

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: The Power to Adjust and Total-Return Unitrust Statutes: State Developments and Tax Considerations

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PANEL: Total Return Trusts - Investment and Administration Issues

DATE: 10/20/06

COMMITTEE: Wealth and Non-Tax Estate Planning Considerations PT

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2006 JOINT FALL CLE MEETING

THE POWER TO ADJUST AND TOTAL-RETURN UNITRUST STATUTES: STATE DEVELOPMENTS AND TAX CONSIDERATIONS

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October 20, 2006

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THE POWER TO ADJUST AND TOTAL-RETURN UNITRUST STATUTES: STATE DEVELOPMENTS AND TAX CONSIDERATIONS

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I. INTRODUCTION

A. Background

The final years of the twentieth century brought many new concepts to trust law. In this paper, I will cover two of these concepts—the power to adjust receipts and disbursements between principal and income under § 104 of the 1997 Uniform Principal and Income Act (“UPAIA”) which I will refer to as the “power to adjust,” and the total-return unitrust statute.¹

B. Prudent-Investor Rule

Most U.S. jurisdictions now follow some version of the 1994 Uniform Prudent Investor Act (“UPIA”),² which includes the following components:

1. In managing investments, a trustee must invest as a prudent person would in the circumstances;³

¹ See Robert B. Wolf, Total Return Trusts—A Decade of Progress, But Are We There Yet? (Parts 1 & 2 of 4), 32 ACTEC J. 5 (Summer 2006); Byrle M. Abbin, Interaction of Total Return Trusts and the Definition of Income Regs., 32 Est. Plan. 3 (Aug. 2005); Von E. Sanborn & Stephen Liss, Defining Trust Income, 144 Tr. & Est. 24 (May 2005); Louis A. Mezzullo, Final Regulations on the Definition of Fiduciary Income, 19 Prob. & Prop. 26 (Mar./Apr. 2005); Laurence J. Kline & Karl R. Anderson, Using Total Return Trusts, 144 Tr. & Est. 30 (Feb. 2005); Laura Howell-Smith, Using a Unitrust or a Power to Adjust Under the Section 643 Regs., 31 Est. Plan. 496 (Oct. 2004); Jonathan G. Blattmachr & Mitchell M. Gans, The Final ‘Income’ Regulations: Their Meaning and Importance, 103 Tax Notes 891 (May 17, 2004). I would like to thank John A. Terrill, II, Lois Eisner Murphy, and Thomas O. Hiscott of Heckscher, Teillon, Terrill & Sager, W. Conshohocken, Pennsylvania, for their help in developing the original content of this paper.

² The text of the UPIA is available at www.law.upenn.edu/bll/ulc/fnact99/1990s/upia94.htm (last visited Sept. 12, 2006). To determine which jurisdictions have adopted the UPIA, go to www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-upria.asp (last visited Sept. 12, 2006). See generally Christopher P. Cline, Do Trustees Have an Absolute Duty to Diversity?, 31 Tax Mgmt., Est., Gifts & Tr. J. 140 (May 11, 2006). For a discussion of the impact of different portfolios on the investment performance of trusts, see Sharon L. Klein, New Dilemmas, 145 Tr. & Est. 42 (Mar. 2006).

³ UPIA § 2(a) (1994).

2. A trustee may acquire any type of investment, and each investment is considered as part of an overall investment strategy;⁴
3. The propriety of a particular investment is assessed on what the trustee knew or should have known when it made the investment, and any determination of liability must consider the performance of the whole portfolio not just the particular investment;⁵ and
4. The governing instrument may expand or restrict the trustee's investment responsibilities.⁶

II. THE POWER TO ADJUST AND TOTAL-RETURN UNITRUST STATUTES

A. Introduction

1. Background

For generations, lawyers drafted trusts that direct the trustee to distribute the income (e.g., interest and dividends) to a beneficiary for a specified period of time, normally the life of that beneficiary. Often, the trustee has a discretionary power (which usually requires it to assess the current beneficiary's needs) to distribute principal to that beneficiary. At the current beneficiary's death, the remaining principal (which usually includes capital gains incurred during the trust's administration) will go to, or continue in trust for, a beneficiary or group of beneficiaries.

Traditionally, trustees invested trust assets to produce enough income to meet the current beneficiary's needs. At one extreme, a trustee might invest all trust assets in stocks that pay no dividends and thereby generate no current income. At the other extreme, a trustee might invest all trust assets in junk bonds and thereby generate as much as 9% interest income. Trustees understand that these extremes might accomplish income goals but create unacceptable investment risk. A trustee's task is rendered more difficult by its obligation to preserve or grow principal for the remainder beneficiaries as well as to produce income for the current beneficiary. Consequently, trustees select a mix of investments to provide satisfactory income flow and an opportunity for principal growth.

Since 1986, most U.S. jurisdictions have replaced the prudent-man rule with the prudent-investor rule for assessing a trustee's investment performance. Under the latter standard, the trustee's performance is measured on the

⁴ Id. §§ 2(e), 2(b).

⁵ Id. §§ 8, 2(b).

⁶ Id. § 1(b).

whole portfolio rather than on the asset-by-asset basis of the prudent-person rule. The prudent-investor rule compels trustees to invest trust assets for total return. Here, the goal is to maximize the sum of income and growth irrespective of income yield, which requires a heavier emphasis on stocks and a lighter emphasis on fixed-income investments than in the past.

2. The Problem

In recent years, current beneficiaries of irrevocable trusts have seen their distributions decrease for two reasons. First, trustees have been investing more heavily in equities, and equities normally provide less current income than fixed-income investments. Second, the interest provided by fixed-income investments and the dividends provided by stocks have been falling. Indeed, some widely held stocks, including 20% of the stocks in the S&P 500, pay no dividend at all.

Thus, in 1980, a \$1 million trust that was invested 50% in long-term government bonds and 50% in S&P 500 stocks would have produced \$78,500 of gross income, but, in 2005, the same trust would have produced only \$32,600 of such income. The gross income of the \$1 million trust would have been 58.5% lower in 2005 than in 1980.

In more and more situations, current beneficiaries “demand” that trustees increase their distributions.

3. Scope

In the rest of this paper, I will cover traditional ways to address the problem described above, describe recently developed statutory solutions, discuss relevant federal tax considerations, and summarize my firm’s experience.

B. Traditional Solutions

1. Power to Distribute Principal

The first place for a trustee to look for a solution to the problem described above is in the trust instrument. Thus, if income distributions to the current beneficiary are inadequate, the trustee should determine if the trust gives it discretion to invade principal. Such a power usually is found in the dispositive provisions and may contain specific limits on the trustee’s authority.

The broadest power is an absolute power to distribute principal without regard to any standard. In such a case, the trustee may simply make discretionary principal distributions in order to confer additional benefits on

the income beneficiary, but the trustee always is bound by its fiduciary duty of impartiality.

A more common provision is the trustee's limited discretionary power to distribute principal, in which case its power is limited by a standard by which it must judge any request for principal. Typical language limits distributions to categories of need such as the beneficiary's health, maintenance, education, and/or support. Discretionary powers subject to a standard can be broad or narrow, and the trustee might or might not have to consider the beneficiary's other resources in exercising its discretion.

The trustee has a duty to treat all beneficiaries impartially, but a court will grant a trustee broad latitude when it has discretionary authority. Whether the discretionary authority is absolute or limited, courts recognize that the trustee, not the court, must make each decision. Thus, when a trustee decides to exercise or not to exercise a discretionary power, a court will not disturb a trustee's decision unless the trustee acts in bad faith or in an arbitrary or unreasonable manner.⁷ A trustee may be found to have abused its discretion if it fails to carry out the testator's or trustor's intent⁸ as reflected in the trust instrument.⁹ If the trustee fails to exercise its discretion because it did not even consider the use of its power, it may be found to have abused its discretion.¹⁰ Consequently, the process of exercising discretion may be more critical than the actual decision reached.

2. Power to Allocate Principal to Income

The classification of a trust's receipts and disbursements as principal or income is generally determined according to the applicable jurisdiction's principal and income act.¹¹ Nevertheless, a testator or trustor may deviate from the statutory rules by directing a different allocation in the governing instrument or by granting the trustee discretion to decide. Many instruments contain administrative provisions that include a discretionary power granted to the trustee to allocate receipts to principal or income.

One Delaware case held that a direction to a trustee to distribute the "income and profits" to the income beneficiary did not entitle him to receive capital gains realized by the trust.¹² Courts sometimes have held, however,

⁷ Finch v. Wachovia Bank & Trust Co., N.A., 577 S.E.2d 306, 310 (N.C. Ct. App. 2003); In re Nancy W. Couch Trust, 723 A.2d 376 (Del. Ch. 1998). See Restatement (Third) of Trusts § 50 (2001); Restatement (Second) of Trusts § 187 (1959); 3 Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 187 at 14–27 (4th ed. 1988).

⁸ Dickinson v. Wilmington Trust Co., 734 A.2d 605 (Del. Ch. 1999), aff'd, 734 A.2d 642 (Del. 1999).

⁹ Couch Trust, 723 A.2d at 382–83.

¹⁰ Finch, 577 S.E.2d at 310. See 3 Scott & Fratcher, supra note 7, § 187.3 at 40–44.

¹¹ See Del. Code Ann. tit. 12, §§ 6101–6114.

¹² In re Houston's Will, 165 A. 132 (Del. Ch. 1933).

that language giving the trustee discretion to allocate receipts to principal or income grants it absolute discretion to allocate without regard to the applicable principal and income act.¹³

When a trustee has complete discretion to allocate receipts to principal or income, a court may still place limits on the exercise of that power. The trustee may not abuse the discretionary power it possesses by simply refusing to allocate gains to income or by indiscriminately allocating all gains to income. As with any other discretionary decision, a court will defer to the trustee's judgment as long as it makes a judgment and does not abuse its discretion. Thus, a trustee may not allocate capital gains to income merely upon the request of an income beneficiary but must follow a decision-making process.

If a trustee is exercising discretion to allocate receipts to income or principal, following the applicable principal and income act may raise a presumption of reasonableness¹⁴ and would be unlikely to constitute an abuse of discretion. Nevertheless, the trustee is still bound by its duties of impartiality and loyalty to deal with the income and remainder beneficiaries fairly and must consider deviating from the usual rules of allocation if it has the power to do so.

3. Recommended Action

A trustee must know if language in each trust instrument permits it to distribute principal to the current beneficiary, either directly in the dispositive provisions or via the authority to allocate receipts in the administrative provisions. Accordingly, if the needs of the income beneficiary for current distributions conflict with the trustee's duty to invest trust assets for total return, the trustee first should confirm that the solution to the problem does not lie in the terms of the governing instrument.

C. Modification of Governing Instrument

In the absence of pertinent provisions in the governing instrument, a trustee wishing to solve the problem mentioned above might seek the help of an appropriate court. A trustee must formulate a sensible approach to the court under an applicable statute or a general provision of trust law. The trustee might consider § 167 of the Second Restatement of Trusts.¹⁵ The Restatement is not governing law but represents a summary of the case law of trusts over a period of many years

¹³ 3A Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 233.5 at 50–58 (4th ed. 1988).

¹⁴ Markley Estate, 19 Pa. D. & C.2d 143 (O.C. Mont. 1959).

¹⁵ Restatement (Second) of Trusts § 167 (1959).

throughout the United States and elsewhere. It often is cited in support of a court's conclusion. Section 167 provides in pertinent part as follows:

(1) The court will direct or permit the trustee to deviate from a term of the trust if owing to circumstances not known to the settlor and not anticipated by him compliance would defeat or substantially impair the accomplishment of the purposes of the trust; and in such case, if necessary to carry out the purposes of the trust, the court may direct or permit the trustee to do acts which are not authorized or are forbidden by the terms of the trust. . . .

(3) Under the circumstances stated in Subsection (1), the trustee is subject to liability for failure to apply to the court for permission to deviate from the terms of the trust, if he knew or should have known of the existence of those circumstances.

Section 66 of the Third Restatement of Trusts¹⁶ and § 412 of the Uniform Trust Code (“UTC”)¹⁷ are comparable to § 167.

If a trustee petitions for court approval to convert an income trust to a unitrust, the court might have to appoint a guardian ad litem to represent the interests of minor beneficiaries and/or a trustee ad litem to represent the interests of unborn, unknown, and unascertained beneficiaries. Unfortunately, the ad litem's role might be so constrained as to make it impossible for him or her to join in the proposal.

