45]

The court observed that the parties entered into an "unequivocal" agreement to the damages caused by the husband's breach "if the damages were determined by reference to the performance of a prudent professional trustee in Portland, Maine, managing family trusts similar to the [decedent's] trust." So, by implication, the parties also agreed that a prudent trustee would not have invested all of the assets in an S&P 500 Index Fund. As a result of this stipulation, the court was required to follow the trustee standard agreed to by the parties and could not impose its own S&P 500 Index Fund measure of damages (as the trial court had done). However, the court noted that "[h]ad the [trial court] had reliable facts before it from which it could have found that a prudent trustee would have used either the more aggressive or the more conservative investment strategy, it could have determined damages with reference to such strategies." In other words, using an index fund as the measure of return that should have been obtained was inappropriate, but only because the parties already had stipulated as to the appropriate measure of damages.

### 3. <u>When an Exculpation Clause Doesn't Exculpate</u>

Many trust agreements contain language that allows the trustee to retain concentrated holdings of a single asset or stock. What level of protection does such language provide? In a New York decision,[46] a remainderman brought an action against a bank trustee. Originally the trust was funded in 1966 with a block of the bank's own stock and stock in 18 other corporations. However, the bank liquidated all outside stock, and eventually its own stock as well, and invested the proceeds in its common trust funds. The remainder beneficiary sued the bank, arguing that the trust agreement allowed the bank to retain its own common stock, and also that it achieved lower investment results than a "prudent investor" would have. Treating the trustee's investment in its own common trust funds as diversification, the court found that the trustee correctly sold its

[42] *Williams v. J. P. Morgan & Co.*, 248 F.Supp.2d 320 (S.D.N.Y. 2003).
[43] *Estate of Wilde,* 708 A.2d 273 (1998).
[44] *<u>Id</u>.*
[45] *<u>Id</u>.*
[46] *In re Strong,* 289 A.D.2d 798 (N.Y. App. Div. 2001).

own stock, regardless of the ability given to hold the stock in the instrument, because "[n]either the trust language permitting retention of the stock nor the preferences of the trust beneficiaries would have insulated [the trustee] from a claim that it breached its fiduciary duty had it failed to achieve appropriate diversification."[47] Thus, in this case the Prudent Investor Act served as a shield for the trustee from liability, rather than as a weapon to be used against it. This case again makes clear that trust language authorizing undiversified holdings does not really relieve the trustee from its duty to do so.

In a Minnesota case,[48] the decedent's testamentary trust was funded 98% with stock in the decedent's closely held business. This business was later acquired by Borden, Inc., and, as of 1980, 98% of the trust assets consisted of Borden stock. The trustees of the trust were Norwest Bank and two individuals, one of which was the plaintiff. Although the trustees did sell a significant amount of Borden stock in an effort to diversify, following that sale Borden stock still made up 40% of the trust assets. The plaintiff trustee voted to continue to diversify, but the other two trustees voted to hold the stock until Borden stock recovered some of its lost value. The stock ultimately dropped from $36 per share to $14 per share. When the plaintiff sought to surcharge Norwest Bank for the losses, the Bank asserted that the trust's exculpation clause protected it from liability. The clause stated that

> [n]o Trustee shall be liable for the fault or doing of any other Trustee, whether the act be one of misfeasance or nonfeasance, nor shall he be held liable for any loss by reason of any mistake or errors in judgment made by him in good faith in the execution of the trust.

The trial court dismissed the action against the Bank on the basis of this clause; however, the appellate court remanded for further findings. The appellate court held that, although the exculpation clause was not void as against public policy, the clause would not protect the Bank if the losses were due to negligence. In so holding, the court found that exculpation clauses were to be strictly construed against the trustee. The first portion of the clause provided no protection to the Bank, since it only protected a trustee from the actions of another trustee. The second portion of the clause protected only against "mere errors in judgment," not negligence. Because the trial court did not determine whether the losses were due to negligence, the appellate court remanded. Following remand, the trial court found that the losses were due to negligence, and Norwest Bank again appealed, this time on the trial court's finding of surcharges of more than $4 million. In a second decision, the appellate court again upheld the lower court.[49]

One of the most significant cases in this area spells out even further the extent to which a trustee may (or may not) rely on language in a trust agreement permitting the

[47] *Id.* at 800.
[48] *Trust of Williams*, 591 N.W.2d 743 (1999), *aff'd* 631 N.W.2d 398 (2001).
[49] *In re Matter of Williams*, 631 N.W.2d 398 (2001).

trustee to maintain a high concentration in a single stock.[50] In this case, the testator created a will in 1951 for the benefit first of his wife, then for his daughter and finally for her issue (or, if she had none, for several named charities). The testator died in 1956. His testamentary trust contained the following language:

> It is my desire and hope that said stock will be held by my said Executors and my said Trustee to be distributed to the ultimate beneficiaries under this Will, and neither my Executors nor my said Trustee shall dispose of such stock for the purpose of diversification of investment and neither they or it shall be held liable for any diminution in the value of such stock. * * * * The foregoing provisions shall not prevent my said Executors or my said Trustee from disposing of all or part of the stock of Eastman Kodak Company in case there shall be some compelling reason other than diversification of investment for doing so.

The corporate fiduciary assumed responsibility as trustee in 1956, and the trust was funded two years later. Ninety-five percent of the trust assets consisted of shares in Eastman Kodak Company. In 1972, the testator's wife died. The trustee filed its first intermediate accounting, which showed that the stock was continuing to be retained. No objections were filed. Despite a significant decline in the value of Kodak stock, the trustee held the stock for approximately 34 years. Beginning in 1997, attorneys for the testator's daughter approached the trustee about selling the Kodak stock. In the face of inaction by the trustee, the testator's daughter filed a compulsory accounting, the bank filed a petition for settlement of its second account in 1998 and the testator's daughter filed objections to this account. She sought damages in excess of $39,000,000 resulting from the improper retention of Kodak stock.

The Surrogate, writing the lower court decision, pointed out that a clause authorizing retention of a single holding "cannot trump the application of prudence in the management of an estate." Under New York law, if a retention clause conflicts with the legal duty of prudence imposed upon a fiduciary, "the clause must lose." In interpreting the retention clause, the Surrogate noted that the fiduciaries had full authority to sell the Kodak stock and that "the language which authorized the sale of stock is worded much more strongly than the language which urges retention." The retention language was "clearly precatory." The Surrogate found that the most important sentence of the entire will was the sentence, already quoted, that allowed disposing of all or part of the Kodak stock "in case there shall be some compelling reason other than diversification of investment for doing so." Although the testator did not define "compelling reason," he did make clear that diversification was not such a reason. As a result, the Surrogate interpreted this clause to mean that the trustee was not to sell simply in order to diversify even if the Kodak stock was performing well; rather, the trustee was to sell the Kodak stock if there were some other compelling reason, such as poor performance. Although

[50] *In re Will of of Dumont*, 809 N.Y.S. 2d 360 (2006), *reversing* 2004 NY Slip Op 50647U; 2004 N.Y. misc. LEXIS 896 (June 25, 2004).

once a sale took place, diversification would follow; selling for the purpose of diversification itself was "preemptive" and was not the same as the sale that was taken to "remedy a suffered loss." The Surrogate found that the trustee never defined for itself the meaning of the term "compelling reason" until 1997 when the testator's daughter approached them about sale. Further, it was troubling that the bank "adhered to the proposed proposition that the Kodak retention itself was the purpose of the trust," and not the benefit of the testator's family. In fact, the Surrogate held that under New York law, the "complete lack of documentation alone is itself a breach of trust." As a result of all of these findings (as well as several others), the Surrogate found the trustee liable and it was surcharged almost $21,000,000.

The Supreme Court of New York, however, overturned the Surrogate's ruling. It first found that the Surrogate determined, on its own motion, the date on which damages began, even though this particular date was not pleaded. However, even assuming there was a compelling reason to sell on a date other than the one presented to the Surrogate, the decision that the trustee should have sold on that date was still made solely in hindsight. The court also found that the low income yield of the stock, which the Surrogate found significant in holding that the trustee should have sold the stock in 1974, was in fact not a compelling reason to sell. The New York Supreme Court held that the dispositive test was not the income yield in the abstract, but whether the income was reasonable in view of the needs and interests of the income beneficiary. Given that beneficiary's other wealth, the income yield was adequate for her circumstances, even though it may have been low in the abstract.

At least one commentator has observed that, while the appellate court's decision may provide comfort to the particular trustee in this decision, it provides little comfort to other trustees holding large single-stock positions, because the appellate decision focuses narrowly on two procedural issues.[51]

The problem with the Surrogate's decision in *Dumont* that was not addressed by the appellate court was the manner in which it puts into question any language that purports to allow for the retention of assets regardless of a duty to diversify or the ability of the grantor of a trust to exculpate the trustee for retaining such holdings. The lawyer drafting Mr. Dumont's will probably thought that the stock retention provision gave the trustee complete discretion to hold the stock regardless of any change in circumstance. The *Dumont* decision, however, says otherwise.

On the other hand, an Ohio case[52] provides some guidance regarding the type of language that can be used to allow a trustee to retain assets regardless of a duty to diversify. In this case, the grantor created a trust worth over $8 million dollars for the benefit of his wife. 80% of the trust assets were in the form of Firstar Bank stock. The trust agreement stated that, upon becoming trustee, Firstar Bank was permitted to retain, manage and invest the stock in the trust "as they deem advisable or proper." The trust also included a retention clause that allowed Firstar to retain its own stock; otherwise, it

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[51] Rikoon, _*Dumont* Reversed_, *Trusts & Estates*, 56 (March 2006).
[52] *Wood v. U.S. Bank, N.A.*, 160 Ohio App.3$^{rd}$ 831, 828 N.E.2d 1072 (2005).

would have had to sell the stock upon becoming trustee. Specifically, the trust agreement gave Firstar the power "to retain any securities in the same form as when received, including shares of a corporate trustee…, even though all of such securities are not of the class of investments a trustee may be permitted by law to make and to hold cash un-invested as they deem advisable or proper." The court noted that this clause contains some "unfortunate wording;" as it was unclear whether the term "advisable or proper" applied to cash and not the other assets. As a side note, the court held that although it was unnecessary to construe this language in this circumstance, it cautioned that "this type of fuzzy drafting can create problems."[53]

Firstar held the assets it received (primarily its own stock), and did not diversify. Indeed, when it needed to raise funds to pay estate taxes, it liquidated assets other than its own stock, with the result that Firstar stock made up an even higher percentage of trust assets. Within a year of the grantor's death, the beneficiary (his wife) asked the trustee to sell some of the Firstar stock. Her advisor made a similar request. Neither of these requests, however, were made in writing, and Firstar did not sell any stock as a result. Shortly after the request was made, the Firstar stock dropped 25% below its date of death value, resulting in a loss of approximately $770,000. The beneficiaries sued Firstar, asserting that it had violated Ohio law by failing to diversify trust assets. Firstar raised affirmative defenses of waiver, consent and ratification, based on the fact that Firstar had met with the beneficiaries to discuss the trust terms. The trial court rejected the beneficiary's proposed jury instructions, adopting instead the instructions proposed by Firstar. The jury found against the beneficiary and she appealed.

The appellate court found first that a trustee has the duty to diversify investments unless the trustee reasonably determines that, "because of special circumstances, the purposes of the trust are better served without diversifying."[54] The appellate court further found that the language allowing Firstar to retain its own stock "merely served to circumvent the rule of undivided loyalty. The trust did not say anything about diversification."[55] Citing the Third Restatement of Trusts, the court held that a general authorization in the terms of the trust "to retain investments received as a part of a trust estate does not ordinarily abrogate the trustee's duty with respect to diversification or the trustee's general duty to act with prudence in investment matters." As a result, the court held that, "to abrogate the duty to diversify, the trust must contain specific language authorizing or directing the trustee to retain in a specific investment a larger percentage of the trust assets than would normally be prudent."[56]

Finally, a Kansas decision[57] holds that a letter from the grantor and beneficiary of a revocable trust to the corporate trustee directing that trustee to retain certain stock is adequate to override the trustee's duty from any responsibility to monitor the stock or to diversify the holdings. This is particularly true when the trust agreement itself states that,

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[53] *Id.* at 835.
[54] *Id.* at 838.
[55] *Id.* at 839.
[56] *Id.* at 840.
[57] *McGinley v. Bank of America, N.A.*, 279 Kan.426, 109 P.3d 1146 (2005).

during the lifetime of the grantor, the trustee is to consult her as to any purchase or sale of trust assets and the trustee must abide by the grantor's decision unless, in the trustee's sole opinion, the grantor is incapable of managing her own affairs.[58] In this case, the grantor delivered significant amounts of Enron stock to the corporate trustee to hold as trust assets, instructed it by letter to hold the stock as trust assets and exculpated the trustee from liability as a result of doing so. Both the trial and appellate courts held that the language in the trust, together with the letter from the grantor, were sufficient to relieve the trustee of liability. This decision turned, it seems, on the fact that the trust was revocable and it was the grantor, and not some other beneficiary, who had written the letter. This is, of course, the correct result and is not especially controversial. However, in light of the *Dumont* holding, it does provide some comfort.

### 4. <u>An Absolute Duty to Diversify?</u>

As pointed out in the discussion of the Prudent Investor Act, there is no absolute duty to diversify; it is simply a default rule. However, some cases have tested the extent to which the default applies. First, in a Fourth Circuit affirmation of a lower court's holding,[59] the court held that a trustee authorized to retain property would not be held liable for failure to diversify under Pennsylvania law unless the plaintiff meets the stringent test of "supine negligence" or "willful default." The case involved an irrevocable trust created by parents for their daughter. The trust corpus consisted entirely of stock in a company founded by the grantor. The trustee was given the power to "retain any and all property . . . until such time as he may deem it desirable to sell or otherwise dispose of the same."[60] After an IPO of the company in July 1998 the stock traded at NASDAQ at $14 per share, but subsequently fell and fluctuated between $0.625 and $2.50 per share. After the lock-up period the beneficiary pressured the trustee to sell the stock, but he refused, stating that in his opinion the stock was undervalued and was worth at least $3 per share. The beneficiary sued the trustee, alleging a failure to diversify and gross negligence. However, the lower court granted trustee's motion for summary judgment, finding no breach of fiduciary duty. In affirming the lower court's decision, the Fourth Circuit noted that the trustee was not required to diversify trust investments under Pennsylvania law and that non-diversification is not presumptively imprudent. Rather, the standard for imposing liability on a trustee authorized to retain investments is "supine negligence or willful default." No evidence was presented that the trustee acted in bad faith or with indolence, supine negligence or willful default, nor that the stock was undervalued (in fact, it was later sold for over $4 per share). Consequently, the trustee was relieved of any liability.[61] This case is probably of limited value outside of Pennsylvania, however, since the Prudent Investor Act is not even mentioned in the decision.