In Murphy Trust,¹⁸ a Pennsylvania court considered a trustee's proposal to convert an income trust to a unitrust pursuant to a Pennsylvania statute and § 167 of the Second Restatement of Trusts. The 1989 perpetuities trust at issue originally received principal of \$2 million to which the trustor and his wife allocated their GST exemptions under the federal generation-skipping transfer tax (“GST tax”). The trust agreement did not permit the trustee to invade principal. The court appointed a trustee ad litem who opposed the change on behalf of the unborn remainder beneficiaries. The court agreed with the ad litem and denied the requested change.

The facts of Murphy suggest that its authority should be narrowly construed because the governing instrument contained no evidence of the trustor's intentions

¹⁶ Restatement (Third) of Trusts § 66 (2001).

¹⁷ UTC § 412 (2005).

¹⁸ Murphy Trust, 20 Pa. Fid. Rep. 2d 46 (O.C. Mont. 1999).

and because the economic arguments were tenuous. Nevertheless, trustees should be aware that other courts might consider Murphy as standing for the proposition that the simple economics of unitrusts alone do not warrant a departure from longstanding precepts of trust law.

Prior to June of 2001, when Delaware enacted its total-return unitrust conversion statute, Delaware trustees withdrew petitions to convert income trusts to unitrusts in the face of opposition by guardians and trustees ad litem. Even if Delaware had not adopted the unitrust statute that is discussed below, such petitions might now be granted in certain circumstances because Delaware has enacted a virtual representation statute (i.e., a statute that permits a beneficiary to represent and bind minor, incapacitated, unborn, and unascertained beneficiaries who have “substantially identical interests”).¹⁹

D. Statutory Changes

1. Introduction

A broader solution to the problems raised by declining income yields, the desire of trustees to invest for total return, and the need to balance the interests of current beneficiaries and remainder beneficiaries is to change the statutory definition of income. States are considering two types of statutory changes. The first approach is to amend the state’s principal and income act to give trustees the power to adjust (i.e., a power to allocate income to principal or principal to income if, after application of the provisions of the governing instrument and the statutory rules governing income and principal, the trustee is unable to administer a trust impartially between the current and remainder beneficiaries). The second approach is to revise state law to permit a trustee to pay a percentage of the value of the trust (i.e., a unitrust amount) rather than the fiduciary accounting income to the current beneficiary.

Appendix A shows that, to date, 44 states and the District of Columbia have enacted the power to adjust. Although most of them enacted the power to adjust with the rest of the UPAIA, two states—Iowa and North Dakota—did not include the power to adjust in their versions of the UPAIA and five states—Delaware, Georgia, Louisiana, Minnesota, and Rhode Island—have enacted the power to adjust but not the rest of the UPAIA.²⁰

¹⁹ Del. Code Ann. tit. 12, § 3547.

²⁰ The text of the UPAIA is available at www.law.upenn.edu/bll/ulc/upaia/2000final.htm (last visited Sept. 12, 2006). To determine which jurisdictions have enacted the UPAIA, go to www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-upia.asp (last visited Sept. 12, 2006).

Appendix A also shows that, to date, 25 states have enacted statutes that permit a trustee of an income trust to convert it to a unitrust, so that, after the conversion, the amount of “income” that must or may be distributed to the current beneficiary or beneficiaries will be defined as a percentage of the total assets of the trust. Because there is no model statute, each jurisdiction must draft its own law.

According to Appendix A, 22 states have enacted both the power to adjust and a unitrust conversion statute, so that a trustee may choose either to follow the traditional income-and-principal rules (in which case it has the power to make adjustments between income and principal) or to convert the trust to a unitrust.

2. Constitutional Considerations

It appears that the power to adjust or a unitrust conversion statute may apply to existing trusts without violating constitutional principles.

In discussing the retroactive application of the UPAIA, E. James Gamble, Esquire, a co-reporter for the act, states:²¹

The last section provides that the Act applies to every trust or decedent’s estate existing on the effective date of the Act except as otherwise expressly provided in the will or terms of the trust or the Act. The rule is the same in the 1962 Act; the 1931 Act is prospective only. Professor Bogert has explained that the 1962 Act was made retroactive, “on the theory that as a result of the Allis case in Wisconsin and the Catherwood case in Pennsylvania most courts would hold that it was constitutional to make such a provision. Under this view principal and income questions are matters of administrative rules and no beneficiary has a property right to their decision in the way provided when the trust was established.

The Scott treatise agrees:²²

It is submitted that there is no violation of the constitutional guaranty of due process in changing the rules as to the allocation of receipts and expenses to

²¹ E. James Gamble, If It’s The 1990s, It Must Be Time For Another Principal And Income Act, 32 U. Miami Inst. on Est. Plan. ¶ 806 at 8-52–8-53 (1998) (footnotes omitted).

²² 3A Scott & Fratcher, supra note 13, § 236.3 at 124 (footnote omitted).

income or principal. It is submitted that as to these matters the beneficiaries do not by the creation of the trust acquire vested interests under the earlier rules that had been applied by the court prior to the enactment of the statute.

3. Impact of New Statutes on Trustee Commissions

When a trustee exercises the power to adjust, there should be no change in the method of calculating its commission if the commissions are based on the market value of the trust. If the trustee bases its commissions on the trust's income, however, it is unclear if it should be compensated on principal allocated to income pursuant to that power.

When a trustee converts an income trust to a unitrust, there should be no change in the method of calculating its commissions if the commissions are based on the market value of the trust. Moreover, if the trustee bases its commissions on the income of the trust, it probably should be compensated on the unitrust amount because, in any year, that amount might be more or less than the trust's fiduciary accounting income.

E. The Power to Adjust

The power to adjust permits a trustee to adjust between principal and income (by allocating income to principal or principal to income) in an income trust if it manages trust investments under the prudent-investor rule and if, after administering the trust in accordance with the governing instrument and the applicable principal and income act, it is unable to administer the trust impartially between the current and remainder beneficiaries, except to the extent that the governing instrument clearly manifests an intention that the trustee favor one or more beneficiaries.²³ The trustee must consider several factors in determining whether, and to what extent, to exercise the power to adjust,²⁴ and the statute enumerates the situations in which the power to adjust is not available.²⁵ A trustee, who is a beneficiary or who (as a result of having or exercising the power to adjust) would become an owner of a trust for federal income-tax purposes or would have the trust included in his or her gross estate for federal estate-tax purposes, may not participate in the decision to make an adjustment, but other trustees may act.²⁶

The UPAIA contains significant protection for trustees. First, it provides that “[a] determination in accordance with this [Act] is presumed to be fair and reasonable to

²³ UPAIA § 104(a) (1997).

²⁴ Id. § 104(b).

²⁵ Id. § 104(c).

²⁶ Id. § 104(d).

all of the beneficiaries.”²⁷ Second, a provision which was added in 2000, provides that a court may not change a trustee’s decision to exercise or not to exercise a discretionary power unless it finds that the trustee abused its discretion.²⁸ If a court so finds, the primary remedy is to restore the income and remainder beneficiaries to their proper positions by distributing additional amounts to, or by withholding future distributions from, the income beneficiary.²⁹ If this remedy is not sufficient, the court may surcharge the trustee.³⁰

Because the various laws are based on a uniform statute, they are very similar. Nevertheless, there are some differences. For example, unlike the uniform statute, Pennsylvania’s statute does not require a trustee to invest as a prudent investor in order to use the power to adjust.³¹ Also, the New Jersey statute provides that:³²

A decision by a trustee to increase the distribution to the income beneficiary or beneficiaries in any accounting period to an amount not in excess of four percent, or to decrease that period’s distributions to not less than six percent, of the net fair market value of the trust assets on the first business day of that accounting period shall be presumed to be fair and reasonable to all the beneficiaries.

In addition, states, such as California,³³ afford additional protection to trustees. Furthermore, a few states give a trustee who adjust principal to income specific authority to include capital gains incurred to make such adjustment in distributable net income (“DNI”).³⁴

Once a jurisdiction adopts the power to adjust, it will apply to most trusts, without action by trustees, beneficiaries, or courts, and a trustee must review its trusts periodically to determine whether adjustments are in order. Although the UPAIA includes protection for a trustee that evaluates whether or not to exercise the power to adjust, a trustee that fails to consider the power might be surcharged. Hence, trustees must formulate procedures to implement the power to adjust.

The power to adjust may be difficult to administer for the following reasons:³⁵

²⁷ Id. § 103(b).

²⁸ Id. § 105.

²⁹ Id. § 105(c).

³⁰ Id.

³¹ 20 Pa. Cons. Stat. § 8104 (a).

³² N.J. Stat. Ann. § 3B:19B-4(a).

³³ Cal. Prob. Code § 16337.

³⁴ See, e.g., Del. Code Ann. tit. 12, § 6113(h); N.H. Rev. Stat. Ann. § 564-C:1–104(i).

³⁵ Stephan R. Leimberg & Albert E. Gibbons, Prop. Regs. on the Definition of Trust Income: The Best Thing for Life

The equitable allocation approach . . . has the disadvantage that trustees (for many reasons) may not want to take the chance or accept the continuing responsibility of exercising the discretion allowed by law. Many would prefer a “rule” that allows them to invest for total return yet without the constant need to take an action that may be subject to both parties’ hindsight judgment (as well as a court’s).

F. Unitrust Conversion Statutes³⁶

1. Statutes

On June 21, 2001, Governor Minner signed the Delaware total-return unitrust statute (“Delaware Statute”) that took effect on that date. The Delaware statute was amended in 2004. The Governor of Missouri signed similar legislation (“Missouri Statute”), which was amended in 2002 and 2004, on July 6, 2001, and the Governor of New York signed similar legislation (“New York Statute”) on September 4, 2001.³⁷ Total-return trust legislation (“Pennsylvania Statute”) was introduced in the Pennsylvania legislature on June 21, 2001, and was signed into law on May 16, 2002. The Pennsylvania Statute was amended in 2006.

Florida, Illinois, Iowa, Maine, Maryland, New Hampshire, South Dakota, and Washington adopted total-return unitrust conversion statutes in 2002; Alaska, Colorado, Indiana, North Carolina, and Oregon did so in 2003; and Kentucky and Virginia enacted it in 2004. California, Georgia, Nebraska, New Mexico, and Wisconsin adopted such legislation in 2005, and Rhode Island did so in 2006.

Because no uniform statute exists, each state must draft its own unitrust conversion statute. The Delaware Statute influenced the Colorado, Indiana, North Carolina, and Virginia laws; the Pennsylvania Statute influenced the Alaska, Georgia, Iowa, Maine, New Hampshire, Oregon, and Washington laws; and the Illinois unitrust conversion statute influenced the California, Indiana, Colorado, Nebraska, and Wisconsin laws.³⁸ Appendix A gives citations for the various statutes; Appendix B compares the current Delaware, Missouri, New York, and Pennsylvania Statutes.

Insurance Planning Since Sliced Bread!, 28 Est. Plan. 231, 234 (May 2001).

³⁶ For an extensive analysis of unitrust percentages, smoothing periods, and investment returns, see Robert B. Wolf, Total Return Trusts—A Decade of Progress, But Are We There Yet? (Parts 3 & 4 of 4), 32 ACTEC J. 100 (Fall 2006).

³⁷ In In re Heller, 6 N.Y.3d 649 (2006), the N.Y. Court of Appeals held that an income trust could be converted into a unitrust retroactively to the effective date of the New York Statute (Jan. 1, 2002).

³⁸ Wolf, supra note 1, 14–15, 58 n.155.

2. Amendments

a. Delaware

On June 24, 2004, amendments were made to the Delaware Statute to take account of three years of experience with the law and the regulations that were issued under § 643 of the Internal Revenue Code of 1986 (“IRC”) early in the year (“§ 643 regulations”) and that will be discussed in Part III below.³⁹ Among other things, the 2004 Delaware amendments do the following:

- (1) Shorten the period during which notified beneficiaries may object to proposed actions under the statute from 60 days to 30 days;
- (2) Provide that the value of real or personal property used by a trust beneficiary does not have to be included in the computation of the unitrust distribution;
- (3) Delete the requirement that a converted trust pay the current beneficiary of a marital-deduction trust or a trust that is grandfathered for GST-tax purposes the greater of trust income or the unitrust percentage (not just the unitrust percentage) to reflect the final § 643 regulations;
- (4) Enable the trustee of a wholly charitable trust to take advantage of the Delaware Statute;
- (5) Revise the tax-ordering rule to net capital gains and losses at the trust level; and
- (6) Expand the statute's availability and clarify the types of trusts for which the statute is not available due to federal tax concerns.

Regarding the Delaware Statute, a commentator observes:⁴⁰

The changes made by Delaware represent a very good attempt to fine tune its statute It provides a worthwhile template for other states which have patterned their unitrust

³⁹ 2004 Delaware S.B. No. 288 (June 24, 2004).

⁴⁰ Wolf, supra note 1, at 58 (footnote omitted).

statute in whole or in part upon Delaware's statute.

For convenience of reference, I have included the 2004 Delaware amendments in Appendix C.

b. Illinois

On August 23, 2004, a few revisions were made in the Illinois statute,⁴¹ the most important of which was to make the change described in (3) above.

c. Pennsylvania

On July 7, 2006, amendments were made to the Pennsylvania Statute that do the following:⁴²

- (1) Fixes a defect in its notice requirements;⁴³
- (2) Revises its tax-ordering rule;
- (3) Permits a trustee to reconvert an income trust to a unitrust without court involvement; and
- (4) Clarifies the method for converting a charitable trust to a unitrust.

3. Comment on the Delaware Statute

The Delaware Statute is to be construed as pertaining to the “administration” of a trust and is available to any trust that is administered in Delaware under Delaware law or to any trust, regardless of its place of administration, whose governing instrument provides that Delaware law governs matters of construction or administration. Because it is easier to change the law that governs the administration of a trust than it is to change the law that governs its construction⁴⁴ and because questions concerning the allocation of receipts and disbursements to principal or income often are treated as matters of construction,⁴⁵ the Delaware Statute stipulates that action taken under it is a matter of administration. It is hoped that inclusion

⁴¹ 2004 Illinois H.B. No. 1080 (Aug. 23, 2004).

⁴² 2006 Pa. S.B. No. 660 (July 7, 2006).

⁴³ Wolf, *supra* note 1, at 26.

⁴⁴ See Restatement (Second) of Conflict of Laws §§ 267–282 (1971).

⁴⁵ *Id.* § 268 cmt. h.

of this provision will enable trustees and beneficiaries of trusts being administered elsewhere to move such trusts to Delaware to take advantage of the Delaware Statute.

4. Procedure

Once a trustee's jurisdiction enacts a unitrust conversion statute, the trustee must write an internal procedure to provide a process for determining which income trusts, if any, should be converted to unitrusts.

5. Caveats

As will be discussed shortly, the § 643 regulations provide preferred gift-tax, GST-tax, and income-tax treatment for unitrust conversions made pursuant to a state statute that permits a unitrust percentage of no less than 3% and no more than 5%. To make sure that unitrust conversions will fall within this safe harbor, states, such as New York and Pennsylvania, should consider amending their statutes to meet the 3%–5% requirement.

Respected commentators describe four situations in which conversion of an income trust to a unitrust is inappropriate as follows:⁴⁶

[A] TRU is typically contra-indicated for a spendthrift trust because a required payout can be reached by creditors. Nor is a TRU indicated when a trust is to be funded primarily with real property or a closely held business interest because the mandatory payout might require a partial liquidation if the income stream produced is insufficient, and an annual valuation of real estate or closely held stock tends to be costly. And generally, TRUs are not indicated for most generation-skipping trusts because providing for mandatory payouts to nonskip persons for life and then the remainder to skip persons would result in taxing the unspent portions of the amounts paid out earlier than otherwise necessary. Finally, TRUs are not usually indicated if it is certain or likely that the trust will end in a relatively short time, because the important advantages of a

⁴⁶ Leimberg & Gibbons, supra note 35, at 236 n.15.

TRU typically increase the longer the trust lasts.

In addition, even if unitrust distributions are “smoothed” using averages of valuation dates (e.g., at the end of the three prior years), such distributions might fluctuate more than distributions from an income trust. Thus, a unitrust might not be acceptable to a current beneficiary who would be uncomfortable with such fluctuations.

Although a beneficiary of an irrevocable trust created after 1976 generally must disclaim his or her interest in the trust within nine months after the trust was created,⁴⁷ a beneficiary of a pre-1977 irrevocable trust may disclaim his or her interest in the trust “within a reasonable time after knowledge of the existence of the transfer.”⁴⁸ Trustees should be aware that notices sent to future beneficiaries of such a trust concerning its conversion to a unitrust might affect the ability of such beneficiaries to disclaim their interests.

G. New Trusts

Attorneys are drafting new trusts that provide for the distribution of a unitrust amount to the current beneficiary. Because the § 643 regulations provide that such distributions will be respected for federal tax purposes only if they are provided for by state statutes, several state statutes now contemplate that trusts will be drafted in this manner. (See Appendix A.)

III. TAX CONSIDERATIONS

A. Federal Income-Tax Treatment of Distributions

1. Introduction

The term “income” has meaning for tax purposes as well as for the purpose of determining, under state law, to which beneficiary or beneficiaries certain property is distributable. Section 643(b) provides the following definition of income for various federal tax provisions:

⁴⁷ IRC § 2518.

⁴⁸ Treas. Reg. § 25.2511-1(c)(2); *Jewett v. Comm’r*, 455 U.S. 305 (1982). See PLRs 200535012 (May 9, 2005); 200530004 (Apr. 6, 2005); 200516004 (Jan. 6, 2005), 200348011 (Aug. 19, 2003), 200248020 (Aug. 27, 2002), 200240015 (June 24, 2002), 200238039 (June 20, 2002), 200202036 (Oct. 5, 2001), 200150020 (Sept. 13, 2001) (renunciation of interest in pre-1977 trust within reasonable time after knowledge of transfer was not taxable gift). See also PLR 200530002 (Apr. 19, 2005) (renunciation of interest in pre-1977 trust not made within reasonable time after knowledge of transfer was taxable gift).

[T]he term “income”, when not preceded by the words “taxable”, “distributable net”, “undistributed net”, or “gross”, means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

The above definition dates to a time when, under state statutes, dividends and interest were considered income and were allocated to the income beneficiary, whereas capital gains were allocated to the principal of the trust.

2. The Regulations

As states began to consider revising the traditional definitions of income and principal in response to the concept of investing for total return, the IRS initiated a regulatory project to examine the definition of income. On February 15, 2001, the IRS issued proposed regulations to redefine income for various purposes under federal tax law, including the definitions of income and DNI, qualification for the marital deduction, and modifications of grandfathered generation-skipping trusts.⁴⁹ The § 643 regulations were issued on January 2, 2004, and generally are effective for tax years ending after that date.⁵⁰

3. New Definition of Income

The § 643 regulations revised Reg. § 1.643(b)-1. The revised regulation begins by stating the following general rule:

“[I]ncome,” 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. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For

⁴⁹ REG-106513-00 (Feb. 15, 2001).

⁵⁰ T.D. 9102 (Jan. 2, 2004).

example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, 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.

It provides the following safe harbor for a state unitrust statute:

For example, 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.

Next, it provides the following safe harbor for state power-to-adjust statutes:

Similarly, 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. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of

receipts and disbursements to income and principal, is unable to administer the trust impartially.

The regulation continues by providing the following helpful rules:

Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.

It then gives the following warnings for actions that do not fall within the unitrust or power-to-adjust safe harbor:

A switch between methods of determining trust income authorized by state statute will 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. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances.

Finally, the regulation concludes as follows:

In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

4. Marital Deduction Concerns—General

Certain transfers of property in trust (at death or during life) qualify for the marital deduction for estate- or gift-tax purposes. Transfers that qualify include trusts in which the spouse has a life estate and a general power of appointment⁵¹ and qualified-terminable-interest property (“QTIP”) trusts.⁵² One requirement of each of the above trusts is that the spouse must be entitled for life to receive all of the income from the trust property. The regulations specify that this income requirement is satisfied if the effect of the trust is to give the spouse substantially that degree of beneficial enjoyment of the trust property during the spouse’s life that the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of the trust.

The § 643 regulations provide that a spouse’s interest satisfies this requirement if the spouse is entitled to income as defined under state law in a way that makes a reasonable apportionment of the total return of the trust between the current and remainder beneficiaries. Thus, if permitted by a state statute, a trustee may convert a marital trust to a unitrust (at a rate no less than 3% and no more than 5%) or make adjustments between income and principal without risking loss of the marital deduction.⁵³

5. Marital Deduction Concerns—Retirement Plan Benefits

Rev. Rul. 2006-26⁵⁴ analyzed whether a marital deduction trust and the proceeds of an individual retirement account (“IRA”) payable to the trust would qualify for the marital deduction in scenarios involving the power to adjust and unitrust statutes. In the fact pattern considered by the ruling, A died at 68 in 2004 survived by B. Prior to death, A established an IRA, executed a Will to create a QTIP trust for B upon death, and named the trust as the beneficiary of the IRA proceeds. A’s executor made QTIP elections for the IRA and the trust. Significantly, the trust gave B the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all of the income of the IRA for the year and to distribute that income to B. All relevant marital-deduction and required-minimum-distribution requirements were met.

⁵¹ IRC §§ 2056(b)(5), 2523(e).

⁵² IRC §§ 2056(b)(7), 2523(f).

⁵³ Treas. Reg. §§ 20.2056(b)-5(f)(1), 20.2056(b)-7(b)(1), 20.2056A-5(c)(2), 25.2523(e)-1(f)(1).

⁵⁴ 2006-22 I.R.B. 939 (May 4, 2006). See Robert E. Madden, Lisa H. R. Hayes, & Frank S. Baldino, IRA Payable to QTIP Trust: Marital Deduction Requirements Rev. Rul. 2006-26, 33 Est. Plan. 44 (Sept. 2006); Richard B. Covey & Dan T. Hastings, IRA Proceeds: Marital Deduction Qualification; Rev. Rul. 2006-26, Prac. Drafting 8638 (July 2006); David L. Weinreb, Rev. Rule 2006-26 Clarifies Circumstances Under Which IRA Payable to QTIP Trust Qualifies for Marital Deduction, 31 Tax Mgmt. Est., Gifts & Tr. J. 196 (July 13, 2006); Natalie B. Choate, IRS Rejects UPIA 10 Percent Rule, 145 Tr. & Est. 18 (July 2006).

Rev. Rul. 2006-26 considered three situations.

In Situation 1, the state whose law governed the trust had adopted the power to adjust. Each year, the trustee calculated the total return of the trust (excluding the IRA), determined the portions that were allocable to principal and income, and distributed the income to B. Similarly, each year, the trustee calculated the total return of the IRA and determined the portions that were allocable to principal and income. If B exercised the withdrawal power, the trustee withdrew from the IRA the greater of income and the required minimum distribution and distributed the income to B. The IRS ruled that the IRA and the trust qualified for the marital deduction.

In Situation 2, the interested parties converted the trust and the IRA into 4% unitrusts pursuant to a state statute. Each year, the trustee calculated the total return of the trust (excluding the IRA) and distributed 4% of such return to B. Similarly, each year, the trustee computed the total return of the IRA and the unitrust amount. If B exercised the withdrawal power, trustee withdrew the greater of the unitrust amount and the required minimum distribution and distributed the unitrust amount to B. The IRS again ruled that the IRA and the trust qualified for the marital deduction. It also noted that if the state had adopted the power to adjust as well as a unitrust statute, it would be acceptable if the IRA were subject to the power to adjust and the trust (excluding the IRA) to the unitrust statute or vice versa.

In Situation 3, the state whose law governed the trust had not adopted the power to adjust or a unitrust statute. Consequently, B could compel the withdrawal of the traditional income of the IRA and cause the trustee to distribute all trust income (including that attributable to the IRA) to B. The IRS ruled that the IRA and the trust would qualify for the marital deduction. In addition, it noted that the result would be the same if the trustee had the power to adjust but did not exercise it.

Several comments regarding Rev. Rul. 2006-26 are in order.

First, the ruling specifies that the marital-deduction requirements must be satisfied separately for a trust and for the proceeds of an IRA payable to it.

Second, it was critical to the ruling's favorable conclusions that the surviving spouse had the power to compel the trustee to withdraw the income of the IRA. The IRS indicated that it also would have ruled favorably if the trust required the trustee to withdraw the IRA income each year.