[58] *Id.* at 429.
[59] *Stopper v. Kestel*, No. 00-2204, 2001 U.S. App. LEXIS 13350 (4th Cir. 2001).
[60] *Id.* at 2.
[61] *Id*. at 6.

It also appears that Oklahoma has no absolute duty to diversify. In a recent case,[62] the settlors established a trust in 1957 and funded it primarily with stock in the AMP company. The trustee, settlors' son, kept the AMP stock as approximately 70-80% of the assets until 1998, when much of it was sold. Although the trust began with a value of approximately $75,000, reached the value of approximately $514,591 in 1999, and approximately $600,000 was distributed over the life of the trust, the beneficiaries (the settlors' grandchildren and great-grandchildren) claimed that trustee breached his duties to diversify. They claimed that had he diversified, the trust's value would have been substantially higher. The trustee requested summary judgment on two theories: performance of the trust assets equaled or excelled the performance which conservative diversification would have produced, and the trust instrument granted him wide discretion as to asset management, exonerating him of all liability. The court refused to uphold summary judgment on the basis of investment return because the beneficiaries presented expert testimony to the contrary. On the subject of exoneration, the court determined that the trust agreement provided no express exoneration, but granted the trustee the power to retain any assets for as long as he may deem advisable. The court rejected the beneficiaries' argument that whatever trustee may deem "advisable" is subject to the Prudent Investor Rule, and held that the Prudent Investor Rule did not create an absolute diversification requirement.[63]

In two other cases, courts have found that there is no absolute duty to diversify, particularly when such diversification is the result of bad behavior on the part of the trustee. First, in *Brackett v. Tremaine*, [64] the Nebraska Supreme Court held that there was no absolute duty to diversify where the trustee sought to purchase the single largest asset of the trust. In this case, the appellant-trustee, a grandson of the settlor, sought to purchase for himself a forty-two acre parcel of farmland that was by far the largest asset of the trust. The trust provided that the trustee (who also was a beneficiary) was to receive income from the property for his lifetime and upon his death it was to be divided among the other beneficiaries. The trustee purchased a house and moved it onto the property before attempting to purchase it. He then petitioned the court for authority to sell and the other beneficiaries objected. The trustee presented evidence from an expert witness that the overall risk to the beneficiaries from lack of diversification, which the expert stated was the greatest risk to the trust, could be reduced by having a portion of the trust property invested in other assets. The other beneficiaries objected because they believed that the settlor intended the farmland to remain in trust for all of the beneficiaries and that it would increase in value over time.

The court noted several facts. First, the trustee had purely personal reasons for purchasing the parcel of property from the trust. Second, the trust agreement gave the trustee the power to retain any property "without regard to the proportion of such property or property of a similar character so held may bear to the entire amount of the trust."[65] Finally, the court noted that, under the Prudent Investor Act as adopted in

[62] *Atwood v. Atwood*, 25 P.3d 936, 940 (Okla. Ct. App. 2001).
[63] *Id.* at 945.
[64] 269 Neb 376 (2005).
[65] *Id.* at 383.

Nebraska, one reason justifying non-diversification of trust assets includes the asset's "special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries." Observing that the law "has looked with disfavor upon a trustee selling assets to himself," the court held that the court "should not approve such a transaction over the objection of a beneficiary unless it can be clearly demonstrated that the transaction is consistent with the trustee's duty to administer the trust solely in the interests of the beneficiaries." Because the trustee in this case could not demonstrate this, the court held against the trustee and against diversification. [66]

In the second decision, a Pennsylvania court[67] held that, where a trustee exercised his power to diversify essentially in a vacuum, and without regard to the actual facts, the diversification amounted to gross negligence. This case involved a corporate trustee acting as the successor to the grantor following her death. The trust provided for the support of the settlor's spouse, who was incapacitated and in ill health. The largest single asset of the trust was stock in the corporate trustee. The corporate trustee, upon taking over, performed an "annual account investment review," after which they determined that the investment objective should be changed from "safety and income" to "balanced." Under this new investment objective, the trustee had the ability to allocate fifty to seventy percent of the trust assets to stock. The trust's "investment horizon" was defined originally as being between three to seven years, but following the re-characterization, it was expanded to seven to ten years. This despite the fact that the income beneficiary's health was rapidly deteriorating at the time. Further, after the life income beneficiary's death and at a time when the trustee was required to distribute all assets to the beneficiaries, the corporate trustee actually purchased more mutual funds. Finally, the investment advisor employed by the corporate trustee made the decision to sell the corporate trustee's own stock immediately before dividends were issued, so that the trust assets did not include the additional stock generated as a result of that dividend. This investment advisor could not explain why he decided to lengthen the investment horizon.

The court began by discussing the applicable law in Pennsylvania, and noting that, due to the timing of the enactment of the Uniform Prudent Investor Act in Pennsylvania, portions of it applied to the trust, while other portions did not. The court also noted the provision, unique to Pennsylvania and a few other states, that the trustee had the ability to retain assets originally acquired from the settlor. The court then held that it was not to "evaluate a trustee's management of trust assets with 20/20 hindsight, nor do we require a trustee to be clairvoyant in selecting only optimal investments that always appreciate in value and never decline in worth." However, even though the standard to which the trustee was being measured was that of gross negligence, the trustee "must be able to explain how an investment strategy was developed for a specific trust and why that strategy was prudent under existing circumstances . . . in other words, a trustee must be able to demonstrate that a chosen investment strategy was not based on a conscious, voluntary act or omission taken in reckless disregard of the consequences of the trust."[68] The court also found that the corporate trustee "never consulted with the life tenant or the

[66] *Id.* at 384.
[67] *In re Stella Scheidmantel* 2005 PA Super 6; 868 A2d 464 (2005).
[68] *Id.* at 48.

remaindermen" after taking over as portfolio manager. Nevertheless, he altered the investment goal of the Scheidmantel trust to "balanced" and increased horizon from "three to seven years" to "seven to ten years." Even though, the court held, that he had no "factual basis for making these changes and that he never made any attempt to ascertain the Life Tenant's physical condition, his prognosis or his current income needs."[69]

In light of this, the court concluded that the trustee determined that "diversification of assets was a prudent course of action, as a general matter, without reference to the specific circumstances pertaining to" the trust. Finding, therefore, that the trustee had acted with gross negligence, the court stated that "diversification cannot become a goal in and of itself. Rather, diversification is a tool that can provide the means to effectuate a settlor's goals for a trust, if used properly and prudently with due regard to the specific facts and circumstances that exist in a particular case." Further, "[w]hether the method and mode chosen for diversifying the assets of any given trust is [or was] 'prudent' or 'imprudent' necessarily must depend on the settlor's goal or goals in creating the trust and the factual circumstances surrounding the trust at the time a diversification program is initiated."[70]

Thus, it appears from these cases that the duty to diversify under the Prudent Investor Act is not absolute. However, language that purports to allow a trustee to avoid the duty of diversification should be viewed very skeptically. Both the *Strong* case, cited in this section, and the *Dumont* case[71] take language that seems pretty clearly to allow a trustee not to diversify and impose a diversification requirement anyway.

Further complicating the problem is the ever increasing complexity of investment options. Should a trustee who holds a single stock, for example, as its most significant asset be required to purchase a derivative in order to avoid the swings in value that such a high concentration can provide? This issue has been raised in the context of individual investments, not trust assets, in a dispute that has spawned three separate decisions. While not arriving at a final decision, the U.S. District Court for the Southern District of New York has allowed a case by an individual investor against a trust company to survive summary judgment.[72] In this case, an individual investor hired the trust company to help him with the management of his assets, which consisted of a large block of stock in a single publicly traded corporation following the sale of his business. The individual was prohibited from trading the shares for one year from issuance. Because of this restriction, the individual alleged that the trust company told him that nothing could be done to diversify investments. However, the individual also alleged that, sometime after receiving this advice from the trust company, he was told by a broker that he could acquire a "collar" as a hedge against fluctuation in the price of this stock. He acted on this advice and purchased the collar, but not before the value of the stock dropped from its value when he transferred it to the trust company. The individual sued the trust

[69] *Id.* at 56-57.
[70] *Id.* at 59-60
[71] See Section 3, above.
[72] *Levy v. Bessemer Trust Company, N.A.*, 1997 U.S. Dist. LEXIS 11056 (1997); *Levy v. Bessemer Trust Company, N.A.*, 1999 U.S. Dist. LEXIS 4045 (1999); and *Levy v. Bessemer Trust Company, N.A.*, 2000 U.S. Dist. LEXIS 13275 (2000).

company, claiming that they had committed gross negligence and breach of a fiduciary relationship in failing to advise him about the availability of collars to avoid price fluctuations. The trust company filed a motion to dismiss for failure to state a claim; however, the court denied that motion. Subsequent to the issuance of the first decision in this matter, there were two further procedural decisions issued.

These decisions do not find that the trust company was negligent in failing to advise the individual about the ability to "collar" his stock holdings (because the matter probably has been settled). These decisions also are of limited relevance to trustees, because they do not involve the trust company acting as a trustee, but rather as an investment advisor to an individual. Therefore, the diversification issues inherent in the Prudent Investor Act do not come into play. Finally, these cases involve a situation where the individual specifically asked the trust company for strategies to diversify. Nevertheless, these cases should stand as a warning to trustees who receive trust assets that are concentrated in a single stock. The trustee obviously must determine first whether the stock should be sold in order to diversify. However, even if diversification is found not to be appropriate (either because of specific terms in the trust or because of adverse tax consequences upon sale or for any other reason) the trustee should consider whether to take the next step of considering derivatives to protect against fluctuations in value. This will be particularly the case when the single asset is a publicly-traded security, which can easily be hedged. This is not to say, of course, that all concentrated positions held by trustees should be hedged; for example, the purpose of the trust might be to hold the single investment because the grantor believes that the beneficiaries should benefit from that investment, and hedging would take away some (and perhaps a significant amount) of potential growth. Nevertheless, such a strategy should be considered by trustees facing this situation.

### 5. Aggressive Investing and Day Trading

The trustee of the Somma Scholarship Fund was found by the Circuit Court for the City of Richmond, Virginia, to have engaged in risky day trading, calls and margins with the trust funds.[73] Charles Somma, the trustee, was a brother and successor trustee of Nicholas Somma, who established the fund. The trustee previously had been warned that he was engaged in unacceptable investment practices, but the trustee continued “investing” in this fashion, ultimately losing 11% of the trust value. When payment of the stockbroker’s commissions from the trust fund was denied, the trustee filed exceptions. The court, applying Virginia’s version of the Prudent Investor Act, found that even though the statute gave the trustee broad discretion in managing funds, the trustee in this case crossed the limits of that discretion by engaging in unsound investment practices. It rejected the trustee’s arguments that the trust only incurred “paper losses,” finding that the value of the stock in the trust at the end of the accounting period was $116,611 less than what the trust had paid for such stock. Thus, the trustee breached his fiduciary duty and was liable for $77,418.75 paid as broker commission and margin interest.[74]

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[73] *In re Somma*, 49 Va. Cir. 213 (Va. Cir. Ct. 1999).
[74] *Id*. at 220.

In an even more disturbing example, a New York Court removed guardians of a mentally impaired Chinese immigrant who was injured in a Greyhound bus accident.[75] The incapacitated person received approximately $2,861,689 in settlement proceeds and guaranteed monthly payments of $17,033.89 for 25 years. However, his co-guardians, a sister in law and her husband, were not to be trusted with those assets. After they incurred $255,000 of losses, and after they had been previously admonished for the pattern of spending, the Court Examiner moved to remove them and surcharge them for the trading losses, claiming that they engaged in high-risk day trading, failed to provide a proper accounting and submitted an excessive budget. The New York Supreme Court noted that all guardianship arrangements are governed by the Prudent Investor Act,[76] and found that the guardians breached their fiduciary duties, not by day trading and incurring substantial losses *per se*, but by displaying a pattern of poor financial judgment. This was evidenced by the stacking of the portfolio almost exclusively with high tech stocks, day trading and failing to fully provide required financial disclosures.

Not all bold trustees get sanctioned, however. In a Washington case,[77] a trust was established by parents who named their son the trustee, their other son the income beneficiary and his children remainder beneficiaries. In 1986, the trustee transferred trust assets worth $476,000 from an account at Merrill Lynch to an account at Kidder Peabody, where by 1994 they were worth $151,000. In 1998, one of the remainder beneficiaries (the trustee's niece) sued the trustee for breach of fiduciary duty, alleging that he had imprudently managed and invested the trust assets, failed to respond to reasonable requests for information, and caused the trust to incur unreasonable expenses. Specifically, she charged the trustee with engaging in excessive trading, dividend capture and imprudent IPO strategies, and with failure to diversify the portfolio. The trial court awarded $193,928 in damages as compensation for unreasonable expenses, but concluded that trustee's overall investment strategy was prudent. The Court of Appeals reviewed these findings and affirmed all of them.[78] In responding to the claim that excessive trading, dividend capture, and imprudent IPO strategies were a breach of fiduciary duty, the court stated that the Washington version of the Prudent Investor Act was directed to fiduciaries, and not to courts assessing damages. The court found that there was substantial evidence that the overall investment portfolio was prudent, as it was properly balanced between income-producing and growth-producing assets. It also found no violation of the duty to diversify for the same reason. The court acknowledged that the trustee engaged in excessive trading and dividend chasing strategy, but affirmed the trial court in concluding that the beneficiary had not borne the burden of showing damages from it. It refused to accept the benchmark of a hypothetical prudent investor as a measure of damages: "While [the niece] points to [her expert's] testimony to establish that a hypothetical investor would have prudently invested in other ways to achieve a growth in the principal several times larger than what was realized, we know of no rule that *required* the court to accept that testimony as a proper measure of damages."[79]

[75] *In re Huang*, 2003 NY Slip Op 50859U (N.Y. Gen. Term. 2003).
[76] *Id*. at 6.
[77] *Flohr v. Flohr*, No. 47734-0-1, 12002 Wash. App. LEXIS 590 (Wash. Ct. App. 2002).
[78] *Id*. at 26.
[79] *Id.* at 38.

### 6. **Relieving Trustees of Liability**

Fortunately, some courts will still try to determine the trustor's intent when determining whether there is liability for failing to diversify. The California Court of Appeals, in an unpublished opinion,[80] addressed the situation of a co-trustee who was also an accountant for a trust, the assets of which were held in Swiss bank accounts and fixed income investments in the United States. The beneficiary, a daughter of the trustors, became dissatisfied with the administration of the trust, including the trustees' failure to diversify the investments to include more stocks. However, the court affirmed judgment for the co-trustee, finding that the evidence supported lower court's conclusion that it was reasonable for trustee to retain the majority of the assets in more conservative investments. Even though it found that "[t]he trustee has a general duty to diversify assets," the trustee did not breach this duty because the evidence showed that the grantors were extremely risk averse. Their low tolerance for risk justified keeping the assets in conservative investments. In addition, the investments produced sufficient income to cover the beneficiaries' expenses, and the court believed that investment in Swiss bank accounts was adequate diversification.[81] Thus, in this case the evidence of the settlor's intent to maintain a particular level of exposure to risk helped to get the trustee off the hook of the failure to diversify.