Third, in discussing Situation 1, the IRS gave a warning concerning subsections (c) and (d) of UPAIA § 409, which provide as follows:⁵⁵

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not “required to be made” to the extent that it is made because the trustee exercises a right of withdrawal.

(d) If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

The IRS discussed the issue as follows:⁵⁶

Depending upon the terms of Trust, the impact of State X's version of sections 409(c) and (d) of the UPIA may have to be considered. State X's version of section 409(c) of the UPIA provides in effect that a required minimum distribution from the IRA under Code section 408(a)(6) is to be allocated 10 percent to income and 90 percent to principal. This 10 percent allocation to income, standing alone, does not satisfy the requirements of §§ 20.2056(b)-5(f)(1) and 1.643(b)-1, because the amount of the required minimum distribution is not based on the total return of the IRA (and therefore the amount allocated to income does not reflect a reasonable apportionment of the total return between the income and remainder beneficiaries). The 10 percent allocation to income also does not represent the income of the IRA under applicable state law

⁵⁵ UPAIA § 409(c)–(d) (1997).

⁵⁶ 2006-22 I.R.B. 941–42 (citations omitted).

without regard to a power to adjust between principal and income. State X's version of section 409(d) of the UPIA, requiring an additional allocation to income if necessary to qualify for the marital deduction, may not qualify the arrangement under § 2056. Based on the facts in Situation 1, if B exercises the withdrawal power, the trustee is obligated under Trust's terms to withdraw the greater of all of the income of the IRA or the annual required minimum distribution amount under § 408(a)(6), and to distribute at least the income of the IRA to B. Thus, in this case, State X's version of section 409(c) or (d) of UPIA would only operate to determine the portion of the required minimum distribution amount that is allocated to Trust income, and (because Trust income is determined without regard to the IRA or distributions from the IRA) would not affect the determination of the amount distributable to B. Accordingly, in Situation 1, the requirements of § 2056(b)(7)(B) (ii) are satisfied. However, if the terms of a trust do not require the distribution to B of at least the income of the IRA in the event that B exercises the right to direct the withdrawal from the IRA, then the requirements of § 2056(b)(7)(B) (ii) may not be satisfied unless the Trust's terms provide that State X's version of section 409(c) of the UPIA is not to apply.

To forestall this problem, instead of § 409(c), states might want to enact statutes based on the following Pennsylvania statute:⁵⁷

(a) General Rule.—

(1) The trustee shall allocate to income the greater of:

(i) the portion of a payment characterized by the payor as interest or a dividend or a remittance in lieu of interest or a dividend; or

(ii) the portion of the payment characterized as imputed interest for Federal income tax purposes.

⁵⁷ 20 Pa. Cons. Stat. § 8149.

(2) The balance of any such payment shall be allocated to principal.

(b) Allocation Under Contract Calling For Equal Installments.—

(1) If no part of a payment under a contract calling for equal installments over a fixed period of time is allocable to income under the provisions of subsection (a), the difference between the trust's acquisition value of the contract and the total expected return shall be deemed to be interest.

(2) The trustee shall allocate to income the portion of each payment equivalent to interest on the then unpaid principal balance at the rate specified in the contract or a rate necessary to thus amortize the difference between the expected return and the acquisition value, where that rate is readily ascertainable by the trustee.

(c) Allocation When Internal Net Income of Fund is Readily Ascertained.—

(1) If no portion of a payment from a separate fund held exclusively for the benefit of the trust is allocable to income under subsections (a) and (b) but the internal net income of the fund determined as if the fund were a separate trust subject to Subchapters B (relating to decedent's estate or terminating income interest) through E (relating to allocation of disbursements during administration of trust) is readily ascertainable by the trustee, the portion of the payment equal to the then undistributed net income of the fund realized since the trust acquired its interest in the fund shall be deemed to be a distribution of such income and shall be allocated to the trust income account.

(2) The balance of any such payment shall be allocated to principal.

(d) When Not Otherwise Allocable To Income.—

(1) The trustee shall allocate to income 10% of the part of the payment which is required to be made during the accounting period and the balance to principal if:

(i) no part of the payment is allocable to income under subsection (a), (b) or (c); and

(ii) all or part of the payment is required to be made.

(2) The trustee shall allocate the entire payment to principal if:

(i) no part of a payment is required to be made; or

(ii) the payment received is the entire amount to which the trustee is entitled.

(3) For purposes of this subsection, a payment is not required to be made to the extent that it is made because the trustee exercises a right of withdrawal.

(e) Allocation to Obtain Marital Deduction.-- If, to obtain a Federal estate or gift tax marital deduction for a trust, the trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

(f) Application.-- This section does not apply to payments to which section 8150 (relating to liquidating asset) applies.

(g) Definition.-- As used in this section, the term "payment" means a payment that a trustee may receive over a fixed period of time or during the life of one or more individuals because of services rendered or property transferred to the payor in exchange for future payments. The term includes all

of the following:

(1) A payment made in money or property from:

- (i) the payor's general assets; or
- (ii) a separate fund created by the payor or another.

(2) A payment on or from:

- (i) an installment contract or note;
- (ii) a private or commercial annuity;
- (iii) a deferred compensation agreement;
- (iv) an employee death benefit;
- (v) an individual retirement account; or
- (vi) a pension, profit-sharing, stock or other bonus, or stock-ownership plan.

Fourth, Rev. Rul. 2006-26's guidance applies to IRAs and to other defined-contribution plans (e.g., 401(k) plans).

Finally, the IRS indicated that it will not apply the ruling adversely to actions involving the power to adjust or a unitrust statute taken for tax years beginning before May 30, 2006.

6. Revision of DNI Rules

In the past, capital gains generally were not included in DNI, and the circumstances in which they were considered paid to and taxable to the current beneficiary (rather than to the trust) were not entirely clear.⁵⁸ The § 643 regulations revised Treas. Reg. § 1.643(a)-3(b) to read as follows:

- (b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant

⁵⁸ IRC § 643(a)(3). See PLR 200409003 (Nov. 6, 2003) (capital gains included in DNI).

to the terms of the governing instrument and applicable local 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 applicable local law).

- (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
- (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
- (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Since the issuance of the § 643 regulations, the IRS has ruled that the exclusion of capital gains from DNI was a reasonable exercise of discretion⁵⁹ and that the inclusion of capital gains in DNI was a reasonable exercise of discretion.⁶⁰ Capital losses generally are netted first at the trust level.⁶¹

The § 643 regulations contain the following four examples that illustrate the

⁵⁹ See PLR 200617004 (Jan. 6, 2006).

⁶⁰ See PLR 200448001 (July 21, 2004).

⁶¹ Treas. Reg. § 1.643(a)-3(d).

inclusion in or exclusion from DNI of capital gains incurred in connection with statutes that fall within the unitrust safe harbor:⁶²

Example 11. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at \$500,000. During the year, Trust receives \$5,000 of dividend income and realizes \$80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A \$20,000 (4% of \$500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of \$15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

Example 12. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. 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 Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire \$80,000 capital gain is taxed to Trust. This treatment of the capital gains is a

⁶² Treas. Reg. § 1.643(a)-3(e), Exs. 11-14.

reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example 13. The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including \$15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

Example 14. Trustee is a corporate fiduciary that administers numerous trusts. State statutes provide that a trustee may make an election to distribute to an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary's right to income. Neither state statutes nor the governing instruments of any of the trusts administered by Trustee has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. With respect to some trusts, 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 the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by not including any capital gains in distributable net income on the Federal income tax returns for those trusts. With respect to other trusts, Trustee intends to follow a regular practice

of treating any net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by including net capital gains in distributable net income on the Federal income tax returns filed for these trusts. Trustee's decision with respect to each trust is a reasonable exercise of Trustee's discretion and, in future years, Trustee must treat the capital gains realized by each trust consistently with the treatment by that trust in prior years.

The § 643 regulations contain no examples that illustrate the inclusion in or exclusion from DNI of capital gains incurred in connection with the exercise of discretion that falls within the power-of-adjustment statutory safe harbor. Commentators suggest that the inclusion of capital gains in DNI in these circumstances is problematic.⁶³

It is not certain that a power to adjust granted by a state statute or under the instrument authorizes the trustee to allocate realized gain to FAI [Fiduciary Accounting Income]. The Uniform Act merely authorizes the trustee to allocate corpus to income (or the reverse). It does not explicitly authorize the trustee to allocate realized gain to income. Realized gain is a tax concept and therefore unlikely to appear in a state statute (other than a state tax statute). Perhaps, the trustee will be permitted to allocate proceeds of sale to FAI pursuant to a power to adjust, thus causing the capital gain inherent in the proceeds to be included in DNI. But even that remains unclear. Hence, even if state law grants the trustee a power to adjust, it would be prudent to include in the governing instrument discretionary authority to allocate realized gain to FAI (reasonably and impartially) to achieve the planning advantages discussed above. In fact, it seems that states should adopt a default rule granting trustees this power in those cases in which it grants a power to adjust or perhaps when the instrument authorizes a discretionary corpus invasion (thereby permitting the trustee to allocate realized gain to income through a corpus invasion).

⁶³ See Blattmachr & Gans, supra note 1, at 914 (footnote omitted). See also id. at 905–07.

In existing trusts, in the absence of such state legislation, it may nevertheless be possible for the trustee to use a power in the instrument to allocate receipts between principal and income to achieve the desired effect. As indicated, in TAM 8728001, the Service concluded that a trustee with that power under the instrument could cause realized gain to be allocated to FAI and, as a result, to be included in DNI. Whether that strategy remains viable is unclear, however, given the regulations' failure to either embrace or reject the conclusion reached in the TAM and the absence of any published guidance on the question.

They recognize, however, that others disagree.⁶⁴

Prof. Ascher argues that under the regulations the conversion of corpus to income under an equitable adjustment power will unquestionably cause realized gain to be included in DNI. In his view, the regulations leave no outstanding questions concerning the tax effect of equitable adjustment. While the preamble to the regulations certainly suggest that the drafters envisioned that an equitable adjustment could cause capital gain to be included in DNI, the text of the regulations unfortunately fail to confirm that suggestion and also fail to indicate how it might mechanically occur. In the absence of further guidance, in our view, trustees and beneficiaries will be uncertain about when the use of an equitable adjustment power will cause realized gain to be included in DNI. Moreover, as discussed, even assuming it does cause gain to be included in DNI, important computational questions remain.

As mentioned previously, a few state statutes now specifically authorize a trustee exercising the power to adjust to include capital gains in DNI.

7. Distributions In Kind

A trustee that makes unitrust distributions or distributions under the power

⁶⁴ Id. at 906 n.53.

to adjust in excess of the trust's fiduciary accounting income might decide to make such excess distributions in kind.⁶⁵ Under the § 643 regulations, capital gain will be realized if the trustee makes such a distribution with appreciated property.⁶⁶ Because distributions of depreciated assets do not generate a tax loss, however,⁶⁷ a trustee that wants to recognize loss must sell depreciated assets prior to distribution.

8. New Unitrusts

A commentator describes a shortcoming of most unitrust statutes as follows:⁶⁸

In retrospect, we as commentators should have requested a clear reference in the Final Regulations to a trust that was drafted as a unitrust from the beginning in a state with a unitrust conversion statute. The author views this as more the fault of himself and other commentators than that of Treasury, since it is we, and not they, who have been drafting unitrusts, and in the case of the author, drafting them for quite some time. The problem is really two fold: First, do the state unitrust conversion statutes tie in sufficiently to the Final Regulations? And second, do our state statutes that do refer to unitrusts that are expressly drafted as unitrusts deal properly with the issue in this context? The Final Regulations require that for example, if there is a state statute which provides that income "is" a unitrust amount of not less than 3% nor more than 5%, then that amount will be considered to be "income" for federal tax purposes as well. In essentially all of the state statutes, "income" is defined as a unitrust amount if the trust is converted to a unitrust pursuant to the provisions of that statute. So, on a very literal and technical basis, if the trust were not a converted "income" trust, the state statute would not provide that the unitrust amount, even if defined identically with the unitrust amount for a converted income trust, is "income." Now the reason these conversions were

⁶⁵ IRC § 643(e).

⁶⁶ Treas. Reg. §§ 1.651(a)-2(d), 1.661(a)-2(f).

⁶⁷ IRC § 267(b)(6).

⁶⁸ Wolf, supra note 1, at 37-38 (footnote omitted).

the focus of all of our concern was that they were the ones that were causing the problem; the squeaky wheels, so to speak. After all, for future trusts, we could always draft the trusts as unitrusts and then provide for the payment of net income at least annually if the net income were greater than the unitrust. But we forgot to ask for explicit guidance on this point, and so we did not get it. It is submitted that it was not intended by the Regulation writers that in Pennsylvania and New York, which have unitrust conversion statutes with a 4% default rate, that a 4% unitrust would not qualify for the marital deduction—or that we would be forced to write the trust as an “income” trust and then convert it to a unitrust to bring it within our statute. And discussions with a representative of Treasury confirms this opinion, but more official guidance would be helpful in this regard for those who want to be able to clearly define the legal support for their tax opinions (which includes the author). And those of us who participated in the drafting of these principal and income statutes should have considered dealing directly with the “express unitrust”; that is a unitrust that is drafted as a unitrust from the beginning. It is particularly clear in states, like Pennsylvania and New York, that while there may continue to be good reasons for selecting a default rate of 4% for income trusts which are converted, there is probably no good reason not to expressly condone by state statute the full 3% to 5% range expressed in the Final Regulations as permissible. After all, the reason for not selecting a range of payouts was to provide a point of reference and legislative imprimatur on a distribution rate thought, on balance, to be fair. But reasonable minds can and do differ on the best rate to use, and there is no reason to limit the freedom of the settlor of a trust to draft a 3% or a 5% unitrust, if that is their wish.

As mentioned earlier and as shown in Appendix A, several state statutes now expressly permit testators or trustors to write new trusts as unitrusts.

B. GST-Tax Implications

1. Introduction

For GST-tax purposes, every trust falls into one of the following three categories:

- a. A trust that was irrevocable on September 25, 1985 (“Grandfathered Trust”);
- b. A trust to which all or a portion of an individual’s GST exemption has been allocated (“Exempt Trust”); or
- c. A trust that is neither a Grandfathered Trust nor an Exempt Trust (“Nonexempt Trust”).⁶⁹

2. Grandfathered Trusts

Since 1987, the IRS has issued numerous rulings on whether or not changes to Grandfathered Trusts will cause them to lose their grandfathered status. Nevertheless, it still is unclear what happens to a trust that loses that status.⁷⁰

On December 20, 2000, the IRS issued regulations concerning modifications to Grandfathered Trusts (“GST regulations”).⁷¹ The GST regulations provide rules regarding the circumstances in which changes to Grandfathered Trusts will not cause them to lose their grandfathered status in four categories—discretionary powers, settlements, judicial constructions, and other changes.⁷² Under the fourth category of permitted modifications, a Grandfathered Trust will not lose its tax-favored status if it is modified in a way that is valid under applicable state law and that will not shift a beneficial interest in the trust to a lower generation beneficiary or extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in the original trust.⁷³ Example 8 in the GST regulations provides guidance on when the conversion of an income trust to a unitrust will be acceptable.⁷⁴ Example 8 provides:

⁶⁹ In PLR 200334025 (May 14, 2003), the IRS considered the applicability of a power-to-adjust statute, but the ruling did not disclose the trust’s GST-tax status.

⁷⁰ See Alan Halperin & Michelle R. Wandler, Decanting Discretionary Trusts: State Law and Tax Consideration, 29 Tax Mgmt. Est., Gifts & Tr. J. 219, 225–26 (Sept. 9, 2004).

⁷¹ T.D. 8912 (Dec. 20, 2000).

⁷² Treas. Reg. § 26.2601-1(b)(4)(i)(A)–(D).

⁷³ Treas. Reg. § 26.2601-1(b)(4)(i)(D). See PLRs 200305024 (Oct. 28, 2002), 200252064 (Sept. 16, 2002), 200231011 (May 6, 2002), 200217036–037 (Jan. 23, 2002), 200148034 (Aug. 29, 2001).

⁷⁴ Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 8.

In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Before the § 643 regulations amended the GST regulations as discussed below, the IRS released private letter rulings that followed this example.⁷⁵

The § 643 regulations, which apply to trust tax years ending after January 2, 2004, amended the GST regulations in three significant respects.⁷⁶ First, they added the following sentence at the end of the regulation that covers the fourth category of modifications of grandfathered trusts:⁷⁷

In addition, 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 between income and principal beneficiaries will not

⁷⁵ PLRs 200409003 (Nov. 6, 2003), 200326029 (Mar. 14, 2003), 200316023 (Jan. 8, 2003), 200314011 (Dec. 20, 2002), 200234047 (Apr. 12, 2002), 200214019 (Dec. 27, 2001), 200211008 (Dec. 14, 2001), 200150016 (Sept. 12, 2001).

⁷⁶ T.D. 9102 (Jan. 2, 2004).

⁷⁷ Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2). See PLR 200437011 (Apr. 29, 2004).

be considered to shift a beneficial interest in the trust, 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 of this chapter.

In addition, they added the following example—Example 11—to the GST regulations that provide a safe harbor for unitrusts created pursuant to certain state statutes:⁷⁸

In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the

⁷⁸ Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 11.

situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

The IRS has released rulings that fall within the safe harbor provided by Example 11,⁷⁹ and, subsequent to the amendments, it has approved unitrust conversions that fall within Example 8's safe harbor that do not satisfy Example 11's requirements.⁸⁰

Finally, the § 643 regulations added the following example—Example 12—to the GST regulations that provides a safe harbor for actions taken under the power to adjust recognized by state statute:⁸¹

The facts are the same as in Example 11, except that in 2002, State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the

⁷⁹ See PLRs 200633002-003 (May 11, 2006), 200632002-003 (May 11, 2006), 200627005 (Mar. 28, 2006), 200609003 (Nov. 21, 2005), 200532042-043 (Apr. 20, 2005), 200507010 (Oct. 25, 2004), 200502031-032 (Sept. 30, 2004).

⁸⁰ PLRs 200604015 (Oct. 24, 2005), 200517009 (Dec. 23, 2004), 200517002 (Dec. 21, 2004), 200502031-032 (Sept. 30, 2004); 200448001 (July 21, 2004), 200447002 (July 15, 2004), 200446002 (July 15, 2004), 200437012 (Apr. 26, 2004), 200437003-004 (Apr. 26, 2004). See PLRs 200532021 (Apr. 14, 2005), 200531008-009 (Apr. 14, 2005) (modification of LLC agreement to administer LLC in accordance with Ex. 8 did not degrandfather trusts that held LLC interests).

⁸¹ Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 12.

trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not authorize the trustee to make adjustments between income and principal or if the situs was changed to such a state from State X.

The IRS has issued rulings that fall within the safe harbor of Example 12.⁸² It also approved a grant of the power to adjust by court order not statute.⁸³

If an income trust has been converted to a unitrust pursuant to a state statute, reconversion to an income trust pursuant to a state statute will not cause the trust to lose its grandfathered status.⁸⁴ It also is acceptable for the trustee and beneficiaries of a trust to change the trust's situs or governing law to take advantage of a jurisdiction's unitrust statute⁸⁵ or statutory power-to-adjust.⁸⁶

3. Exempt Trusts

The IRS has ruled that the conversion of an Exempt Trust to a unitrust within the parameters of Example 8 of the GST regulations did not cause the trust to lose its exempt status⁸⁷ and that the conversion of such a trust to a unitrust under the parameters of Example 11 of such regulations did not have adverse GST-tax consequences.⁸⁸ The earlier ruling noted that:

No guidance has been issued concerning judicial modifications that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a

⁸² PLRs 200544017 (Nov. 4, 2005), 200543039–046 (July 25, 2005).

⁸³ PLR 200533006 (Apr. 20, 2005).

⁸⁴ Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 11.

⁸⁵ Id. See PLRs 200633002–003 (May 11, 2006), 200632002–003 (May 11, 2006).

⁸⁶ Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 12. See PLRs 200544017 (Nov. 4, 2004), 200543039–046 (July 25, 2005).

⁸⁷ PLR 200615001 (Dec. 12, 2005).

⁸⁸ PLR 200417014 (Dec. 31, 2003).

modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

The later ruling contains comparable language.

4. Nonexempt Trusts

The applicability of the power to adjust to a Nonexempt Trust or the conversion of such a trust to a unitrust should have no GST-tax implications.

C. Federal Gift-Tax Implications

1. Introduction

IRC § 2501(a)(1) provides in part that:

A tax . . . is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

IRC § 2511(a) provides that:

Subject to the limitations contained in this chapter, the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible

In Dickman v. Commissioner,⁸⁹ the Supreme Court held that the gift tax applied to imputed interest on intrafamily loans. The decision is important because the Court's opinion was expansive. The Court reviewed the tax law, the regulations, the legislative history, and its own prior decisions and concluded that "the gift tax was designed to encompass all transfers of property and property rights having significant value."⁹⁰ The Dickman decision gave the IRS a firm basis to extend the application of the gift tax to any gratuitous transfer of property, including the use of property.

An IRS argument that a gift results from the failure of a beneficiary of an income trust to object to the trustee's exercise of the power to adjust or to the trust's conversion to a unitrust would be an extension of Dickman. The

⁸⁹ Dickman v. Comm'r, 465 U.S. 330 (1984).

⁹⁰ Id. at 334.

IRS's argument would be that a current beneficiary's or a remainder beneficiary's failure to object is a taxable gift because the interest of the current beneficiary, or the remainder beneficiary (depending on the circumstances), increases as a result of the conversion.

2. Defenses Against Gift Argument

There are several defenses against the gift argument that will apply in certain cases. They include arguments that there was court approval, that the beneficiary did not participate, and that no right was transferred.⁹¹

3. Prior Cases and Rulings Regarding Distribution of Trust Income

Despite the universal understanding that trustees and beneficiaries join to reduce income payouts in trusts in which the current beneficiaries do not need the income, the IRS has rarely asserted that a gift has been made by the current beneficiaries. In theory, the adoption of a low unitrust payout is no different from skewing the trust portfolio toward growth or any other reasonable exercise of a discretionary power by a trustee. The IRS has made analogous arguments in cases involving grantor-retained income trusts, the failure of shareholders to compel corporations to pay dividends, and the failure of spouses to compel the complete funding of marital-deduction trusts.⁹²

4. Comments

In theory, both the current beneficiary and the remainder beneficiaries will “win” if an income trust is converted to a unitrust or if the trustee possesses the power to adjust, so that no gift should be made. If a gift in trust actually is made, however, the gift probably will qualify for the annual exclusion, but the balance will be fully taxable because the remainder beneficiary's retained interest is not a unitrust or annuity interest under IRC § 2702. Moreover, although an estate-tax credit might be available for gift tax paid with respect to the transfer,⁹³ some or all of the trust property attributable to the gift might be includable in the beneficiary's gross estate under IRC § 2036 and/or another estate-tax provision.

Before the IRS issued Example 11 as part of the § 643 regulations and in subsequent rulings to which Example 11 did not apply, it sometimes specifically refrained from addressing whether a proposed unitrust

⁹¹ See Richard W. Nenko, Implementing Total Return Trust Statutes, 36 U. Miami Inst. on Est. Plan. ¶ 1408.2 at 14-33–14-35 (2002).

⁹² See *id.* ¶ 1408.3 at 14-35–14-40.

⁹³ IRC § 2012.

conversion resulted in a taxable gift,⁹⁴ it sometimes did not mention the issue at all,⁹⁵ and it ruled twice that such a conversion was not a taxable gift.⁹⁶ It also ruled that trustees' possession of a statutory power to adjust was not a taxable gift.⁹⁷

Example 11, which was added to the GST regulations by the § 643 regulations, provides that the conversion of an income trust to a unitrust under a 3%–5% state conversion statute will not result in a taxable gift.⁹⁸ Nevertheless, in conversions under Example 11, the IRS sometimes has specifically not ruled on the gift tax issue⁹⁹ or has not mentioned the issue.¹⁰⁰ In other rulings, it has confirmed that there was no taxable gift.¹⁰¹

Example 12, which also was added to the GST regulations by the § 643 regulations, provides that the applicability of the power to adjust to a trust pursuant to certain state statutes will not result in a taxable gift.¹⁰² The IRS has confirmed this result in some rulings,¹⁰³ but, in one instance, it specifically declined to address the gift-tax issue.¹⁰⁴

D. Federal Income-Tax Implications

1. Introduction

Treasury Regulation § 1.1001-1(a) provides that:

Except as otherwise provided . . . the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

⁹⁴ PLRs 200447002 (July 15, 2004), 200446002 (July 15, 2004), 200437003–004 (Apr. 29, 2004), 200409003 (Nov. 6, 2003), 200314011 (Dec. 20, 2002), 200305024 (Oct. 28, 2002), 200252064 (Sept. 16, 2002), 200234047 (Apr. 12, 2002), 200214019 (Dec. 27, 2001), 200211008 (Dec. 14, 2001), 200150016 (Sept. 12, 2001), 200148034 (Aug. 29, 2001).