Finally, three recent cases have been decided under which the trustees were found not to be liable for failure to diversify. These cases also were not decided under the Prudent Investor Act, and the holdings in each case may have been different if they were. However, all three pay at least lip service to the Restatement for the investment standard of a prudent trustee. First, a Rhode Island case decided in federal court[82] addressed cotrustees who held the stock of a single company. Here, the defendants (a bank and an individual) assumed management of a trust in 1991, when the grantor of the trust died. At the time of the grantor's death, he held as trustee convertible debentures of CML Group (the NordicTrak people) that constituted 1.37% of the total value of the trust assets. In the two years after the grantor's death, following several stock splits, the debentures were converted to shares of stock and became worth over half the total value of the trust assets. The value of the stock went from a high of $32 per share in 1993, to a low of $17 per share when the plaintiff took over as trustee in 1994. The plaintiff as successor trustee sued the defendants for breach of trust, apparently alleging that the CML stock was not "trust quality" and that the trustees should not have allowed the stock to have grown to such a significant portion of the total value of trust assets. The plaintiff claimed as damages the difference between the value the trustees would have realized upon sale at the stock's highest value and the low price at which it was actually sold.

The plaintiff argued that the defendants had an absolute duty to diversify under the Prudent Person Rule, as enumerated in the Restatement. The defendants countered that that diversification rule is only a default, and that the standard could be and was

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[80] *Freedman v. Blumberg*, No. B146760, 2002 WL 551021 (Cal. Ct. App. 2002) (unreported).
[81] *Id.* at 3.
[82] *Donato v. BankBoston, N.A.*, 110 F.Supp 2d 42 (USDCRI 2000).

overridden by the trust agreement, which stated that the grantor specifically authorized the trustees

> to hold and retain any property delivered to them by [the grantor] or subsequently acquired by them pursuant to [the grantor's] written instructions, notwithstanding any lack of diversification in the investment of such property . . . [83]

This section of the agreement also contained exculpation language, under which the defendants were relieved of liability in the absence of "negligence or bad faith."

The court first observed that "a permissive provision does not relieve trustees from scrutiny under a 'prudence' standard for their investment decisions; it means only that a trustee cannot be found to have acted imprudently per se for holding a particular type of investment." The court found that, as a result of the trust language, the defendants could not be found liable for "investing in non-trust quality or non-diverse assets per se, but may be liable" if a particular investment was imprudent under the circumstances. The court found that the only "interesting" issue was whether the CML stock was an original trust asset received from the grantor, since what he held on the date of death were convertible debentures. They held that it was not, and therefore a higher standard was applied to the analysis. The court found no evidence that holding the stock was imprudent: the defendants had sold a quarter of the stock at the highest price, and the stock was given to wide swings in value. This decision is somewhat confused, but it is clear from the opinion that the plaintiffs presented their arguments very ineffectively; the court went to great lengths to point out how unclear their thinking was.

Second, in a District of Columbia case,[84] the court addressed a claim of breach of trust against the trustees of a trust that held a one-quarter interest in unimproved, non-income producing real property in Virginia. For several years the trustees (including a corporate trustee) held the property as a cotenant with the trust beneficiary's brother. The trust was created for the beneficiary, a son of the grantor, who was unable to manage assets on his own behalf, and the beneficiary relied on the trust for support. Several years after the trust was created, the trustee determined that it was appropriate to sell the property, subject to the approval of the co-owners. However, the Virginia real estate market was continuing to increase, and the trustee rejected all offers to buy, either because the co-owners objected to the offer or because the offer came with unacceptable contingencies.

The trustee continued to distribute all of the other assets to the beneficiary, so that between 1988 and 1990, the property made up 80 – 90% of the trust assets. In 1990, the value of Virginia real property dropped considerably, and by 1991 the owners of the property stopped receiving offers to sell. The beneficiary sued the corporate trustee for failing to sell the property by 1990. The court, in determining whether there was a breach, looked first to the terms of the trust. Under it, the trustees were "expressly 'not . . . required to diversify'," they were given the authority to "retain, invest and reinvest in any

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[83] *Id.* at 48.

[84] *Estate of Cavin*, 728 A.2d 92 (1999).

real or personal property," and the amounts of principal distribution to be made to the beneficiary were within the sole discretion of the trustees.[85] The court also noted that the trustees did not attempt to sell only their portion of the undivided interest in real property because there was no market for such an interest and, even if a buyer could have been found, the sale price would have been significantly diminished. Finally, the court noted that the record did not establish that a forced sale was necessary in 1990, because at that point the beneficiary's need for trust distributions was not "acute." Therefore, the court overturned the trial court's ruling and found that the trustee was not liable for failing to sell at distressed price.

The third case, decided in Delaware,[86] dealt with a trustee that invested solely in tax-exempt government bonds. The trust was to pay the deceased grantor's husband all of the income and as much principal as needed for his support, maintenance and general welfare during his lifetime, and was to distribute the balance of the trust property at his death to the grantor's two children (who were also the trustees and the defendants) and in trust for the four children of the grantor's deceased child (the plaintiffs). The trustees, who never filed statutory accountings and did not hire an investment advisor, invested all of the trust assets in tax-exempt bonds. The trial court, relying on the expert opinion of an investment advisor, found the trustees liable. However, the appellate court, ruling that this determination was based on hindsight, overturned the trial court. This decision was based in part on the fact that the trustees were not professional investors, and in part on the Delaware law applicable at the time. It seems unlikely that a court would reach a similar conclusion if the Act were the governing state law. Therefore, this case may be of only limited relevance.

One final note: even when a trustee takes actions in order to comply with the Prudent Investor Act, communication is still critical, whether it be between the trustee and the beneficiary or, in the case of corporate fiduciaries, between the various corporate officers. A New York case [87] found that, where the investment officer assigned to a trust account undertook a sale of concentrated holdings in four securities in order to achieve diversification, but did not communicate the reasons for this sale to the administrative officer in charge of the account, a triable issue of fact existed when, as the result of that sale, a capital gains tax liability was incurred. There had previously been a historical understanding that the concentrations in the four stocks would be managed to avoid unnecessary sales. The beneficiary plaintiff only learned of this sale when his accountant received a statement detailing his capital gains tax liability. Further, and more troubling for the court, the corporate fiduciary's administrative officer for the trust had no personal knowledge of the factors that the investment officer considered at the time of the sale. Because this lack of communication created a triable issue of fact, the lower court's summary judgment in favor of the bank was overturned. In other words, even when a court might otherwise be inclined to relieve a trustee of liability, it may not do so if the trustee makes the right decision, but does not communicate the reasons for the decision prior to making it.

[85] *Id*. at 98.
[86] *Law v. Law*, 753 A.2d 443 (2000).
[87] *Margesson v Bank of New York,* 291 Ad2d a.d.2d 694, 738 N.Y.S.2d 411 (2002).

### 7. <u>Interpreting Intent When Determining Investment Strategies</u>

Two recent cases show how a court can interpret the intent of the trustor and relieve the trustee from liability as a result, even if the trustee has not properly diversified its investments. The first case, out of Nebraska, [88] was decided before the Prudent Investment Act was adopted in that state. The trustor created the trust for the benefit of his daughter, paying all of the income annually and as much of the principal as was necessary for her "health, maintenance and reasonable comfort and best interests, considering her other income and means of support." Upon the daughter's death, the trustees were to distribute the remaining trust property to the daughter's "then living descendants." Beginning in 1989, US Bank and the daughter were co-trustees. The trust assets originally consisted of a farm and fixed income investments. The decision to use fixed income was "consistent with the bank's determination that the objective of the trust was to provide maximum income" to the daughter. The farm was sold in 1993 and the trust was invested for a time solely in fixed income investments. In 1994, the bank began investing in equities and, as of 1996, 14% of the trust assets were invested in equities, with the balance in fixed income investments. The daughter removed the bank as trustee and sued the bank for breach of fiduciary duty. The daughter argued that the bank failed to invest trust assets in accordance with Nebraska law, which required the bank to invest those assets in a way that would balance the interests of the income and remainder beneficiaries.

The court stated that although a trustee "is not under a duty to the beneficiary entitled to the income to endanger the safety of the principal in order to produce a large income, he is under a duty to him not to sacrifice income for the purpose of increasing the value of the principal." Relying on an Arizona case, the court found that, because the trust was to provide the beneficiary with a lifetime income, the trustees could not sacrifice that income in order to increase the value of the principal.

This is clearly a case where the court had no understanding of the principles of prudent investing, at least as outlined under modern portfolio theory. It assumed that the provisions allowing for the distribution of income were the primary source (perhaps the only source) of funds for the income beneficiary and ignored completely the ability of the trustee to invade principal. It is equally clear that under the Prudent Investor Act the trustee would have had the duty to invest for a total return and to make up any shortfall between trust income and the beneficiary's actual needs by invading principal. Nevertheless, it is an example of a court attempting to define, in the absence of any specific language, the intent of the trust and the primary and secondary beneficiaries thereof.

The second case was decided in New York.[89] This fairly simple decision is the first recorded case in New York to deal with that state's statute allowing the conversion of an "income" trust to a unitrust. The only important aspect of this decision was the

[88] *USBank v Martin-Walker*, 266 Neb. 353; 664 NW2d 923 (2003).
[89] *In the matter of the estate of Edward J. Ives, deceased*, 192 misc.2d 479; 745 NYS2d 904 (2002).

court's interpretation of the intent of the testator in creating the trust. The petitioner, (the surviving spouse of the trustor) provided affidavits from herself, a remainder person of the trust and the attorney who drafted the will. Because the trust was created in order to minimize estate taxes (which would not have occurred with an outright bequest) and because the trust gave the surviving spouse not only all of the income, but a power of invasion "for her support and maintenance in the standard of living to which she is accustomed," and because it was also clear that her income without the trust was insufficient to provide for current living expenses, the court decided that the primary intent of the trust was to benefit the surviving spouse. As a result of this determination, the court granted the petition to convert the trust to a unitrust.

This case is important more for its future ramifications than its actual result. The court determined that the trust was created for the primary benefit of the surviving spouse. Therefore, this determination could lead to the conclusion that the trustee could have invested trust assets to favor her over the remainder beneficiaries (for instance, by investing primarily in fixed income investments that would guarantee an income stream but would not keep pace with inflation). In some cases this might be the appropriate result, while in others it may not (for example, if the children of the trustor came from a prior marriage). Therefore, this case is important not only because it shows a court trying to determine the intent behind the document, but it also shows that it is important for the drafter of a trust to include intent language wherever possible in order to assist a future court in that determination.

**C. <u>Dealing with Diversification Issues in Drafting and Administration</u>.**

So, in light of the law and cases just discussed, how should a trustee respond? Although every situation is different, trustees can arrive at some general conclusions:

1. The duty to diversify is not mandatory, it is merely a default. Particular circumstances such as the age or economic condition of one or more of the beneficiaries, the length of the trust term, specific provisions in the trust agreement or the relationship of the assets to the grantor or the beneficiaries all can mandate a deviation from the duty to diversify.

2. Notwithstanding the first conclusion, case law indicates that, once having decided that diversification is inappropriate in a particular case, a trustee should always communicate this conclusion to co-trustees, if any, and to all beneficiaries (both current and remainder). This is not a legal requirement, but rather a "best practice" that a trustee ignores at her peril.

3. If, after communicating this position, the trustee receives a complaint from any beneficiary, the trustee should take steps to remedy the problem, rather than simply relying upon the consent of others or language in the trust agreement as a shield. The best possible course in this case is to seek instructions from the court having appropriate jurisdiction that the investment plan is correct and does not violate the trustee's duty to diversify.

4. Even if the trustee receives no complaints, she should continue to “check in” with the beneficiaries (perhaps annually) and reconfirm the investment strategy, along with the fact that the trustee is not diversifying investments.

5. Any trustee who has decided that the trust agreement requires, or the facts indicate, that the trustee hold a concentrated position, should not stop the analysis there, but rather should consider whether some hedging technique like a collar is available and appropriate. If the trustee believes such a technique should be considered, she should communicate the proposal to all beneficiaries before undertaking it and seek their approval or the approval of the court before proceeding.

These conclusions can appear to be nothing more than common sense; however, the case law indicates that following such procedures can keep a trustee out of trouble, or at a minimum help her obtain summary judgment if she is sued by beneficiaries for her investment strategies.

Lawyers who draft trust provisions that take into account special circumstances in investing should also take these laws and cases into account. What follows are some drafting suggestions:

1. It is important to remember that the Restatement and several of the cases have limited the effectiveness of exculpation clauses and investment direction clauses. Therefore, as a starting point, the drafter should remember that any such provisions will be strictly construed against the trustee and in favor of diversification.

2. At least as important as exculpation and direction language is “intent” language from the grantor. An explanation from the grantor as to why the trustee should not diversify investments, and is exculpated in the event that the trustee does not do so, may be persuasive to a court when interpreting such provisions. Conversely, when interpreting exculpation or investment direction provisions without any statement of intent, the court is left to determine for itself what the grantors intent was, a determination that more often than not probably will lean toward diversification.

3. Intent language with respect to investing can come in two forms: a statement in general of how the trust is to be administered (e.g., for the exclusive benefit of the income beneficiary to the exclusion of the remainder beneficiaries, or vice-versa), and statements regarding the importance of a particular asset, such as the family farm or closely-held business, to the family. Using both types of intent language, when appropriate, can doubly reinforce the exculpation and direction provisions.

Perhaps the most important aspect of drafting is to do so with the assumption that any court reviewing the language will have a strong preference to find a duty to diversify. Drafters, therefore, should not rely on older, more generic language that has been included in their documents for many years, but rather should reexamine the language that they have used and think about such language more carefully.

## III. The UPIA.

### A. Introduction

Trusts are being used with greater frequency each year. Many of these trusts are designed to hold property for the grantor's spouse, children or other relatives, often because the beneficiary is a minor or is unable for whatever reason to handle money. Such trusts are almost always irrevocable and therefore cannot be changed once created (unless a court decides to allow a subsequent amendment). Many such trusts are drafted to provide all income to the current beneficiary and a remainder interest in the principal to the remainder beneficiaries. So, for example, if a client creates a trust for her husband and her children, the husband might be entitled to all of the trust income, while the children would be entitled to all of the trust property upon the husband's death. Although many such trusts also provide the current beneficiary with principal at the discretion of the trustee (e.g. for health, education, maintenance and support), many more trusts do not, leaving the current beneficiary with the right only to the net income ("income only trusts"). There are several reasons why this style of trust drafting has become so prevalent, but perhaps the biggest reason is that it perpetuates the idea that the trust property is preserved for future generations, and only the "excess wealth" is being distributed.