⁹⁵ PLRs 200615001 (Dec. 12, 2005), 200604015 (Oct. 24, 2005), 200517009 (Dec. 23, 2004), 200517002 (Dec. 21, 2004), 200502031–032 (Sept. 30, 2004), 200448001 (July 21, 2004), 200326029 (Mar. 14, 2003), 200316023 (Jan. 8, 2003), 200217036–037 (Jan. 23, 2002).

⁹⁶ PLR 200437012 (Apr. 26, 2004), 200231011 (May 6, 2002).

⁹⁷ PLR 200334025 (May 14, 2003).

⁹⁸ Treas. Reg. §§ 1.643(b)-1, 26.2601-1(b)(4)(i)(E), Ex. 11.

⁹⁹ PLRs 200532042 (Apr. 20, 2005), 200507010 (Oct. 25, 2004).

¹⁰⁰ PLRs 200633002–003 (May 11, 2006), 200632002–003 (May 11, 2006), 200532043 (Apr. 20, 2005), 200502031–032 (Sept. 30, 2004).

¹⁰¹ PLRs 200627005 (Mar. 28, 2006), 200609003 (Nov. 21, 2005), 200417014 (Dec. 31, 2003).

¹⁰² Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 12.

¹⁰³ PLRs 200544017 (Nov. 4, 2005), 200543039–046 (July 25, 2005), 200533006 (Apr. 20, 2004).

¹⁰⁴ PLR 200437011 (Apr. 29, 2004).

In Revenue Ruling 56-437,¹⁰⁵ the IRS concluded that neither the conversion of a joint tenancy into a tenancy in common nor the severance of a joint tenancy under a partition action pursuant to state law was a sale or exchange so that the taxpayers did not realize a taxable gain or sustain a taxable loss. In Revenue Ruling 69-486,¹⁰⁶ however, the IRS found that a non-pro rata distribution of trust principal in kind by mutual agreement of the beneficiaries was a taxable event under IRC § 1001.

2. The Cottage Savings Decision

In Cottage Savings Association v. Commissioner,¹⁰⁷ two financial institutions exchanged participation interests in packages of home mortgage loans. The transaction was tax motivated (each lender wanted to recognize a loss on the loans it exchanged), but, for bank regulatory reasons, the two packages of loans were virtually identical (i.e., the loans had the same maturity dates, the same interest rates, and the same type of single-family residential mortgages in the same area). Cottage Savings claimed that the trade allowed it to recognize a tax loss under IRC § 1001(a). The IRS argued that it could not recognize the loss because the package of loans received was not “materially different” from the package of loans exchanged.

The Supreme Court held that, under the above regulation, properties exchanged are “materially different” if, after the exchange, the owners “enjoy entitlements that are different in kind or extent.” Because the exchanged participation interests were on different parcels of real estate, the Court held that, after the transaction, the financial institutions had entitlements different in kind or extent from what they possessed beforehand. Consequently, Cottage Savings was entitled to recognize the loss.

3. The Power to Adjust and Unitrust Conversions

In the context of the power to adjust or the conversion of an income trust to a unitrust, the question is whether the exercise of the power to adjust or the conversion of an individual’s income interest (or remainder interest) to a unitrust interest results in gain or loss to that individual. It is difficult to argue that a disposition of property would occur so as to require the realization of gain for three reasons. First, it is unclear how the change in the way that the income of a trust is calculated results in a disposition

¹⁰⁵ 1956-2 C.B. 507.

¹⁰⁶ 1969-2 C.B. 159.

¹⁰⁷ Cottage Sav. Ass’n v. Comm’r, 499 U.S. 554 (1991).

because the beneficiary still has a right to the income of a trust as defined under state law. Second, it is difficult to determine how to value the consideration transferred by each party, particularly because any decision by a trustee to adjust or not to adjust or to convert or not to convert a trust is not permanent. Third, a current beneficiary or remainder beneficiary probably does not have the ability to prevent the adjustment or the conversion to a unitrust, but only to force a court to make the decision.

In rulings that the IRS issued before the § 643 regulations added Examples 11 and 12 to the GST regulations and in later rulings to which Examples 11 and 12 did not apply, it sometimes specifically declined to address the sale issue for unitrust conversion,¹⁰⁸ sometimes did not mention the issue,¹⁰⁹ and sometimes ruled that there was no sale.¹¹⁰ In one instance, which involved unusual facts,¹¹¹ the IRS ruled that a unitrust conversion was a taxable sale. On one occasion, a ruling was silent regarding whether or not the exercise of a statutory power to adjust was a taxable sale.¹¹²

In rulings under Example 11, the IRS has confirmed several times that the conversion of an income trust to a unitrust was not a taxable exchange¹¹³ and, in one instance, has declined to rule whether there was a sale.¹¹⁴

In rulings under Example 12, the IRS has confirmed several times that the trustee's possession of a statutory power of adjustment was not a taxable exchange¹¹⁵ and, on one occasion, did not address the issue.¹¹⁶ Without mentioning Example 12, the IRS ruled once that the exercise of the power to adjust under a state statute was not a taxable exchange.¹¹⁷

E. Implications of § 643 Regulations

1. Introduction

¹⁰⁸ PLRs 200447002 (July 15, 2004), 200446002 (July 15, 2004), 200437003-004 (Apr. 26, 2004), 200314011 (Dec. 20, 2002), 200305024 (Oct. 28, 2002), 200252064 (Sept. 16, 2002), 200234047 (Apr. 12, 2002), 200214019 (Dec. 27, 2001), 200211008 (Dec. 14, 2001), 200150016 (Sept. 12, 2001), 200148034 (Aug. 29, 2001).

¹⁰⁹ PLRs 200615001 (Dec. 12, 2005), 200604015 (Oct. 24, 2005), 200517002 (Dec. 21, 2004), 200409003 (Nov. 6, 2003), 200326029 (Mar. 14, 2003), 200316023 (Jan. 8, 2003).

¹¹⁰ PLRs 200517009 (Dec. 23, 2004), 200502031-032 (Sept. 30, 2004), 200448001 (July 21, 2004), 200437012 (Apr. 26, 2004), 200217036-037 (Jan. 23, 2002).

¹¹¹ PLR 200231011 (May 6, 2002).

¹¹² PLR 200334025 (May 14, 2003).

¹¹³ PLRs 200633002-003 (May 11, 2006), 200632002-003 (May 11, 2006), 200627005 (Mar. 28, 2006), 200609003 (Nov. 21, 2005), 200532042-043 (Apr. 20, 2005), 200502031-032 (Sept. 30, 2004), 200417014 (Dec. 31, 2003).

¹¹⁴ PLR 200507010 (Oct. 25, 2005).

¹¹⁵ PLRs 200544017 (Nov. 4, 2005), 200543039-046 (July 25, 2005).

¹¹⁶ PLR 200533006 (Apr. 20, 2005).

¹¹⁷ PLR 200437011 (Apr. 29, 2004).

The § 643 regulations allayed many concerns about the potential income-tax, GST-tax, and gift-tax consequences of unitrust conversions and the exercise of the power to adjust provided that the action is based on a state statute. Questions remain, however, if there is no such basis.

2. Observations

Noted commentators make several observations about the § 643 regulations.

First, they emphasize the importance of state legislation:¹¹⁸

[T]he preamble rejected a request by commentators that a unitrust or equitable-adjustment power be respected if authorized solely by the governing instrument. . . . In fact, the regulations' limited acceptance of a power to adjust and the unitrust rules will force property owners who wish their trustees to be able to administer the trust under the rules to forum shop—that is, create trusts under the laws of states that have expressly adopted those rules by legislation. And in policy terms, the regulations' overemphasis on state law will have the unintended consequence of forcing states to enact unitrust and power-to-adjust legislation to avoid the loss of trust business.

Next, they emphasize the importance of creating trusts in a state that permits trusts to be converted to unitrusts under a statute that permits the 3%–5% range:¹¹⁹

[I]t may be appropriate for a QDOT to be converted to a 5 percent payout. That will tend to maximize the amount that may be distributed to the surviving spouse free of estate tax. On the other hand, it might be appropriate to convert a QSST to a 3 percent unitrust where it is desirable to minimize distributions to the current income beneficiary to maximize the amount in a trust that is exempted from generation-skipping transfer taxation. Similarly, if the trust must distribute all of its income currently and is not subject to state and local income tax but the income of the income

¹¹⁸ Battmachr & Gans, supra note 1, at 896–97 (footnote omitted).

¹¹⁹ Id. at 896 n.19.

beneficiary is subject to those taxes, it might be better, if a conversion occurs, to choose only a 3 percent payout percentage. Given that the choice of an optimal unitrust rate will depend on the circumstances in each case, locating a trust in a state with legislation authorizing a 3–5 percent range may prove to be advantageous. Indeed, to compete more effectively, states with fixed-rate unitrust statutes may eventually decide to adopt a more flexible 3–5 percent approach.

Finally, they note that the trustee and beneficiaries might want to consider relocating a trust and discuss relevant considerations as follows:¹²⁰

[T]he exercise of a power to adjust or conversion to a unitrust payment regime will be respected only if done under a state law. Similarly, the safe harbor under which a switch between methods is permitted without adverse tax consequence is available only if made under a state statute.

For several reasons, it may be appropriate to change the situs of a trust to a state that has a statute permitting conversions to unitrusts or the exercise of a power to adjust. The new GSTT regulations, issued in connection with the definition-of-income regulations, contain two examples (Examples 11 and 12) that conclude that such a change in the situs of a trust from a state that has no such statute to one that does (or the reverse) will not cause any beneficiary to be treated as having made a taxable gift or as having made an income-taxable exchange.

A change of situs may not necessarily alter the law governing the trust. If the instrument contains a choice-of-law provision, it may continue to control even after a change in situs. Thus, if a trust is located in a jurisdiction that does not provide for a unitrust or equitable-adjustment regime, changing its situs to a jurisdiction that does have such a regime may not be sufficient (to permit a unitrust conversion or to exercise a power to adjust) if the instrument contains a choice-of-law provision

¹²⁰ *Id.* at 914 (footnotes omitted).

directing that the law of the original jurisdiction is to govern. On the other hand, in the absence of a choice-of-law provision, the law of the state of administration will probably control questions concerning allocations between principal and income. Thus, if the instrument fails to contain a choice-of-law provision, it may be easier to secure tax recognition for a move to a state with a unitrust or equitable-adjustment regime. This suggests that, when possible, any court order authorizing a change in the situs of the trust should include a direction also for a change in the law that governs the determination of its income and corpus.

Another commentator warns that:¹²¹

Outstanding issues in those states include whether a deviation from the 3% to 5% standard for determining the unitrust amount stated in the regulations will be respected. For example, if a state's unitrust statute allows a trustee of a marital trust to adopt a unitrust amount of less than 3%, the marital deduction may be jeopardized for any marital trust in that state unless the trust agreement specifically prohibits a lower percentage. In addition, a unitrust amount in excess of 5% may be treated as a taxable gift to the income beneficiaries by the remainder beneficiaries.

Nonetheless, the IRS did not express concern about possible deviation from the 3%–5% range in a ruling that involved such a statute.¹²²

The same commentator expresses concern about certain power-to-adjust statutes:¹²³

What is unclear is whether an adjustment under a statute [e.g., the Pennsylvania Statute] that does not have the same three conditions discussed in the regulations would be treated as a reasonable apportionment of the total return of the trust.

¹²¹ Mezzullo, *supra* note 1, at 31.

¹²² PLR 200609003 (Nov. 21, 2005).

¹²³ Mezzullo, *supra* note 1, at 28.

Yet another commentator opines that:¹²⁴

One of the areas that differentiates the state unitrust statutes is the degree to which court involvement is required or discouraged. Our Pennsylvania statute allows many conversions to occur without court involvement, but there are many things that require court involvement, such as a reconversion to an income trust, a rate different from 4%, a smoothing rule different from 3 years, or the payment of traditional “income” if greater than the unitrust amount if needed for tax reasons. Anecdotally, the requirement of court involvement for a reconversion appears to have discouraged conversions to a unitrust, as trustees did not want to be “stuck” in a unitrust mode, unless they were willing to go to court, and trustees generally do not want to go to court.