Whatever the historical reason for this drafting style, income only trusts have several problems. First, they do not properly consider the "total return" approach contemplated by modern portfolio theory. By granting the current beneficiary the right to income, the trustee may be tempted to invest trust property primarily with an eye to increasing the amount of trust accounting income generated. This emphasis on income-producing assets may result in a below-average total investment performance, particularly during a time when investments in stocks perform well. Second, as a "one size fits all" style, it does not consider the needs of a given beneficiary. For example, an elderly spouse may require more money from the trust than simply its net income if that spouse needs long-term care.

The rights of the beneficiaries in income only trusts are determined by the definition of "income," which is found in the UPIA of the state in which the trust is administered; generally, income includes interest, dividends, rents and royalties, but not capital gains, which are a return of principal. This division of returns leads to a conflict between beneficiaries: the income beneficiary would prefer that the trustee invest in income-producing assets (such as bonds), which generally yield little if any growth, while the remainder beneficiary would prefer investment in high-growth, low yield assets (like equities). This conflict is exacerbated by the "total return" approach to investing contemplated by modern portfolio theory and the Prudent Investor Act.

The best insight into the workings of the UPIA is provided by the Comments to that Act (referred to herein as "Comments"), drafted by the National Conference of Commissioners on Uniform State Laws. The Prefatory Note to the UPIA states that it has two purposes: to revise the 1931 and 1962 Acts, and to "provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act." The UPIA "deals conservatively with the tension between modern investment theory and traditional income allocation."

## B. <u>General Principles, Duties And Definitions</u>

The UPIA begins in Section 102 with a list of definitions that are necessary for interpreting the balance of the Act. The Comments indicate that the term, "Income Beneficiary" now means both mandatory and discretionary beneficiaries; the distinction between the two is now irrelevant. Further, the term "inventory value" has been eliminated. Comments, Section 102.

The most important section of the entire UPIA is set forth in Section 103. To begin with, a trustee shall allocate receipts and disbursements among principal and income in accordance with the terms of the trust or will, whether or not it creates a result different from that under the UPIA. In other words, the UPIA creates default rules that can be drafted around.

Assuming the trust or will terms do not alter the results under the UPIA, a trustee generally shall add a receipt or disbursement to principal, unless the terms of the will or trust provides differently, or unless there is a specific rule in the UPIA to the contrary. However, as discussed *infra*, the number of specific rules with respect to the nature of receipts and disbursements are so many that they largely swallow up this general rule. Instead, this rule was provided to cover those investments not contemplated by the drafters of the UPIA. Comments, Section 103.

The trustee has a duty of impartiality when exercising the power to adjust between principal and income, "based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. " The Comments point out that if the trust terms "give the trustee discretion to favor one beneficiary over another, a court will not control the exercise of such discretion except to prevent the trustee from abusing it." Comments, Section 103.

Finally, a determination under the UPIA is "presumed to be fair and reasonable to all of the beneficiaries."

## C. <u>Trustee's Power To Adjust</u>

Perhaps the most significant change made by the UPIA is the power to adjust; Section 104(a) provides that a trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b).

The purpose of this adjustment power, as explained in the Comments to this section, is "to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income." The adjustment power is available (subject to other restrictions) if three conditions are met: (1) the trustee is managing trust assets under the prudent investor rule; (2) the trust instrument expresses the current beneficiary's rights in terms of traditional "income;" and (3) the trustee cannot exercise her duty of impartiality after applying the provisions of the UPIA or the trust instrument. Comments, Section 104.

The Comments go on to indicate the intent behind this adjustment power: it does not "empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled." Rather, it compensates for those times when "the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule." Id. Further, although this adjustment power eliminates the trustee's need to be concerned about the income component of the trust's investment portfolio, the trustee still must "determine the extent to which a distribution must be made to an income beneficiary and the adequacy of the portfolio's liquidity as a whole to make that distribution." Id.

**1. Factors in Determining Whether to Adjust.**

Section 104(b) provides a list of some of the factors a trustee shall consider when deciding whether or not to adjust between income and principal:

- The nature, purpose and expected duration of the trust;
- The intent of the settlor;
- The identity and circumstances of the beneficiaries;
- The needs for liquidity, regularity of income and preservation and appreciation of capital;
- The trust assets, and the extent to which the trust assets consist of financial assets, interests in closely held businesses or personal or real property, the extent to which an asset is used by a beneficiary and whether an asset was purchased by the trustee or received from the settlor (notice that this last factor contradicts the Prudent Investor Act, which requires the trustee to

assess the appropriateness of each asset, whether or not received from the settlor);

- The net amount allocated to income under other sections of the Act and the increase or decrease in the value of principal;
- The extent to which (if any) the trust allows the trustee to invade principal or accumulate income, and the extent to which the trustee has exercised this power;
- The actual and anticipated effects of economic conditions and inflation or deflation on principal and income; and
- The anticipated tax consequences of an adjustment.

### 2. Prohibitions on Adjustment Power.

Not all trustees can exercise the power to adjust. Section 104(c) provides several prohibitions on the trustee's ability to make adjustments. First, a trustee cannot make any adjustment that would disqualify the trust for marital deduction treatment, or that would fail to qualify a trust for the gift tax exclusion. Second, the trustee cannot make an adjustment that changes the amount payable to a beneficiary as a fixed annuity or a fraction of trust assets. Third, an adjustment cannot be made from any amount that is permanently set aside for charitable purposes under a will or trust unless both income and principal are set aside. Fourth, a trustee may not make an adjustment if the adjustment power is the sole reason that the trustee would become the owner of the trust property for income tax purposes. Fifth, the trustee cannot make an adjustment if holding the power causes any part of the trust assets to be included in the taxable estate of an individual who has the power to remove or appoint a trustee. Finally, the trustee does not have the adjustment power if he or she is a trust beneficiary.

Note that these limitations are not entirely clear. For example, the Comments seem to indicate that Section 104(c)(3) governs charitable remainder trusts, including the "net-income-with-makeup charitable remainder unitrust," or "NIMCRUT," under which the income beneficiary receives the lesser of trust accounting income or the unitrust amount for any given year. The Comments to that subsection suggest that, in certain circumstances, the trustee may be able to adjust income for such trusts. However, Section 104(c)(4) states that no adjustment is available for any amounts "permanently set aside" for charitable purposes. A cautious reading of these two provisions would indicate that adjustment is not available for NIMCRUTs unless specifically authorized by the terms of the trust. If drafted incorrectly, however, such an adjustment clause could disqualify the trust as a charitable remainder trust under federal tax law.

## D. Judicial Control Of Discretionary Powers.

Section 105 states that the court "may not order a fiduciary to change a decision to exercise or not exercise a discretionary power conferred by this chapter unless it determines that the decision was an abuse of the fiduciary's discretion." Further, a particular decision to exercise or not exercise a discretionary power is not an abuse of discretion "merely because the court would have exercised the power in a different manner or would not have exercised the power." The decisions to which this section applies include a decision as to whether, and to what extent, an amount should have been allocated from income to principal or from principal to income; and a decision regarding the relevant factors to the trust and its beneficiaries, and the extent to which those factors are given weight in determining whether to make an adjustment under Section 104.

If a court does find that a trustee abused its discretion, it has the authority to try to put the beneficiaries in the position they would have occupied had the trustee not abused its discretion, in accordance with certain rules that apply, depending upon whether the abuse involved a distribution that was too large or too small. Section 105(c). Note, however, that the trustee must pay from its own funds to make the beneficiaries whole <u>only after</u> the court has tried to make the beneficiaries whole from trust assets first. .

In a contentious situation, a trustee may not want to make a decision, only to have it challenged as an abuse of discretion later. In this case, Section 105(d) grants the trustee the ability to petition the court for instructions regarding whether a given action is an abuse of discretion. This provision is designed to "provide a fiduciary the opportunity to obtain an assurance of finality in a judicial proceeding" before proceeding with the exercise (or nonexercise) of a discretionary power. It is not intended, however, to "have the court instruct the fiduciary how to exercise the discretion." Comments, Section 105. If the petition describes the proposed exercise or nonexercise of the discretionary power and contains sufficient information to apprise the beneficiaries of the reasons for the proposal, the facts on which the fiduciary relies and an explanation of how the beneficiaries will be affected, then a beneficiary challenging the proposed exercise or nonexercise has the burden of establishing that it results in an abuse of discretion.

**E. <u>Decedent's Estate Or Terminating Interest</u>.**

The UPIA provides some additional provisions, more prosaic, that allow for greater clarity in trust administration. Section 201 describes how income is to be determined and distributed after a decedent dies (in the case of an estate) or after an income interest in a trust ends. First, if an asset has been specifically devised to a beneficiary, the trustee pays net income and net principal receipts attributable to that property as determined under the UPIA. These receipts are determined by including all amounts received or paid with respect to the property, whether due before, on or after the date that triggers the transfer. Further, they are not to be reduced by disbursements from income or principal under Sections 501 or 502 if the trust, will or applicable law provide that such disbursements are to be made from another source, or to the extent that the fiduciary expects to recover payment from another source.

Second, the trustee determines the remaining net income by applying the UPIA, and then doing the following:

- Including in net income all income from property used to discharge liabilities;
- Paying from either income or principal, in the fiduciary's discretion, professional fees (attorneys, accountants and fiduciaries), court costs, other administrative expenses and any interest on death taxes (but the fiduciary's discretion is limited in this regard, as discussed below);

- Paying from principal all other disbursements made in connection with either settling the estate or winding up the terminating income interest (including debts, funeral expenses, family allowances and death taxes and related penalties attributable to the estate or terminating interest under either the terms of the document or, if none, applicable law).

Section 201(2). Although the fiduciary has the discretion to pay professional fees, court costs and other expenses of administration from either income or principal, the fiduciary may pay only those expenses from income that will not reduce either the estate tax marital and charitable deduction. This provision puts the UPIA in line with the U.S. Supreme Court's decision in the Hubert case and with Service regulations promulgated in light of that case. Comm'r v. Hubert, 117 S.Ct. 1124 (1997).

Third, pecuniary gifts are treated separately, and the UPIA is designed to equalize the treatment of lifetime and testamentary gifts. The beneficiary of a pecuniary gift is entitled to as much interest provided under the will, trust or applicable law, to be paid first from net income determined under Section 201(2) and second, to the extent such income is insufficient, from principal. If the pecuniary gift is made from a trust upon the termination of a terminating interest, then the gift bears interest as though the gift were made under a will.

Under Section 201(4), the net income distributable to residuary or remainder beneficiaries is to be paid in accordance with the rules in Section 202. That section states that each such beneficiary is entitled to receive a portion of net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the date of distribution. If more than one distribution is made, each beneficiary is entitled to a portion of the income not distributed by a subsequent distribution date. The specific rules governing this division of net income are set forth in Section 202(b). The fiduciary must maintain appropriate records if the fiduciary does not distribute all income on a single distribution date. Section 202(c). Finally, the fiduciary may, if the fiduciary deems it appropriate, to allocate gain and loss among residuary or remainder beneficiaries in the same manner as net income. Section 202(d).

## F. Apportionment At Beginning And End Of Income Interest.

Section 301 defines when income interests begin and end, including when an asset becomes subject to trust. Section 302 defines the manner in which receipts and disbursements are made if the due date of such receipt or disbursement occurs before the decedent's death, in the case of an estate, or before an income interest begins in the case of a trust. Periodic payments, such as rents, dividends, interest and annuities, or periodic disbursements, such as the interest portion of a mortgage payment, in this case are allocated entirely to principal. The next such payment is allocated without apportionment to income. Nonperiodic payments, those that provide no due date for payment (e.g., interest on an income tax refund), also are allocated to principal to the extent they accrue before death or before the income interest begins, unless the obligation is given specifically to a beneficiary. Comments, section 302.

Finally, Section 303 addresses the apportionment of "undistributed income," that is, income received before the date on which an income interest ends. In general, the income beneficiary who was entitled to the payment, or the estate of that beneficiary if the interest terminates upon death, is entitled to the undistributed income if the interest was a mandatory one, unless the beneficiary had the power to revoke more than five percent of the trust. In this case, the undistributed income attributable to the revocable portion of the trust is added to principal.

## G. Allocation Of Receipts During Trust Administration.

One of the great benefits of the adoption of the UPIA is the number of provisions relating to the specific allocation to either of income or principal of several types of receipts not previously accounted for.

### 1. Character of Receipts from Entities.

In general, Section 401(b) states that "a trustee shall allocate to <u>income</u> money received from an entity." An "entity" is defined as a corporation, partnership, limited liability company, regulated investment company, real estate investment trust (REIT), common trust fund or any other organization in which the trustee has an interest, <u>other than</u> trusts, estates, business activities governed by Section 403 or asset-backed securities governed by Section 415.

There are, however, important exceptions to this general rule. A trustee shall allocate to principal the following receipts from an entity:

- Property other than money;
- Money received in one or more distributions in exchange for part of all of the trustee's interest in the entity;
- Money received in total or partial liquidation of the entity; and

- Money received from an entity that is a regulated investment company or REIT if the money distributed is a capital gain dividend for federal income tax purposes.

Section 401(c). In other words, cash distributions from an entity to a trustee are assumed to be income unless it can be proven that the distribution is a return of principal, either in the form of property other than money, distributions in redemption or liquidation of interests and capital gain distributions.

Under Section 401(d), money is received in partial liquidation either to the extent that the entity indicates that it is a distribution in partial liquidation or if the total amount of money and other property received in one or more distributions is greater than 20% of the entity's gross assets. This 20% test must be indicated on the entity's year-end financial statements immediately preceding initial receipt of property. However, Section 401(e) points out that money is not received in partial liquidation to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money. In other words, "[i]n determining whether a distribution is greater than 20% of the gross assets, the portion of the distribution that does not exceed the amount of income tax that the trustee or beneficiary must pay on the entity's taxable income is ignored." Comments, Section 401.

The Comments to the UPIA also take into account the effects of large distributions. For example, a distribution greater than 10% but not more than 20% of the entity's assets may "have characteristics that suggest it should be treated as principal rather than income." If the entity sold an investment asset or a business asset other than one held for sale to customers in the normal course of business or borrowed a large sum of money, securing it with a loan against principal, or finally had a principal source of cash from an asset like mineral interests, "90% of which would have been allocated to principal if the trust had owned the asset directly," then in this case the trustee "may decide to exercise the power to make an adjustment between income and principal," subject to any limitations in the Act. Id.

Finally, a trustee may rely on the statement of an entity about the source or character of a distribution if the statement is made on or near the date of distribution and is made by the board of directors, or persons with equivalent authority. Section 401(f).

**2. Distributions from Trusts or Estates.**

Distributions from trusts or estates are dealt with in Section 402. Three factors should be considered when allocating such distributions between income or principal: the character of the distribution as defined under the distributing trust, the character of the distribution as it is received by the recipient trust and the definition of the distribution under the UPIA.

These three factors can lead to conflicts (for example, when they direct that the distribution, even though made from the income of the distributing trust or estate, is to be added to the principal of the recipient trust). If the terms of the recipient trust contain a provision requiring such a distribution to be allocated to income, the trustee may have to obtain a judicial resolution of the conflict between the terms of the two documents. Comments, section 402.

Distributions from trusts that are investment entities, such as real estate investment trust (REITs), are characterized either under Section 401, just discussed, or under Section 415, dealing with asset-backed securities.

### 3. <u>Business and Other Activities Conducted by the Trustee</u>.

Some trustees may choose to operate a business as a proprietorship rather than in entity form. Section 403 allows the trustee who accounts separately for a business or other activity to determine the extent to which its net cash receipts must be retained for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity. Section 403(b). The trustee may conduct this separate accounting if the trustee determines that it is in the best interest of all the beneficiaries. If the trustee maintains a separate accounting, the trustee may also determine the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records. The trustee may maintain separate accounting records for these business transactions whether or not those assets are segregated from other trust assets.

The following activities are those for which a trustee may maintain separate accounting records:

- Retail, manufacturing, and service industries;
- Other traditional business activities;
- Farming;
- Raising and selling livestock;
- Managing rental properties;
- Mineral, timber and other natural resource operations; and
- Derivative and option transactions to which Section 414 applies.

Note, however, that this section is not intended "to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of this Act that apply to such securities." Comments, Section 403.

### 4. <u>Principal Receipts</u>.

Under Section 404,the following miscellaneous items are allocated to principal:

- To the extent that not allocated to income under another part of the UPIA, assets received from a transferor (typically by gift), from a decedent's estate, from a trust with a terminating income interest (e.g., where the recipient trust is a remainder beneficiary of the distributing trust), or by the recipient trust as a payer under a contract naming the trust or its trustee as a beneficiary;

- Property, including money, received from the sale, exchange, liquidation or change in form of a principal asset (including realized profit), but subject to the other provisions of Article 4 of the UPIA;

- Money received from third parties in reimbursement for trust distributions relating to environmental matters under Section 502(a)(7);

- Proceeds of property taken by eminent domain is principal, except for separate awards made for the loss of income during an accounting period in which a current income beneficiary had a mandatory income interest, which is allocated to income;

- Net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income is deemed principal; and

- Receipts that are stated specifically in Sections 408 through 415.

**5. Rental Property.**

Receipts from rental property that are not separately accounted for under Section 403 are addressed by Section 405, which provides that the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. However, amounts received as a refundable deposit, including security deposits or deposits to be applied as rent for future periods, must be added to principal and held subject to the terms of the lease. This property is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount. If the trustee is accounting for rental income under this section, a transfer from income to reimburse principal may be appropriate under Section 504 to the extent that some of the "rent" is really a reimbursement for improvements. Comments, Section 405.

**6. Obligation to Pay Money.**

Interest, whether determined at a fixed, variable or floating rate, on an obligation to pay money to the trustee must be allocated to income without any provision for amortization of premium. Section 406(a). "Interest" for purposes of this section, includes amounts received as consideration for prepayment of principal. Note that, even though an obligation's interest rate may change from time to time (e.g., as a result of changes in a market indicator), the obligation is subject to this section and not to Section 414 (dealing with derivatives and options).

There are two exceptions to this general rule. First, amounts received from sale, redemption or other disposition of an obligation are allocated to principal if the sale or disposition occurs more than one year after it is purchased or acquired by the trustee. This includes obligations whose "purchase price or value when *** acquired is less than its value at maturity." Section 406(b). However, if the obligation matures within one year after it is purchased or acquired by the trustee amounts received in excess of its purchase price or value when acquired is allocated to income.

The Comments point out that this first exception applies to all obligations acquired at a discount, "including short-term obligations such as U.S. Treasury Bills, long-term obligations such as U.S. Savings Bonds, zero-coupon bond, and discount bonds that pay interest during part, but not all, of the period before maturity." Comments, Section 406. The entire increase in value of such obligations is principal when the trustee receives the proceeds of sale unless the obligation, when acquired, has a maturity of less than one year. Id. Further, all of the increase in principal of an inflation-indexed bond that is attributable to inflation is attributable to principal unless the obligation matures within one year, in which case it is attributable to income.

The second exception to this general rule carves out obligations to which Sections 409, 410, 411, 412, 414 or 415 apply.

The Comments also point out that, when a trustee is deciding whether to adjust between principal and income, a relevant factor is the effect on the portfolio as a whole of having some portion of the assets invested in bonds that pay no current income. Id.

**7. Insurance and Similar Contracts.**

In general, Section 407 provides that a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or trustee is named as beneficiary, including contracts insuring the trustee against loss for damage to, destruction of or loss of title to a trust asset. The trustee allocates dividends on an insurance policy to income if the premiums on the policy are paid from income and to principal if the premiums are paid from principal. There is an exception to this general rule: proceeds of a contract that insure the trustee against loss of occupancy or other use by an income beneficiary, loss of income or loss of profits from a business are allocated to income. Further, these provisions do not apply to contracts to which Section 409 applies.

**8. Insubstantial Allocations.**

A trustee does not have to make relatively small allocations between principal and income, even though the trustee's right to do so is preserved if an allocation is large in terms of absolute dollars. An allocation is presumed to be insubstantial if either the amount of the allocation would increase or decrease net income in a single accounting period, as determined before the allocation, by less than 10%; or the value of the asset producing the receipt to be allocated is less than 10% of the total value of the trust's assets. In the case of these insubstantial receipts, the entire amount should be allocated to principal. Section 408.

### 9. <u>Deferred Compensation, Annuities and Similar Payments</u>.

Section 409 deals with several different types of payments made over a fixed number of years or during the life of one or more individuals as a result of either services rendered or property transferred in exchange for future payments. It includes payments made in money or property from a payer's general assets or "from a separate fund created by the payer, including a private or commercial annuity, an individual retirement account and a pension, profit-sharing, stock-bonus or stock-ownership plan." Section 409(a). To the extent that such a payment is characterized as interest or a dividend (or a payment made in lieu of an interest or a dividend), it is allocated to income. The balance of the payment is allocated to principal. If no part of a payment is characterized as interest, dividend or an equivalent, and all or part of the payment is required to be made, a trustee allocates to income 10% of the payment required to be made. If no part of the payment is required to be made, or if the payment received is the entire amount to which the trustee is entitled, then the trustee allocates the entire payment to principal.

There are two exceptions to this general rule. First, if a trustee must allocate more of a payment to income than to provided for by this section in order to obtain an estate tax marital deduction for a trust, the trustee shall allocate to income the additional amount necessary to obtain that deduction. Second, this section does not apply to liquidating assets described in Section 410.

This section is an important one, as it applies to IRAs, deferred compensation plans, retirement plans, variable annuities, deferred annuities, annuities issued by commercial insurance companies and "private annuities." Note that IRAs and arrangements with payment provisions similar to IRAs are considered payments no part of which are characterized as interest, dividend or an equivalent, and therefore 10% of any IRA distribution is allocated to income. For example, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation (except to the extent that the Internal Revenue Service may require them to be taken into account for estate tax marital deduction purposes). Comments, Section 409. Note that this 10% allocation to income applies only to payments that are required to be made. This would include payments of "required minimum distributions" under Internal Revenue Code Section 401(a)(9). On the other hand, if the trustee withdrew all of the funds from an IRA such a withdrawal is not required to be made, and therefore the entire withdrawal is allocated to principal. Thus, absent a specific term in the trust agreement, the trustee cannot increase the amount of IRA property that is distributable to an income beneficiary simply by accelerating the rate of withdrawal above the required minimum distribution rate. Instead, the trustee must rely on the ability to make adjustments, described earlier.

A Revenue Ruling[90] with respect to the availability of the estate tax marital deduction when retirement plan assets are held by the trustee of a QTIP trust involves UPIA §409. That ruling addresses three different factual situations involving the potential application of §409 when a "marital trust" (the ruling's term for a QTIP trust) is named as the beneficiary of the decedent's "IRA or other defined contribution plan."

The factual background for each of the three situations is the same: Decedent dies in 2004 at age 68, survived by Spouse. Decedent previously established an IRA, which names as beneficiary a testamentary marital trust (the "Trust") created under Decedent's will. The IRA is invested in productive assets and Spouse has the right to compel the IRA to invest in productive assets. The IRA plan document allows withdrawals from the IRA in excess of the required minimum distribution under IRC §408(a)(6). The executor of the Decedent's estate elects to treat both the IRA and the Trust as QTIP under IRC §2056(b)(7). The Trust provides that all income is payable annually to Spouse for Spouse's lifetime, and no one has the power to appoint property to someone other than Spouse during Spouse's lifetime. Finally, as provided in Rev. Rul. 2000-2,[91] the Spouse has the annual right to compel the trustee to withdraw from the IRA an amount equal to all of the IRA income for that year and distribute it to Spouse.

In Situation 1, the Trust is administered in State X, which has adopted a version of the UPIA that includes a provision similar to UPIA §104(a), allowing for adjustments between income and principal. State X also incorporates a provision similar to UPIA §409(c), under which 10% of an IRA distribution to a trustee is allocated to income and 90% to principal; and a provision similar to UPIA §409(d), under which the trustee is required to allocate to income an additional amount of an IRA distribution necessary to qualify for the estate tax marital deduction. The trustee of the Trust in each year determines the total return of the Trust assets, determines the respective portions of that return that should be allocated to income and principal and then makes that allocation "without regard to, and independent of, the trustee's determination with respect to Trust income and principal."

In Situation 2, the Trust is administered in State Y, the laws of which allow a trustee to convert an "all income" trust to a 4% unitrust, and distribute to the beneficiary 4% of the fair market value of the trust assets in each year, rather than trust income. With the consent of all interested parties, the trustee makes the conversion. In addition, if Spouse exercises the withdrawal power, the trustee withdraws from the IRA the greater of the required minimum distribution or an amount equal to 4% of the value of the IRA assets, and distributes to Spouse at least an amount equal to 4% of that value.

In Situation 3, the Trust is administered in State Z, which has not enacted the UPIA and therefore has provisions similar to UPIA §§104 or 409 (nor, by implication, does it include the power to convert the trust to a 4% unitrust). As a result, in determining the amount that Spouse can compel the trustee to withdraw from the IRA, the trustee looks

[90] Rev. Rul. 2006-26, 2006-22 I.R.B. 939 (5/4/06).
[91] 2000-1 C.B. 305.

only to the State Z principal and income law, and the income of the IRA is separately determined based on IRA assets.

After reviewing the law and regulations under IRC §§643(b) and 2056(b), the IRS ruled as follows. First, with respect to Situation 1, because the trustee is allocating the total return of the Trust under state law in a manner that satisfies the trustee's duty of impartiality, the allocation constitutes a reasonable apportionment of total return under IRC §§643(b) and 2056(b), and therefore the Trust qualifies for QTIP treatment. However (and most importantly), the IRS went on to rule that, depending upon the terms of the Trust, the provisions of UPIA §§409(c) and (d) may have to be considered. The requirement under those sections of an allocation of 10% of the IRA required minimum distribution, standing alone, does <u>not</u> satisfy the requirements of IRC §§643(b) and 2056(b) and therefore the Trust does not qualify for QTIP treatment. Further, the IRS ruled that the provisions of UPIA §409(d), which require an additional allocation to income if it is necessary to qualify for the estate tax marital deduction, was the equivalent of a "savings clause," and was "ineffective to reform an instrument for federal transfer tax purposes."[92] Therefore, the IRS concluded, if the terms of a trust under the facts in Situation 1 do not require the distribution to Spouse of at least the income of the IRA in the event Spouse exercises the right to direct an IRA withdrawal, then that trust will not qualify for QTIP treatment unless the trust agreement overrides the 10%/90% allocation provisions under UPIA §409(c).

The IRS went on to rule that the Trust under Situations 2 and 3 also qualify for QTIP treatment, in both cases because Spouse had the right to compel a distribution from the Trust of at least all of the "income" of the IRA, and that income was determined under either a 4% of fair market value, or (impliedly) under a state law that does not adopt a "savings clause" type approach.

This Revenue Ruling modifies and therefore supersedes Rev. Rul. 2000-2, and its provisions under Situations 1 and 2 will not be applied adversely to taxpayers for taxable years beginning prior to May 30, 2006, "in which the trust was administered pursuant to a state statute" described in IRC §§643(b) and 2056(b), "granting the trustee a power to adjust between income and principal or authorizing a unitrust payment in satisfaction of the income interest of the surviving spouse.

On the one hand, this ruling is consistent with Rev. Rul. 2000-2, and so does not change the way careful drafters always have approached drafting for QTIP trusts that might hold IRAs. On the other and, it is somewhat disturbing for a number of reasons. First, it gives no effect or standing to state law, treating provisions similar to UPIA §409 as "savings clauses," not the law of trust administration in a given state. The IRS position failing to uphold savings clauses in documents already is of questionable validity; extending the logic to a state statute is simply unacceptable. Second, in stating that trustees can rely on the power to adjust or to convert to a unitrust, it ignores the fact that, as previously discussed, not all trustees can avail themselves of that power. For example, if the

[92] *Citing* Rev. Rul. 75-440, 1975-2 C.B. 372.

surviving spouse is the trustee of the QTIP trust as well as the beneficiary (as is often the case), that spouse will not be able to adjust or, under the laws of some states, convert to a unitrust.

**10. <u>Liquidating Assets</u>.**

Under Section 410, a "liquidating asset" is one "whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration." The term includes leaseholds, patents, copyrights, royalty rights and rights to receive payments during a period for more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. Note that it does not include payments under Section 409 (deferred compensation, etc.), Section 411 (natural resources), Section 412 (timber), Section 414 (derivatives and options), Section 415 (asset-backed securities) or for any asset for which the trustee establishes a depreciation reserve under Section 503. A trustee shall allocate to income 10% of the receipts from a liquidating asset and the balance to principal. Interestingly, the reference to rights to receive payments under an arrangement that does not provide for the payment of interest includes state lottery prizes and similar fixed amounts payable over time that are not deferred compensation arrangements. Comments, Section 410.

**11. <u>Minerals, Water and Other Natural Resources</u>.**

Section 411, dealing with mineral, water and other natural resources (other than timber) provides a somewhat complex allocation scheme. As a general rule, 10% of receipts from an interest in minerals or other natural resources is allocated to income and 90% is allocated to principal. However, several payments receive special treatment: (1) nominal delay rentals and nominal annual rent on a lease are allocated to income; (2) production payment receipts are allocated to income to the extent that the agreement creating the production payment provides a factor for interest or its equivalent and the balance is allocated to principal; (3) amounts received as royalty, shut-in-well payments, take-or-pay payments, bonus or delay rental are allocated 10% to income and 90% to principal if the payment is more than nominal. Note that this section applies whether or not a decedent or donor was extracting the resources before the interest became subject to the trust.

There is an exception for trustees that own an interest in natural resources on the effective date of the UPIA. In this case, the trustee may allocate receipts from the interest as provided in the UPIA or in the manner used by the trustee before the effective date of the UPIA. Section 411(d).