While these requirements were intended to make the case for the unitrust as a proper definition of income stronger for tax purposes, at this point it seems clear that allowing reconversions to an income trust ought to be allowed upon the same conditions and procedures as the conversion from an income trust to a unitrust. This is allowed in a number of states, and was the model used in the Delaware statute.

In addition, the flexibility to choose a rate consensually, as was done in the Illinois model if the trustee and all of the beneficiaries consent, seems to be quite sensible as long as it is within the 3–5% range, permitted by the Final Regulations.

Again, encouraging flexibility seems wise in choosing a three-year smoothing rule or other rules. Such flexibility is built into a few state statutes, such as Delaware. For reasons that will become clear after our discussion of further research on the “best” smoothing rule, this flexibility may well be of value.

¹²⁴ Wolf, *supra* note 1, at 26–27 (footnotes omitted).

He continues that:¹²⁵

[T]he use of an “ordering rule” is more likely to be equivalent to a difference in payout rate of 25 to 40 basis points,

Finally, he notes that:¹²⁶

For the power to adjust, some commentators would view the ability to “steer” the capital gains in one direction or another to be an advantage. This author views it as more frequently akin to having two steering wheels—necessary for a fire truck but otherwise probably more confusing than beneficial. The power to adjust has the inherent flexibility to raise or lower the adjustment to take into account the tax characteristics of the adjustment and the distribution. For most circumstances, that is all the flexibility that you need and all that is helpful.

3. Disclose Transaction

Whether or not the trustee is using a state statute, the current and remainder beneficiaries of a trust that is converted from an income trust to a total-return trust or to which the power to adjust applies should describe the transaction in sufficient detail on income- and gift-tax returns to get the statute of limitations running under IRC § 6501 and to hold the IRS to the usual three-year assessment period under that section. Adequate disclosure of a transaction that is not viewed as a gift starts the statute of limitations on any assertion by the IRS that the transaction was a gift.¹²⁷ Unfortunately, the statute of limitations will not expire until several years after the conversion.

4. Private Letter Ruling

If a proposed unitrust conversion or exercise of a power to adjust would not be based on a state statute or if a proposed unitrust conversion would not be within the 3%–5% safe harbor, the trustee and beneficiaries should obtain a private letter ruling before converting an income trust to a unitrust. Unfortunately, it takes several months or longer to get a ruling, the IRS might not be willing to issue a favorable ruling on one or more of the issues,

¹²⁵ Id. at 43.

¹²⁶ Id. at 59 (footnote omitted).

¹²⁷ Treas. Reg. § 301.6501(c)-2(f)(4).

or it might decline to rule because the transaction is factual¹²⁸ or because it simply prefers not to do so.

IV. MY FIRM'S EXPERIENCE

In the spring of 2001, my firm assembled a team that consisted of a senior investment officer, a trust officer, the head of the tax-preparation group, a financial planner, and two trust attorneys to write a procedure. Because the procedure was in place when the Delaware Statute was enacted, my firm was able to present it to clients immediately. As of August 11, 2006, my firm had converted 311 trusts (including one moved from another jurisdiction) worth about \$746 million.

¹²⁸ Rev. Proc. 2006-3 § 4.02(1), 2006-1 I.R.B. 122, 129 (Jan. 3, 2006).

APPENDIX A

**STATE POWER TO ADJUST
AND UNITRUST STATUTES**

STATE POWER TO ADJUST AND UNITRUST STATUTES

STATE	POWER TO ADJUST	PROTECTION FOR TRUSTEE	UNITRUST CONVERSION STATUTE	NEW UNITRUST STATUTE
Alabama	Ala. Code § 19-3A-104	Ala. Code § 19-3A-104(f)		
Alaska	Alaska Stat. § 13.38.210	Alaska Stat. § 13.38.220	Alaska Stat. §§ 13.38.300–13.38.410	
Arizona	Ariz. Rev. Stat. § 14-7403	Ariz. Rev. Stat. § 14-7404		
Arkansas	Ark. Code Ann. § 28-70-104			
California	Cal. Prob. Code § 16336	Cal. Prob. Code §§ 16337–16338	Cal. Prob. Code §§ 16336.4–16336.7	Cal. Prob. Code § 16328
Colorado	Colo. Rev. Stat. § 15-1-404	Colo. Rev. Stat. § 15-1-405	Colo. Rev. Stat. § 15-1-404.5	
Connecticut	Conn. Gen. Stat. § 45a-542c			
Delaware	Del Code Ann. tit. 12, § 6113	Del. Code Ann. tit. 12, § 6114	Del. Code Ann. tit. 12, § 3527	Del. Code Ann. tit. 12, § 3527A
District of Columbia	D.C. Code § 28-4801.04			
Florida	Fla. Stat. Ann. § 738.104	Fla. Stat. Ann. § 738.105	Fla. Stat. Ann. § 738.1041	Fla. Stat. Ann. § 738.1041(11)
Georgia	Ga. Code Ann. § 53-12-220	Ga. Code Ann. § 53-12-222	Ga. Code Ann. § 53-12-221	
Hawaii	Haw. Rev. Stat. § 557A-104	Haw. Rev. Stat. § 557A-105		
Idaho	Idaho Code § 68-10-104	Idaho Code § 68-10-105		
Illinois			760 ILCS 5/5.3	760 ILCS 5/5.3(m)
Indiana	Ind. Code § 30-2-14-15	Ind. Code §§ 30-2-14-16–30-2-14-17	Ind. Code §§ 30-2-15-1–30-2-15-26	
Iowa			Iowa Code §§ 637.601–637.615	
Kansas	Kan. Stat. Ann. § 58-9-104			
Kentucky	Ky. Rev. Stat. Ann. § 386.454		Ky. Rev. Stat. Ann § 386.454	
Louisiana	La. Rev. Stat. Ann. §§ 9:2158–2162	La. Rev. Stat. Ann. § 9:2163		
Maine	Me. Rev. Stat. Ann. tit. 18-A, § 7-704	Me. Rev. Stat. Ann. tit. 18-A, § 7-706	Me. Rev. Stat. Ann. tit. 18-A, § 7-705	
Maryland	Md. Code Ann., Est. & Tr. § 15-502.2	Md. Code Ann., Est. & Tr. § 15-502.3	Md. Code Ann., Est & Tr. § 15-502.1	
Massachusetts	Mass. Gen. Laws ch. 203D, § 4	Mass. Gen. Laws ch. 203D, § 5		
Michigan	Mich. Stat. Ann. § 555.504	Mich. Stat. Ann. § 555.505		

STATE POWER TO ADJUST AND UNITRUST STATUTES

STATE	POWER TO ADJUST	PROTECTION FOR TRUSTEE	UNITRUST CONVERSION STATUTE	NEW UNITRUST STATUTE
Minnesota	Minn. Stat. Ann. § 501B.705	Minn. Stat. § 501B.705, Subd. 7		
Mississippi				
Missouri	Mo. Rev. Stat. § 469.405	Mo. Rev. Stat. § 469.409	Mo. Rev. Stat. § 469.411	Mo. Rev. Stat. § 469.411(5)(1)
Montana	Mont. Code Ann. § 72-34-424	Mont. Code Ann. § 72-34-424(8)		
Nebraska	Neb. Rev. Stat. § 30-3119	Neb. Rev. Stat. §§ 30-3120–30-3121	Neb. Rev. Stat. § 30-3119.01	
Nevada	Nev. Rev. Stat. § 164.795			
New Hampshire	N.H. Rev. Stat. Ann. § 564-C:1-104	N.H. Rev. Stat. Ann. § 564-C: 1-104(h), 564-C:1-105	N.H. Rev. Stat. Ann. § 564-A:3-c	
New Jersey	N.J. Stat. Ann. § 3B:19B-4	N.J. Stat. Ann. § 3B:19B-31		
New Mexico	N.M. Stat. Ann. § 46-3A-104		N.M. Stat. Ann. §§ 46-3A-105–46-3A-113	
New York	N.Y. Est. Powers & Trusts Law § 11-2.3(b)(5)	N.Y. Est. Powers & Trusts Law § 11-2.3-A	N.Y. Est. Powers & Trusts Law § 11-2.4	N.Y. Est. Powers & Trusts Law § 11-2.4(e)(1)(A)
North Carolina	N.C. Gen. Stat. § 37A-1-104	N.C. Gen. Stat. § 37A-1-105	N.C. Gen. Stat. §§ 37A-1-104.1–37A-1-104.9	N.C. Gen. Stat. §§ 37A-1-104.21–37A-1-104.26
North Dakota				
Ohio	Ohio Rev. Code Ann. § 5812.03	Ohio Rev. Code Ann. § 5812.03 (G)		
Oklahoma	Okla. Stat. tit. 60, § 175.104			
Oregon	Or. Rev. Stat. § 129.215	Or. Rev. Stat. § 129.220	Or. Rev. Stat. § 129.225	
Pennsylvania	20 Pa. Cons. Stat. § 8104	20 Pa. Cons. Stat. § 8106	20 Pa. Cons. Stat. § 8105	20 Pa. Cons. Stat. § 8107
Rhode Island	R.I. Gen. Laws § 18-4-28		R.I. Gen. Laws § 18-4-29	R.I. Gen. Laws § 18-4-29
South Carolina	S.C. Code Ann. § 62-7-904			
South Dakota			S.D. Codified Laws §§ 55-15-1–55-15-14	
Tennessee	Tenn. Code Ann. § 35-6-104	Tenn. Code Ann. §§ 35-6-104(g), 35-6-106		
Texas	Tex. Prop. Code § 116.005	Tex. Prop. Code § 116.006		Tex. Prop. Code § 116.007
Utah	Utah Code Ann. § 22-22-3-104	Utah Code Ann. §§ 22-3-105–22-3-107		
Vermont				

STATE POWER TO ADJUST AND UNITRUST STATUTES

STATE	POWER TO ADJUST	PROTECTION FOR TRUSTEE	UNITRUST CONVERSION STATUTE	NEW UNITRUST STATUTE
Virginia	Va. Code Ann. § 55-277.4		Va. Code Ann. § 55-277.4:1	
Washington	Wash. Rev. Code § 11.104A.020	Wash. Rev. Code § 11.104A.030	Wash. Rev. Code § 11.104A.040	Wash. Rev. Code § 11.104A.040
West Virginia	W.V. Code § 44B-1-104	W.V. Code § 44B-1-105		
Wisconsin	Wis. Stat. § 701.20(4)	Wis. Stat. § 701.20(4c)	Wis. Stat. § 701.20(4g)	Wis. Stat. § 701.20(4j)
Wyoming	Wyo. Stat. Ann. § 2-3-804	Wyo. Stat. Ann. § 2-3-832		

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APPENDIX B

A COMPARISON OF FOUR TOTAL-RETURN UNITRUST CONVERSION STATUTES

A COMPARISON OF FOUR TOTAL-RETURN UNITRUST CONVERSION STATUTES

	DELAWARE	MISSOURI	NEW YORK	PENNSYLVANIA
Citation	Del. Code Ann. tit. 12, § 3527	Mo. Rev. Stat. § 469.411	N.Y. Est. Powers & Trusts Law § 11-2.4	20 Pa. Cons. Stat. § 8105
Effective Date	June 21, 2001; amended June 24, 2004	July 6, 2001; amended July 10, 2002; amended July 7, 2004	Jan. 1, 2002	July 16, 2002; amended July 7, 2006
What must trustee do to convert income trust to unitrust?	Trustee may convert if adopts written policy and notifies specified parties and if no one objects within 30 days of receiving notice. Rules provided for multiple/interested trustees.	Trustee must notify qualified beneficiaries and trustor of intent to make election at least 60 days before making election and later deliver signed writing making election to trustor and beneficiaries.	Trustee must deliver instrument to trust creator, all persons interested in trust, and court having jurisdiction over trust.	Unless expressly prohibited by governing instrument, trustee may release power to adjust and convert income trust to unitrust if determines that conversion will enable it to better carry out creator's intent and purposes of trust, if it notifies specified parties, and if no one objects within 60 days of mailing of notice. Trustee must consider specified factors. Following conversion, trustee must invest for total return. Rules provided for multiple/interested trustees.
When must court be involved?	Trustee may petition court if unable to convert under usual procedure (e.g., because beneficiary objects or because competent beneficiary not in current and next generation) or if wants court approval. Court also might be involved if interested trustee wants to convert or if beneficiary petitions.	Court approval to convert not necessary. Court may revoke trustee's election to convert.	Court may direct statute to apply to trust otherwise subject to power to adjust or direct power to adjust to apply to trust otherwise subject to statute.	Trustee may petition court if unable to convert under usual procedure (e.g., because beneficiary objects or because competent beneficiary not in current and next generation). Court may set payout percentage different from 4% and smoothing period different from prior three years.