**13. <u>Timber</u>.**

Proceeds from timber are addressed under Section 412. To the extent that a trustee accounts for receipts from the sale of timber and related products, the trustee allocates the net receipts as follows: (1) to income to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest; (2) to principal to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber; (3) to or between income and principal if the net receipts are from the lease of timber or from a cutting contract from land owned by the trustee, by determining the amount of timber removed from the land under the lease or contract and applying the first two rules; or (4) to principal to the extent that advance payments, bonuses and other payments are not allocated in the manner just described.

There are three caveats to this general rule. First, in determining net receipts to be allocated, a trustee shall deduct and transfer to principal a reasonable amount for depletion. Second, the Act applies whether or not the decedent or transferor was harvesting timber from the property before it became subject to the trust. Finally, as with natural resources, a trustee who owns the timber interests prior to the effective date of the UPIA may allocate net receipts either in accordance with the UPIA or in accordance with the method the trustee was using prior to the effective date of the UPIA.

The comments provide some additional illumination on this section. It is intended to apply to net receipts from the sale of "trees and byproducts from harvesting and processing trees without regard to the kind of trees that are cut or whether the trees are cut before or after a particular number of years of growth." It applies to the sales of trees that are expected to produce building lumber, trees sold as pulp wood and Christmas or other ornamental trees. This section applies only to the extent that the trustee does not account separately for the net receipts or allocates all of the receipts to principal under the rules previously described. Comments, Section 412.

**14. Unproductive Property.**

Section 413 represents a significant change from prior law. With the exception of property subject to a marital deduction, proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period. However, in the case of property for which a marital deduction is allowed that does not provide the spouse with sufficient income from or use of the trust assets, the spouse may require the trustee to make property productive of income, convert property within a reasonable time or exercise the adjustment power. The decision of which of these to take is in the hands of the trustee.

Previous UPIAs gave to an income beneficiary the right to receive a portion of the proceeds from the sale of underproductive property as "delayed income." This analysis applied on an asset by asset basis and not by taking into consideration the trust portfolio as a whole. This conflicted with the basic precepts of the Prudent Investor Act. Comments, Section 413. To implement the Uniform Prudent Investor Act, the UPIA abolishes the right to receive delayed income from the sale proceeds of an asset that produces no income. Id.

**15. Derivatives and Options.**

Section 414 deals with the difficult concept of "derivatives." The section defines derivatives as "contracts or financial instruments (or a combination of the two) which give the trustee the right or obligation to participate in some or all changes in the price of tangible or intangible assets or groups of assets, or changes in a rate, an index of prices or rates or other market indicator for an asset or group of assets." The section states that, to the extent that the trustee does not allocate receipts from derivatives under Section 403 (dealing with business and other activities conducted by the trustee), the trustee shall allocate to principal receipts from and disbursements made in connection with derivative transactions.

With respect to options, if a trustee grants an option to buy property from the trust whether or not the trustee owns the property when the option is granted, amounts received for granting the option must be allocated to principal. Any amounts paid to acquire options must be paid from principal. Finally, gain or loss realized upon the exercise of an option including an option granted to a settler of the trust for services rendered, also are allocated to principal. Section 414(c).

For further discussion of the definition of derivatives, including gain or loss that occurs as a result of "marking to market," see the Comments, Section 414.

#### 16. Asset-Backed Securities.

Typically, asset-backed securities include arrangements in which debt obligations such as real estate mortgages, credit card receivables and auto loans are acquired by an investment trust and interests in the trusts are sold to investors. The source for payments to the investor is money received from principal and interest payments on the underlying debts. Section 415 deals with these asset-backed securities. The section defines them as assets "whose value is based upon the right they give the owner to receive distributions from the proceeds of financial assets that provide collateral for the security." The term "asset-backed security" also includes an asset that gives the owner the right to receive from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return."

The trustee allocates to income the portion of a payment from these assets "which the payer identifies as being from interest or other current return" and allocates the balance of the payment to principal. If the trustee receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period, then the trustee allocates the payments to principal. On the other hand, if the payment is one of a series of payments that results in the liquidation of the interest in the security over more than one accounting period, then the trustee allocates 10% of the payment to income and the balance to principal.

### H. Allocation Of Disbursements During Trust Administration.

#### 1. Disbursements from Income or Principal.

Article 5, consisting of Sections 501 through 506, sets forth the rules for making disbursements from either principal or income. Under Sections 501 and 502, payments of trustee compensation, as well as investment, advisory or custodial services, are paid half from income and half from principal. The same is true for expenses for accountings, judicial proceedings and other matters involving both the income and remainder interests. On the other hand, all ordinary expenses incurred in connection with the administration of the trust (including interest, ordinary repairs, regularly recurring taxes) are paid solely from income, while disbursements related to environmental matters, estate and inheritance taxes and payments of principal on trust debts are payable from principal.

The Comments discuss environmental expenses at some length; they note that such expenses usually assumed to be "extraordinary in nature" and therefore payable from principal. However, such expenses could be payable from income if the trustee "is carrying on a business that uses or sells toxic substances." In such a case, environmental cleanup costs would be a normal cost of doing business and would be accounted for under Section 403 (dealing with business and other activities conducted by the trustee). Comments, Section 502.

**2. <u>Adjustments for Depreciation and Taxes</u>.**

Section 503 gives the trustee the power to transfer to principal a reasonable amount of cash receipts from a principal asset that is subject to depreciation, with the exception of amounts for depreciation attributable to real property used by a beneficiary as a residence, incurred during the administration of an estate or any other depreciation if the trustee is accounting under Section 403 for the business for which the asset is being used.

Section 504 deals with reimbursements from income to principal for such things as extraordinarily large repairs paid in part from principal capital improvements and disbursements made to prepare property for rental.

Finally, Sections 505 and 506 deal with income taxes, and adjustments to be made between income and principal as a result of payment of those taxes. This includes payment of taxes passed through from an entity, such as a partnership, and adjusting between income and principal for certain elections the fiduciary makes relating to taxes.

## I. <u>Conversion To Unitrust</u>

One of the most significant developments in the area of principal and income acts is not a feature of the UPIA. Several states, including Oregon, Washington and New York, include in their principal and income act statutes the power of a trustee to release the power to make adjustments between principal and income and instead convert the trust to a unitrust. Following such a conversion, the trustee continues to make regular distributions under the terms of the trust; however, all provisions relating to distribution of income are instead construed to refer to an annual unitrust distribution of the fair market value of trust assets. Some states allow a range of percentages (typically between 3% and 5%), while others fix available percentage distribution (typically 4%).

Once the trust has been converted to a unitrust, the trustee typically must invest and manage trust assets under the prudent investor statute of its state. Each state has separate rules for when and over what period trust assets are valued, and how expenses are to be deducted. Further, some states (Oregon and Washington, for instance) provide an ordering structure for distributions: they are deemed to be made first from net income, as that amount would be determined if the trust were not a unitrust, then from short-term capital gains, then from long-term capital gains and finally from trust principal. Note that this creates a sort of "worst in, first out" distribution scheme for the unitrust beneficiary, since the assets with the worst characterization from a tax perspective are deemed to be distributed first. Whether the state in question has adopted this ordering provision can be important for income tax purposes (see below).

### J. Problems with the UPIA

As noted above, the UPIA is intended to correct trusts that provide trust accounting income only to one beneficiary with a remainder interest to another, thus pitting the beneficiaries against each other. However, it also creates several problems. First, it is problematic for trusts that were properly drafted in the first place. For example, assume a trust grants all income to a beneficiary plus as much principal as the trustee deems appropriate for the beneficiary's health, education, maintenance and support (a very common situation). The trustor may want the trustee to rely upon the standards for principal distribution and may not want the trustee to have a reallocation power. Indeed, I would argue that, if a drafter is thoughtful, she will virtually always want to eliminate the power to allocate because she will already have provided instructions elsewhere. Thus, the UPIA becomes yet another paternalistic piece of legislation, like marital deduction savings clauses, anti-lapse statutes and the like, that assume drafters will continue to draft poorly.

Second, the standards for reallocating principal and income seems rather arbitrary, given that the trustee must consider the best interests of all beneficiaries. I don't know of a beneficiary who would agree that not giving her as much property as possible is in her best interest. The trustee is damned if it does and damned if it doesn't. Because it has the power, the income beneficiary will be clamoring for the trustee to use it. The remainder beneficiary will be equally loud in its opposition. The result often will be paralysis and the same kind of beneficiary conflict the trustee was trying to avoid.

Third, because the power is so broad, it limits the number of trustees who can use it in two ways. As noted above, section 104 of the UPIA provides statutory prohibitions on the exercise of the power for certain trustees. Additionally, this broad power has raised concerns about adverse transfer tax consequences. For example, what is the effect of holding this adjustment power on a charitable remainder trust, a trust grandfathered for GST purposes or trusts intended to qualify for the marital deduction? On February 15, 2001, the Service issued proposed regulations to deal with these problems (discussed below); however, these provisions are not yet effective.

I would argue that many (perhaps most) lawyers will want to include language in their instruments disengaging the UPIA powers. This will be particularly true where the trustee already has the power to invade principal pursuant to some kind of standard. The additional power to reallocate income is not necessary and, in the wrong hands, subject to abuse. Having said that, however, the lawyer who takes that step may be open criticism after the client's death by her beneficiaries, who have developed their own idea of what the client wanted. In that case, the lawyer, like the trustee, may be damned if she does and damned if she doesn't.

## IV. <u>Changes to the Income Tax Definition of "Income"</u>.

To keep pace with the changes implemented by the Prudent Investor Act and the UPIA, the Treasury Department issued final regulations, effective January 2 of this year, revising the definition of income under section 643(b) ("Final Regulations"). The Final Regulations also make conforming changes to regulations governing ordinary trusts, pooled income funds, charitable remainder trusts, trusts that qualify for the gift and estate tax marital deduction and trusts that are exempt from the generation-skipping transfer tax ("GST Tax"). This article will provide a brief background on the developments leading up to the Final Regulations and will analyze them in detail.

The Final Regulations began almost three years ago as proposed regulations, issued on February 15, 2001. The preamble to the proposed regulations stated that, using the prudent investor standard for managing trust assets, "under certain economic circumstances, equities, rather than bonds, would constitute a greater portion of the trust assets than they would under traditional investment standards." As a result of this shift in investments, the income beneficiary may be potentially adversely affected. Noting that many states either have made or will make revisions to their definitions of income and principal in order to prevent this problem, the proposed regulations were designed to reflect these state law changes in the income and estate tax areas.[93] Public hearings were held on June 8, 2001, and written comments were received. Finally, on January 2, 2004, the Final Regulations were issued.

### A. <u>Definition of Income</u>.

The Final Regulations rewrite the definition of income. The term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.[94] This definition is unchanged. Further, trust provisions departing fundamentally from "traditional principles of income and principal" generally are not recognized. However (and this is a change),

[93] All descriptions of the proposed regulations come from the preamble, Fed. Reg. Vol. 66, No. 32, p. 10396.
[94] Treas. Reg. § 1.643(b)-1.

“an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation.”[95] This “reasonable apportionment” takes into account the two changes that states recently have made in adopting the UPIA and refinements to it. First, “a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.”[96] Second, a state statute “that permits the trustee to make adjustments between income and principal to fulfill the trustee’s duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust.” In other words, the Final Regulations allow either the adjustment between income or principal contemplated under the UPIA or the conversion to a unitrust enacted by several states.

Note that adjustments between income and principal or conversions to unitrusts, when authorized under state statute, are respected whether the distribution of income is mandatory or discretionary, whether there is one or more beneficiaries and “regardless of which alternate permitted method is actually used.”[97]

The Final Regulations also describe the rules for switching between methods of distributing income. If the trust complies “with all requirements of the state statute for switching methods,” and if the methods are authorized by state statute, then the switch does not constitute “a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust’s grantor or any of the trust’s beneficiaries.” This is a significant development, because many practitioners feared that converting to a unitrust or to a regime in which principal was frequently adjusted to be deemed to be income would result in taxable gain, following a 2002 private ruling from the Service.[98] That ruling dealt with a testamentary trust that was the subject of some controversy among the beneficiaries. To resolve the conflict, the trustee proposed that it would seek a court order modifying the trust so that the current income beneficiary (who was entitled to income, subject to a floor and a ceiling) would become the beneficiary of a 7% unitrust interest. The Service ruled that this modification would result in a realization event under Section 1001 because the properties exchanged were “materially different” under the Supreme Court standard in the Cottage Savings case.[99]

Note, however, that if the methods of distributing income are not specifically authorized by state statute, but are valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event for purposes of section 1001 and may result in taxable gifts, “based on the relevant facts and circumstances.”[100]

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[95] Id.
[96] Id.
[97] Id.
[98] PLR 200231001.
[99] Cottage Savings Association v. Comm’r, 499 U.S. 554 (1991).
[100] Treas. Reg. § 1.643(b)-1.

**Cautionary Note:** Many states, even those that have not adopted the UPIA, have statutes that authorize a modification of trust terms either by judicial or non-judicial settlement. The Final Regulations appear to say that a state that specifically allows a conversion to a unitrust as part of its UPIA provides protection from gain recognition and taxable gifts to its trustees that avail themselves of that statute, while a state that allows for a judicial modification but does not specifically refer to a unitrust conversion cannot provide the same protection. The Background Comments to the Final Regulations state that "an allocation to principal of traditional income items should be respected for Federal tax purposes only if applicable state law has specifically authorized such an allocation in certain limited circumstances, such as when necessary to ensure impartiality regarding a trust investing for total return." Further, "a court order applicable only to the trust before the court would not constitute applicable law for this purpose."[101]

There are two significant changes in the Final Regulations from the proposed regulations. First, the Final Regulations make clear that allocations apportioning the total return of the trust pursuant to state statute will be respected "regardless of whether the trust has one or more income beneficiaries and irrespective of whether income must or may be paid out each year." It was not clear in the proposed regulations the types of trusts to which they applied. Second, the Final Regulations allow for switching between permitted methods as described above, but only methods specifically authorized by state statute.[102]

**Clarification:** The comments to the Final Regulations make clear that the changes to the definition of income under Section 643(b) pass through to the definition of income required to be distributed by Qualified Subchapter S Trusts (QSSTs) under Section 1361. Treasury Regulation § 1.1361-1(j) provides that QSSTs are required to distribute income "as defined in § 1.643(b)-1" therefore no amendment to the QSST regulations is needed in order to apply the new definition of "income."[103]

The comments add one further clarification. It was suggested that a discretionary power to allocate capital gains to income should not have to be exercised "consistently," as the proposed regulations provided. The "IRS and the Treasury Department agree that the power does not have to be exercised consistently, as long as it is exercised reasonably and impartially." However, for trusts that have converted to unitrusts, the exercise of the discretionary power to allocate capital gains to income has no affect on the amount of the distribution, but it does affect "whether the beneficiary or the trust is taxed on the capital gains." Therefore, under those circumstances, "a discretionary power must be exercised consistently."[104]

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[101] TD 9102(January 2, 2004).
[102] Id.
[103] Id.
[104] Id.

**Query:** What is a "consistent" exercise of the power to allocate capital gains to income when a trustee is distributing a unitrust amount annually? One obvious method would be to allocate the same percentage of capital gain to income (an therefore passed through to the income beneficiary) as the percentage of trust property that is distributed as the unitrust amount. However, one could argue equally persuasively that, but for the need to distribute cash to satisfy the unitrust amount distribution, no capital gains would be recognized at all. What is clear under the Final Regulations is that the trustee must determine the method that she thinks makes the most sense and apply it consistently every year.

## B. Capital Gains and Distributable Net Income.

Section 643(a)(3) provides that gains from the sale or exchange of capital assets generally are excluded from distributable net income (or "DNI") to the extent that these gains are allocated to trust principal. However, there is an exception for capital gains that are either paid, credited or required to be distributed to a beneficiary during the year; or paid, permanently set aside or to be used for charitable purposes. In these limited cases, even though the capital gains are allocated to principal they are nevertheless included in DNI. An obvious example is the situation where a trust instrument provides that proceeds from the sale of a specific asset are to be paid to a beneficiary upon sale; in this case, the gain recognized on sale is includable in DNI. Such allocations, however, are fairly rare.

The more common problem involves one of two situations: the trustee has the discretionary power to make distributions of principal, or the trustee is acting under a state that has adopted the UPIA and is either adjusting between principal and income or is distributing a unitrust amount following a statutory conversion. In such cases, the amount distributed does not depend upon how much capital gains is realized during a year and it is difficult to ascertain whether proceeds from sale are actually paid to a beneficiary.

The Final Regulations amend Treas. Reg. § 1.643(a)-3 as follows. First, the general rule is that "gains from the sale or exchange of capital assets are ordinarily excluded from [DNI] and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary."[105] There are, however, two exceptions to this general rule. The first, dealing with income of foreign trusts under Treas. Reg. § 1.643(a)-6 is unchanged from prior law. The second exception, added in new subparagraph (b), provides that gains "from the sale or exchange of capital assets are included in [DNI] to the extent they are, pursuant to the terms of the governing instrument and applicable law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by local law)" in any of the three circumstances:

[105] Treas. Reg. § 1.643(a)-3(a).

- First, if they are allocated to income, with the proviso that if income under the state statute is defined as or consists of a unitrust amount, the discretionary power to allocate gains to income is exercised consistently and the amount so allocated is not greater than the excess of the unitrust amount over the amount of DNI determined without regard to this subparagraph (b).

- Second, if the gain is allocated to principal but treated consistently by the fiduciary on the books, records and tax returns as part of a distribution to a beneficiary.

- Third, if the gain is allocated to principal but actually distributed to the beneficiary or used by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.[106]

The new regulation also provides examples of the applicability of these provisions. In the first example, the Beneficiary has the right to all income and the trustee has the discretionary power to invade principal for the Beneficiary's benefit and to deem discretionary distributions to be made from capital gains realized during the year. If, during a given year the trustee has $10,000 of capital gain from the sale of securities, the trustee distributes $12,000 to the Beneficiary pursuant to the discretionary principal distribution power and the trustee does not exercise the discretionary power to deem that distribution as being paid from realized capital gains, then the gains are not included in DNI. Instead, the $10,000 of capital gain is taxed to the trustee at trust rates. More importantly, in the future the trustee must treat all discretionary distributions as not being made from any realized capital gains. This is part of the "consistency" requirements under the Final Regulations.[107]

The requirement of consistency is made even clearer by the next example. Here, the facts are the same as in Example 1, except that the trustee intends to follow a regular practice "of treating discretionary distributions of principal as being paid first from any net capital gains realized by [the trustee] during the year." As evidence of this intention, the trustee includes the $10,000 capital gain in DNI on the trust's federal income tax return so that it is taxed to the Beneficiary. The example goes on to point out that in future years, the trustee "must treat all discretionary distributions as being made first from any realized capital gains."[108] Example 3 provides a refinement of Example 2, where the trustee intends to follow a practice of treating discretionary principal distributions as being paid from gains realized from the sale only of certain specified assets or a particular class of investments. Example 3 makes clear that such treatment is a "reasonable exercise of Trustee's discretion."

Examples 4 and 5 provide less likely alternatives. If the governing instrument, in a provision not prohibited by local law, allocates to income capital gains realized by the trustee, then those capital gains are includable in DNI for the taxable year. Further, if the

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[106] Treas. Reg. § 1.643(a)-3(b).
[107] Treas. Reg. § 1.643(a)-3(e) Ex. 1.
[108] Treas. Reg. § 1.643(a)-3(e) Ex. 2.

trustee decides that discretionary distributions are to be made only to the extent the trustee has realized capital gains during the year, then following Example 1, only $10,000, and not $12,000 would be distributable to the beneficiary in that year and all $10,000 is includable in DNI for that year.[109] Example 6 provides an unremarkable example of the treatment of proceeds of sale of real property where the proceeds are directed to be distributed to a specific beneficiary. Examples 7 through 10 all deal with different circumstances upon the termination of a trust upon the beneficiary reaching a given age. Examples 9 and 10 are interesting because they address tax treatment for trusts that distribute half the corpus at one age and half at another.[110]

Examples 11 through 13 deal with distributions after the trustee has elected to pay an income beneficiary a unitrust amount. If, in this circumstance, state statute provides that the unitrust amount is considered paid first from ordinary and tax exempt income then from net short-term capital gain, third from net long-term capital gain and finally as a return of principal, and if the trust agreement follows state statute then capital gains are allocate in accordance with the ordering rule and are includable in DNI to that extent.[111] If there are no ordering rules for the character of distribution, either in state statute or in the governing instrument, but rather such decisions are in the discretion of the trustee, and if the trustee intends to "follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax exempt income then all capital gain is allocated to the trust and none is includable in DNI." Again, in future years the trustee "must consistently follow this treatment of not allocating realized capital gains to income."[112] On the other hand, if under the same circumstances the trustee intends to "follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent that unitrust amount exceeds the trust's ordinary and tax-exempt income and the trustee evidences this intent by including capital gain as DNI on the trust's income tax return then such a decision is a 'reasonable exercise of Trustee's discretion,'" and in future years, the trustee must "consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent the unitrust amount exceeds ordinary and tax-exempt income."[113] Finally, if a trustee (probably a corporate trustee) is acting as trustee of many different trusts, over which the trustee has elected to distribute to the income beneficiary a unitrust amount, and neither state statute nor any of the governing instruments of the trusts provide for an ordering rule, then the trustee may follow a regular practice of treating distributions from some trusts as coming from capital gain to the extent the unitrust amount exceeds ordinary income while treating other trusts as though distributions are made from principal but not capital gains to the same extent, provided that the trustee treats each trust consistently in all subsequent years.[114]

> **Drafting Tip:** Drafting attorneys may want to consider including ordering provisions as part of their boilerplate in all of their trust agreements if the state in

[109] Treas. Reg. § 1.643(a)-3(e) Ex.s 4 & 5.
[110] Treas. Reg. § 1.643(a)-3(e) Ex.s 6-10.
[111] Treas. Reg. § 1.643(a)-3(e) Ex. 11.
[112] Treas. Reg. § 1.643(a)-3(e) Ex. 12.
[113] Treas. Reg. § 1.643(a)-3(e) Ex. 13.
[114] Treas. Reg. § 1.643(a)-3(3) Ex. 14.

which they practice has no ordering statute. Alternatively, if such an approach is too restrictive, then the drafting attorney should consider including language that specifically puts these decisions in the trustee's discretion and that further requires consistency of treatment after the first year's decision of such treatment.

**Practice Tip:** Trustees who exercise discretion in deciding whether to allocate capital gains to income either as part of their power to adjust between income and principal under state statute or following a conversion to a unitrust, must do so "consistently," and must provide evidence of this consistent treatment. However, the regulation examples show only federal income tax reporting as evidence of the trustee's intent. A trustee may wish to go farther and make a specific statement at the outset of the trust's administration of the manner in which the trustee intends to treat capital gains. Such a statement could be mailed to the beneficiaries (and indeed probably should be).

There is little change in these provisions between the proposed regulations and the Final Regulations, other than providing greater clarification in the examples.

## C. Trusts Qualifying for the Marital Deduction.

The Final Regulations amend the regulations governing marital deduction treatment for transfers to trust in both the gift and estate tax contexts. The new rule is that a spouse will be treated as entitled to receiving all net income from a trust, as required for the trust to qualify for the gift and estate tax marital deductions under § 20.2056(b)-5(a)(1) and § 25.2523(e)-1(f)(1), if the trust is administered under applicable state law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1 (described above). Further, the QTIP election requirements under Treas. Reg. § 20.2056(b)-7 now states that a power under applicable local law permitting the trustee to adjust between income and principal that fulfills the trustee's duty of impartiality and that meets the requirements of § 1.643(b)-1 "will not be considered a power to appoint trust property to a person other than the surviving spouse."[115] As a result of these changes, a spouse who, as the income beneficiary, is entitled to a unitrust amount between 3% and 5% is deemed to be entitled to all the income for purposes of qualifying the trust for the estate and gift tax marital deduction. Finally, these marital deduction rules are applied to qualified domestic trusts, or "QDOTs," under § 2056A.[116]

## D. GST Tax Exempt Trusts.

In general, the GST Tax does not apply to any distribution from a trust that was irrevocable on September 25, 1985.[117] Such trusts are referred to as "grandfathered" trusts. These provisions allow older trusts, created before the enactment of the GST Tax,

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[115] Treas. Reg. § 20.2056(b)-7(d)(1).
[116] Treas. Reg. § 20.2056A-5(c)(2).
[117] Treas. Reg. § 26.2601-1(b).

to make distributions to people two generations or more below the original transferor without the imposition of the tax. As a result, it is often critical to maintain the "grandfathered" status of such trusts. Many practitioners were concerned that, by changing a grandfathered trust that distributed all income to a beneficiary to a unitrust under the state statute, or by adjusting between income and principal for such a trust, the trust would lose its grandfathered status.

The Final Regulations make clear that "administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality will not be considered to shift a beneficial interest in the trust" and therefore eliminate the trust's grandfathered status. This exception applies only "if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1."[118] The Final Regulations go on to provide two examples of conversions of income interests for grandfathered trusts.[119] The Final Regulations changed these examples to clarify that changing situs of the trust in order to permit unitrust conversion or income adjustments also will not affect grandfathered status.

## E. Charitable Remainder Trusts.

The Final Regulations affect only charitable remainder unitrusts that make distributions partially by reference to "income." These trusts include Net Income Charitable Remainder Unitrusts (so-called "NICRUTs") and Net-Income-With-Makeup Unitrusts (or "NIMCRUTs"). They do not affect charitable remainder annuity trusts or charitable remainder unitrusts that pay only a unitrust interest.

The Final Regulations provide that, although trust income generally means income as defined under § 643(b), "trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law."[120] Further, gains from the sale of assets contributed to the trust by the donor must be allocated to principal and not to trust income "at least to the extent of the fair market value of those assets on the date of their contribution to the trust." In addition, capital gains may not be allocated to trust income "at least to the extent of the trust's purchase price of those assets." With those two exceptions, capital gains from assets contributed to the trust by the donor or purchased by the trust may be allocated to income, "pursuant to the terms of the governing instrument, if not prohibited by applicable local law." Further, the trustee's discretionary power to make this allocation is acceptable, "but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially."[121]

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[118] Treas. Reg. § 26.2601-1(b)(4)(D)(2).
[119] Treas. Reg. § 26.2601(b)(4)(i)(E), Ex.s 11 & 12.
[120] Treas. Reg. § 1.664-3(a)(1)(i)(b)(3).
[121] Id.

These changes are reasonable and not particularly controversial.

## F. **<u>Pooled Income Funds</u>.**

The Final Regulations alter the definition of income for pooled income funds. In general, the term "income" has the same meaning as it does under Section 643(b) and the regulations thereunder. However, the Final Regulations amend Treas. Reg. § 1.642(c)-2(c) to provide that no amount of "net long-term capital gain shall be considered permanently set aside for charitable purposes if, under the terms of the fund's governing instrument and applicable local law the trustee has the power, whether or not exercised, to satisfy the income beneficiaries' right to income by the payment of either: an amount equal to a fixed percentage of the fair market value of the fund's assets (whether determined annually or averaged on a multiple year basis); or any amount that takes into account unrealized appreciation in the value of the fund's assets." In other words, the charitable deduction for a contribution of long-term capital gain is unavailable if the income beneficiary's right to income may be satisfied either as a unitrust amount or by adjusting between income and principal.

If state law allows a unitrust definition of income for pooled income funds that would disqualify a contribution to a pooled income fund from receiving the charitable deduction, the fund has until September 2, 2004 to reform the fund's governing instrument.

## G. **<u>Effective Dates</u>.**

The Final Regulations, in general, become effective for taxable years of trusts and estates ending after January 2, 2004. Further, taxpayers may rely on the provisions of the Final Regulations for any taxable years in which a trust or estate is governed by a state statute authorizing a unitrust payment in satisfaction of the income interest of the income beneficiaries or granting the trustee a power to adjust between income and principal. The effective date with respect to charitable remainder trusts and pooled income funds, however, allow some grandfathering: the charitable remainder trust provisions that prohibits a trustee's discretionary power to allocate capital gains to income, when that discretion is granted only by the governing instrument and not by applicable state statute, applies to trusts created after January 2, 2004. With respect to pooled income funds, although the provision under which net long-term capital gains fail to qualify for the charitable deduction if income beneficiaries may receive a unitrust amount is applicable to taxable years for funds beginning after January 2, 2004, the fund's governing instrument may be amended or reformed to eliminate this possibility so long as income has not already been determined in that manner. A judicial proceeding to reform the governing instrument must be commenced by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in this manner.[122]

[122] TD 9102, January 2, 2004.

## H. **Summary and Conclusions.**

The Final Regulations represent one of the most important trust and estate income tax innovations in recent years. They create several important opportunities for estate planners. First, they complete the chain of legislation that began with the Restatement and the Prudent Investor Act. Trustees can finally invest for total return without harming an income beneficiary because the trustee can either adjust income and principal or convert to a unitrust under the UPIA without fear of generating Section 1001 gain under the rationale in PLR 200231011 and the Cottage Savings case, disqualifying a trust for marital deduction treatment or sacrificing a trust's "grandfathered" status for GST purposes.

Second, and perhaps as importantly, attorneys can now draft marital deduction trusts as unitrusts, so long as the unitrust amount to the spouse is between 3% and 5% (or the percentage mandated by state statute) and there is a state statute that allows such a provision. Using sophisticated wealth forecasting, at least one investment house has developed an analysis of total return trusts that is helpful.[123] They begin with the premise that asset allocation and distribution policy should be considered together when drafting and later administering a total return trust. The Bernstein study notes that different distribution policies and asset allocations can shift risk from one beneficiary to another. For example, if a spouse is given the greater of all trust income or $400,000 from a $10 million marital trust (thus ensuring that the spouse will have a reliable source of distributions) and if the trust is invested 80% in stocks and 20% in bonds, the range of potential values to the remainder beneficiaries is anywhere from $1.6 million to $34.5 million after thirty years. There is a 90% probability of the assets falling within that range at that time.

Faced with that disparity, the trustor could create a trust that distributes the greater of a 4% unitrust amount or all income, with the same asset allocation. After thirty years the range of potential values to the children would have closed to a high of $23.9 million down to a low of $5.6 million. In exchange for this more closely defined value range, the spouse has slightly more risk of fluctuation; under the first scenario her range was between $9.3 million and $10.8 million (fairly well defined) while with the second scenario her range changes from between $7.3 million and $18.6 million. She receives more potential upside but with slightly increased downside risk.[124] The importance of this study is not to advocate for any one type of method, but rather to demonstrate the

[123] Bernstein Wealth Management Research, Managing Trusts: Better Decisions in an Uncertain World (2003).

[124] The study goes on to suggest that perhaps the most equitable technique to balance the values of the income and remainder beneficiaries is to give the income beneficiary a 4% unitrust interest, but that has a floor of 80% of the initial distribution and a ceiling of 120%. This approach would protect the income during bear markets and excess distributions during bull markets. The study cautions, however, that "finding the unitrust percentage and the level of the floor and ceiling that best meets the unique needs of each trust requires careful planning." Further, there are trade-offs in this scenario: by adding a floor, the trustor increases the downside risk to the remainder beneficiaries, while a ceiling provides greater upside potential to the reminder beneficiaries than to the income beneficiary. The "floor and ceiling" technique may very well cause problems with marital deduction qualification, even under the Final Regulations, because it could cause the percentage distribution to fall outside the authorized 3-5% range.

complexity of the analysis that is needed when using a total return trust. As a result of the Final Regulations, such analysis can now be applied.

Third, they clarify the income tax treatments of capital gains as between trustees and beneficiaries when these income adjustment and unitrust conversion statutes are used. This is also an important development, and can, in some circumstances, allow for planning in the drafting stage.

Finally, they may hasten the pace of adoption of the Prudent Investor Act and the UPIA by states that to date have not done so by allowing trustees to move trusts into jurisdictions that have such legislation.

## V. <u>The Total Return Trust</u>.

### A. <u>Reasons for the Total Return Trust (or Unitrust)</u>.

As mentioned above, the income only trust creates several problems, which the UPIA is designed to fix. To avoid these problems at the drafting phase, however, several commentators have suggested a new approach to trust drafting that allows the trustee to invest on a total return basis, rather than emphasizing income producing investments. Under this approach, the current beneficiary receives an annual percentage or annuity interest in the value of the trust property rather than an interest in trust accounting income and principal. Such trusts are often referred to as "total return trusts."

The distribution provisions for current beneficiaries under a total return trust can be drafted in several different ways. Perhaps the most common is to create a "unitrust," with distribution provisions similar to those of a charitable remainder trust; that is, the current beneficiary receives annually a percentage of the trust property valued at the beginning of that year. As the value of the trust property changes from year to year, so does the amount of property distributed to the current beneficiary. One of the chief drawbacks of such a trust is that the current beneficiary is exposed to potentially significant swings in the amount of her annual distributions. This risk can be reduced if the annual distribution is based on a percentage of the average value of the trust property over the previous five years. Alternatively, the trust could provide that the current beneficiary receives an annuity that is indexed for inflation at regular intervals. This latter approach allows the trustor to decide how much money in current dollars the beneficiary should have each year.

Regardless of the method chosen, the total return trust is superior to the income only trust in several respects. First, and most importantly, the total return trust allows the trustee to invest under the Prudent Investor Act in a manner most likely to achieve the purposes of the trust, without worrying about the characterization of trust property. As a result, the conflict between the current beneficiary and the remainder beneficiaries is eliminated: If the current beneficiary receives a fixed percentage value of the trust, then both the current beneficiary and remainder beneficiaries gain from an investment policy that encourages overall growth, rather than the mere production of income. Second, the total return trust allows the trustor to be more specific in the property rights conferred on the current beneficiary. The beneficiary is not subject to a potential loss of income due to current interest rates or changes in investments if she receives a percentage of the trust property averaged over five years or an inflation-indexed annuity.

As an additional refinement to the total return trust, at least one commentator[125] has suggested that, rather than making the annual unitrust payment occur automatically, the current beneficiary should have an annual right to withdraw trust property each year in an amount not to exceed 5% of the trust property for that year. In this way, the current beneficiary presumably will only take as much trust property as she needs. Further, assuming that the power is limited to the lesser of the 5% or $5,000 in any one year, the beneficiary will not have the trust property includable in the beneficiary's estate except to the extent of the withdrawal right for the year in which the beneficiary dies under Code § 2041. This flexibility is available without having to trust the trustee with the power to make the distribution.

Using sophisticated wealth forecasting, one investment house has developed an analysis of total return trusts that is helpful.[126] They being with the premise that asset allocation and distribution policy should be considered together when drafting and later administering a total return trust. The Bernstein study notes that different distribution policies and asset allocations can shift risk from one beneficiary to another. For example, if a spouse is given the greater of all trust income or $400,000 from a $10 million marital trust (thus ensuring that the spouse will have a reliable source of distributions) and if the trust is invested 80% in stocks and 20% in bonds, the range of potential values to the remainder beneficiaries is anywhere from $1.6 million to $34.5 million after thirty years. There is a 90% probability of the assets falling within that range at that time.

Faced with that disparity, the trustor could create a trust that distributes the greater of a 4% unitrust amount or all income, with the same asset allocation. After thirty years the range of potential values to the children would have closed to a high of $23.9 million down to a low of $5.6 million. In exchange for this more closely defined value range, the spouse has slightly more risk of fluctuation; under the first scenario her range was between $9.3 million and $10.8 million (fairly well defined) while with the second scenario her range changes from between $7.3 million and $18.6 million. She receives more potential upside but with slightly increased downside risk.

The study goes on to suggest that perhaps the most equitable technique to balance the values of the income and remainder beneficiaries is to give the income beneficiary a 4% unitrust interest, but that has a floor of 80% of the initial distribution and a ceiling of 120%. This approach would protect the income during bear markets and excess distributions during bull markets. The study cautions, however, that "finding the unitrust percentage and the level of the floor and ceiling that best meets the unique needs of each trust requires careful planning." Further, there are trade-offs in this scenario: by adding a

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[125] Horn, fn. 2.

[126] Bernstein Wealth Management Research, <u>Managing Trusts: Better Decisions in an Uncertain World</u> (2003).

floor, the trustor increases the downside risk to the remainder beneficiaries, while a ceiling provides greater upside potential to the reminder beneficiaries than to the income beneficiary. The importance of this study is not to advocate for any one type of method, but rather to demonstrate the complexity of the analysis that's needed when using a total return trust.

### B. Problems with the Total Return Trust

Clients create trusts, for the most part, with real human beings in mind, and for a particular purpose: to educate, to support, to provide creditor protection. Promoters of total return trusts are right to point out that income only trusts are short sighted and inadequate. However, the total return trust tries to solve the problem without reference to the goals the client seeks, replacing one arbitrary standard with another. I have yet to have the client come into my office that asks that their spouse or child be given a unitrust interest on the client's death (unless, of course, the idea was already sold to them by another estate planner). Unitrust interests simply do not track any human need.

Total return trusts are useful for maximizing distributions to the current beneficiary without eroding principal to inflation. Such a trust is designed by using several assumptions: the anticipated trust investments, the expected return from those investments and the expected rate of inflation. The unitrust amount will be the expected return less the rate of inflation. Studies that have addressed the issue have put that unitrust amount at about 3 - 4%, assuming investment 100% in equities, not debt instruments.[127] Indeed, distributions of even 5% will, over time, erode the buying power of the remainder interest to inflation even if the trustee maintains an all equities portfolio.[128] This approach works best with current beneficiaries who are not relying on the trust property for their support, or when trust assets are large enough that a small annual percentage distribution will still greatly exceed the current beneficiary's needs. Even in this case, though, the total return trust can be problematic, because there is always the chance that, due to a significant change in trust asset values, the unitrust interest will be too large or too small.

Further, I doubt that the drafters of total return trusts are maintaining this lower level of distribution to avoid erosion of the remainder interest to inflation. Instead, I suspect that many drafters are starting with 5% as a baseline, if for no other reason than that they are used to doing so in the context of charitable remainder trusts (which of course require a minimum distribution of 5%).

## VI. Some Modest Alternatives.

To begin with, as all of the doctrines described in this article show, trust drafting has become a much more thoughtful process (as indeed it should always have been). The drafter must take into account the purpose of the trust, the assets to be transferred to it and the amount of discretion a trustee is to have when determining to make or withhold

[127] See, e.g., Hoisington, fn. 2, at 6-18 (citing several studies).
[128] Id.

distributions to a beneficiary. The drafter who does not consider these factors will suddenly find herself with statutory default provisions drafted for her. Further, in my experience at least, clients are becoming much more concerned about the way trusts are drafted, particularly trusts for younger children. This heightened awareness to trust drafting has two aspects: first, how should the drafter deal with the new legislation described in this article; and, second, what additional provisions should a drafter consider not contained in that legislation.

## A. <u>Drafting For (and Around) the Current Legislation</u>.

This article has identified several potential problems with the recent legislation. These problems can be circumvented in many cases by drafting. First, in my view, the Prudent Investor Act ought not to be simply followed in most cases. For example, closely held family businesses are assets that trustors would almost always like to have maintained as trust assets into the future. However, holding such a business as the primary asset of a trust could easily be deemed to violate the Prudent Investor Act either because it is a riskier investment than many or because it prevents diversification. Therefore, trust agreements should almost always include a provision allowing the trustee to hold an interest in a closely held family business regardless of the Prudent Investor Act. Second, large houses or vacation homes can constitute a significant trust asset that also should not be required to be sold because of diversification. This is especially true for credit shelter and QTIP trusts for the benefit of a surviving spouse. The trust agreement also should contain a provision allowing the trustee to maintain a residence or vacation home for a surviving spouse with no duty to diversify.

Next, a statement from the trustor as to the primary purpose of a trust also will help to establish investment priorities. For example, a trust that is supposed to last for a minor child only until he or she reaches age 35 should be invested taking into consideration only the interests of that child. This seems self-evident, since the child actuarially will survive age 35, but a statement confirming that priority is helpful. More importantly, a trust that is created for multiple generations and to which GST exemption has been allocated should include a statement regarding the trust's purpose and which generation, if any, is to be the primary beneficiary of this trust.

Finally, the UPIA should be addressed. Paradoxically, a properly drafted trust, with thoughtful distribution provisions and a clear statement of intent, should not need a provision allowing the trustee to allocate between principal and income. Indeed, such an additional power probably will be unwanted. This is particularly true where a beneficiary is given the right to income only to ensure that income is not trapped at the trust level, and whose primary source of distributions should come from discretionary distributions of principal.

## B. <u>Some Alternative Approaches</u>.

So if neither income only trusts nor total return trusts are workable solutions, what's a poor drafter to do? As a starting point, we should not overlook the hoary old "net-income-plus-principal-for-ascertainable-standards" approach. Under this trust, the current beneficiary is entitled to all of the net income, plus as much of the principal as the beneficiary needs for health, education, maintenance or support. This approach has drawn criticism recently because trustees are often hesitant to use the principal invasion power, rendering the trust effectively as an income only trust. This criticism has some merit, although the whole point of having an ascertainable standard is that it is one that can be enforced by a court, so a trustee who is unwilling to make principal distributions can be sued or removed. However, a more constructive approach is to add precatory statements from the trustor, indicating how the principal invasion power is to be exercised. Such statements might include the following:

- "I have created this trust for the sole purpose of maintaining trust property until the person for whom this trust is created is capable of managing such property, and intend that this trust be administered for the sole benefit of such person. In keeping with this intent, the trustee shall not consider the interests of any beneficiary other than such person when making investment or distribution decisions." This type of language is helpful in trusts that last until the beneficiary reaches a certain age.

- Exculpation language that relieves the trustee from liability for making principal distributions.

- Allowing the trustee to buy and hold as a trust asset a residence for the beneficiary and to allow the beneficiary to live there rent-free as part of the support distribution. This would also require modifying the effects of the Prudent Investor Act to allow the trustee to hold the residence regardless of its proportionate value to the rest of the trust assets.

- Adding a level of specificity to the meaning of the ascertainable standard. For example, "health" could be defined to include payments of medical insurance. Care must be taken, however, not to make the ascertainable standard overly broad to the point that it becomes unascertainable, possibly creating a general power of appointment under Code §2041.

Guidance of this kind can go a long way in ensuring that the principal invasion power is used in the manner the trustor intended.

A variation on this theme is to create a total return trust with a relatively small percentage distribution (say 2-3%), coupled with principal invasion provisions of the type described above. Indeed, this approach is advocated by the promoters of total return trusts.[129] This change from the income only approach could be somewhat helpful, but I would argue that, in either case, the principal invasion feature is the most significant and that choosing between income and a unitrust amount is of little importance. The key, of

[129] See, e.g., Hoisington, fn. 2, at 6-14 ("The answer to this inherent 'problem' is to lower the fixed percentage of the unitrust amount and to provide the trustee with the power to invade principal for support . . .").

course, is convincing the trustee to make principal distributions. Again, the type of language mentioned above is critical.

A completely different approach, and one that is becoming increasingly popular with my clients, is to view trust administration in stages, corresponding with stages in the beneficiary's life. This is particularly true for trusts for minor children that will terminate upon the child's reaching a certain age. Such a trust might have the following features:

- Until age 18, the child can have income and principal for her health, education maintenance and support. Additionally, distributions can be made to the guardian to help with housing costs.

- From age 18 to age 25, the child can have as much income and principal as she needs for her education and health. Additionally, she can have support distributions, but only if she is enrolled at least ¾ time in school.

- After age 25 and until the termination of the trust, the child can have as much income and principal as she needs for education and health, but not support. Additionally, the trustee automatically distributes a fixed dollar amount, adjusted for inflation, to help supplement her income. This amount is not big enough to allow the child not to work, but is enough to make life easier for her. Finally, the trustee has the power to purchase a home and hold it as a trust asset, or to invest in any business the child establishes.

This type of trust is designed for the parent who wants to see that her child is educated, but is concerned that too easy access to trust property will drain the child's initiative. Variations, of course, are endless, depending upon the purpose to be served by the trust. The point is not whether these particular provisions are effective as a "default," but whether they are designed with both the specificity and the flexibility necessary to accomplish the trustor's objectives.

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