	DELAWARE	MISSOURI	NEW YORK	PENNSYLVANIA
How is trust valued for unitrust purposes?	Trust must be valued at least annually. Trustee may select any valuation date or dates and any averages of valuation dates.	For first three years, unitrust amount determined using value of trust on first business day of year. Thereafter, unitrust amount determined using average of values of trust on first business day of current year and two prior years.	Same as Missouri.	Unless court directs otherwise, unitrust distribution determined using trust value averaged over lesser of three preceding years or period trust has been in existence. Trustee may value trust annually or more frequently and select valuation date or dates.
How is illiquid asset valued?	Trustee may choose valuation method; trustee may exclude from valuation, provided income distributed as required by trust; asset used by beneficiary also may be excluded from computations.	Certain residential property and tangible personal property excluded in determining unitrust amount, and use is deemed to be unitrust amount. Trustee must value illiquid asset at least annually.	Similar to Missouri.	Trustee may decide how frequently to value or estimate value of nonliquid assets. Trustee may omit from calculations trust property occupied or possessed by beneficiary.
What requirements apply in setting unitrust percentage?	Unitrust percentage must be not less than 3% nor more than 5% and reasonable current return from trust. Trustee must consider specified factors.	Unitrust percentage must be between 3% and 5%.	Unitrust percentage is 4%. Trustee must consider specified factors in choosing between statute and power to adjust. There is rebuttable presumption in favor of statute over power to adjust.	Unless court directs otherwise, payout percentage is 4%.
What special rules apply to marital trust?	During surviving/donee spouse's life, spouse may compel reconversion.	As provided in § 104(c)(1) of UPAIA.	None.	Trust may not be converted if conversion would result in disallowance of estate or gift tax marital deduction.
What special rule applies to grandfathered GST trust?	None.	None.	None.	No specific provision, but court may direct payment of net income in excess of unitrust distribution to preserve tax benefit.

	DELAWARE	MISSOURI	NEW YORK	PENNSYLVANIA
How is unitrust distribution taxed?	Trustee must treat as coming first from net accounting income determined as if trust were not unitrust and then from ordinary income not allocable to net accounting income. After calculating capital gain net income, trustee may consider paid from net short-term capital gain and then from net long-term capital gain. Balance considered paid from principal.	No pertinent provision.	No pertinent provision.	Unless otherwise provided by governing instrument, trustee must consider as coming first from net income, then from ordinary income not allocable to net income, then from net realized short-term capital gains, then from net realized long-term capital gains, then from principal.
How are administrative issues determined?	Subject to governing instrument, trustee may determine conversion date, timing of distributions, whether distributions made in cash or in kind, etc. Principal invasion provisions still available.	Trustee must adjust unitrust amount for certain distributions, payments, and receipts. Guidance provided for short year and incorrect valuation.	Trustee must adjust unitrust amount for certain distributions and receipts. Guidance provided for short year and incorrect valuation.	Trustee may determine conversion date, timing of distributions, etc. Principal invasion/withdrawal provisions still available. No expenses charged to unitrust distribution.
When is statute unavailable?	When governing instrument requires trustee to distribute amount other than reasonable current return; trust is pooled income fund or CRT, or governing instrument prohibits use of statute.	As provided in § 104(c) of UPAIA.	Estate or trust pursuant to which amount is permanently set aside for charitable purposes unless income also so devoted.	If payment of unitrust distribution would change amount payable as annuity or fraction of value of trust; if unitrust distribution would be made from amount permanently set aside for charitable purposes, unless income and principal are so set aside; if possessing or exercising power to convert would cause individual to be treated as owner for income tax purposes or cause trust assets to be subject to estate or gift tax; or if trustee is beneficiary of trust.

	DELAWARE	MISSOURI	NEW YORK	PENNSYLVANIA
What remedy does aggrieved beneficiary have?	Trustee which takes or fails to take action in good faith not personally liable. Aggrieved person's exclusive remedy is to obtain court order directing trustee to convert trust, reconvert trust, or change unitrust percentage.	Beneficiary had to bring action against trustee for election made or not made under statute by August 28, 2004. Beneficiary may bring judicial proceeding challenging valuation of illiquid asset within two years after trustee sends report disclosing valuation.	Person interested in trust may bring proceeding challenging valuation of illiquid asset within three years after close of year in which determination was made.	If trustee has abused discretion, court may direct action to restore trust and beneficiaries to appropriate positions, require trustee to convert trust to unitrust or reconvert trust to income trust, or surcharge trustee.
Does statute contemplate transfer of trust to jurisdiction?	Yes—statute is to be construed as pertaining to administration of trust and is available to trust administered in Delaware under Delaware law or to trust, regardless of place of administration, that provides that Delaware law governs matters of construction or administration.	No.	No.	No.
Does statute cover wholly charitable trust?	Yes.	No.	Yes.	No—but covered by 20 Pa. Cons. Stat. § 8113.
For which trusts is statute available?	Trusts in existence on or created after June 21, 2001.	Trusts in existence on, before, or after August 28, 2001, if trustee elects to have statute apply unless governing instrument directs otherwise.	Trusts in existence on December 31, 2001, if trustee, with consent of persons interested in trust or in trustee's discretion, elected to have statute apply by December 31, 2005.	Trusts in existence on July 15, 2002, and created thereafter.
Does state also have statute recognizing new unitrust?	Yes—Del. Code Ann. tit 12, § 3527A.	Yes—Mo. Rev. Stat. § 469.411(5)(1).	Yes—N.Y. Est. Powers & Trusts Law § 11-2.4(e)(1)(A).	Yes—20 Pa. Cons. Stat. § 8107.
Is power to adjust also available?	Yes—Del. Code Ann. tit. 12, §§ 6113–6114.	Yes—Mo. Rev. Stat. § 469.405.	Yes—N.Y. Est. Powers & Trusts Law § 11-2.3(5).	Yes—20 Pa. Cons. Stat. § 8104.

APPENDIX C

2004 DELAWARE S.B. NO. 288



SPONSOR: Sen. DeLuca & Rep. Stone
Sens. Sokola, Still, Sorenson & Rep. Valihura

DELAWARE STATE SENATE

142nd GENERAL ASSEMBLY

SENATE BILL NO. 288

AN ACT TO AMEND TITLE 12 OF THE DELAWARE CODE RELATING TO TRUSTS.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF DELAWARE:

Section 1. Amend paragraph (2) of subsection (a) of § 3527 of Title 12 of the Delaware Code by deleting the second sentence of such paragraph and by inserting the following phrase before the period at the end of the first sentence of such paragraph:

“and regardless of whether the trust directs or permits the trustee to distribute the principal of the trust to one or more such persons”.

Section 2. Amend subsubparagraph 3. of subparagraph b. of subsection (b) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety and substituting in lieu thereof the following:

“3. Without regard to the exercise of any power of appointment, all living persons who would receive principal of the trust if the trust were to terminate at the time of the giving of such notice and all living persons who would receive or be eligible to receive distributions of income or principal of the trust if the interests of all of the beneficiaries currently eligible to receive income under subsubparagraph 2. of this subparagraph b. were to terminate at the time of the giving of such notice; and”

Section 3. Amend subparagraph d. of subsection (b)(3) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety and substituting in lieu thereof the following:

“d. No person receiving such notice objects, by written instrument delivered to the trustee, to the proposed action of the trustee within thirty (30) days of receipt of such notice.”

Section 4. Amend subsubparagraph 3. of subparagraph c. of subsection (c)(3) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety and substituting in lieu thereof the following:

“3. without regard to the exercise of any power of appointment, all living persons who would receive principal of the trust if the trust were to terminate at the time of the giving of such notice and all living persons who would receive or be eligible to receive distributions of income or principal of the trust if the interests of all of the beneficiaries currently eligible to receive income under subparagraph 2. of this subparagraph c. were to terminate at the time of the giving of such notice; and”

Section 5. Amend subparagraph e. of subsection (c) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety and substituting in lieu thereof the following:

“e. no person receiving such notice objects, by written instrument delivered to the trustee, to the proposed action or the determinations of the disinterested person within thirty (30) days of receipt of such notice.”

Section 6. Amend the third sentence of subsection (e) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety and substituting in lieu thereof the following:

“Assets used by a trust beneficiary, such as a residence property or tangible personal property, may be excluded from fair market value for computing the unitrust amount.”

Section 7. Amend subsection (g) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety and substituting in lieu thereof the following new subsection:

“g. A trustee may act pursuant to subsection (b) or subsection (c) of this section with respect to a trust for which both income and principal have been permanently set aside for charitable purposes under the governing instrument and for which a federal estate or gift tax deduction has been taken, provided that:

(1) instead of sending written notice to the persons described in subparagraphs 2. and 3. of subparagraph b. of subsection (b) of this section or subparagraphs 2. and 3. of subparagraph c. of subsection (c) of this section, as the case may be, the trustee shall send such written notice to the named charity or charities then entitled to receive income of the trust and, if no named charity or charities are entitled to receive all of such income, to the Attorney General of this State;

(2) subparagraph c. of subsection (b) or subparagraph d. of subsection (c), as the case may be, shall not apply to such action; and

(3) in each taxable year, the trustee shall distribute the greater of the unitrust amount and the amount required by I.R.C. § 4942.”.

Section 8. Amend subsection (h) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety and substituting in lieu thereof the following new subsection:

“h. Following the conversion of an income trust to a total return unitrust, the trustee:

- (1) shall consider the unitrust amount as paid from net accounting income determined as if the trust were not a unitrust;
- (2) shall then consider the unitrust amount as paid from ordinary income not allocable to net accounting income;
- (3) after calculating the trust’s capital gain net income described in I.R.C. § 1222(9), may consider the unitrust amount as paid from net short-term capital gain described in I.R.C. § 1222(5) and then from net long-term capital gain described in I.R.C. § 1222(7); and
- (4) shall then consider the unitrust amount as coming from the principal of the trust.

Section 9. Amend subsection (l) of § 3527 of Title 12 of the Delaware Code by inserting the following phrase before “unless” in the introduction of such subsection:

“or to any trust, regardless of its place of administration, whose governing instrument provides that Delaware law governs matters of construction or administration”.

Section 10. Amend paragraph (2) of subsection (l) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety and substituting in lieu thereof the following:

“(2) the trust is a pooled income fund described in I.R.C. § 642(c)(5) or a charitable remainder trust described in I.R.C. § 664(d);”

Section 11. Amend paragraph (3) of subsection (l) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety.

Section 12. Amend paragraph (3) of subsection (l) of § 3527 of Title 12 of the Delaware Code by deleting it in its entirety and substituting in lieu thereof the following:

“(3) the governing instrument expressly prohibits use of this section by specific reference to the section or expressly states the trustor's intent that net income not be calculated as a unitrust amount. A provision in the governing instrument that “The provisions of 12 Delaware Code Section 3527, as amended, or any

corresponding provision of future law, shall not be used in the administration of this trust.' or 'My trustee shall not determine the distributions to the income beneficiary as a unitrust amount.' or similar words reflecting such intent shall be sufficient to preclude the use of this section."

Section 13. Amend Title 12 of the Delaware Code by adding the following new § 3527A thereto:

“§ 3527A. Express total return unitrusts.

- (a) The following provisions shall apply to a trust that, by its governing instrument, requires or permits the distribution, at least annually, of a unitrust amount equal to a fixed percentage of not less than three (3) nor more than five (5) percent per year of the fair market value of the trust's assets, valued at least annually, such trust to be referred to in this section as an 'express total return unitrust.'
- (b) The unitrust amount for an express total return unitrust may be determined by reference to the fair market value of the trust's assets in one year or more than one year.
- (c) Distribution of such a fixed percentage unitrust amount is considered a distribution of all of the income of the express total return unitrust.
- (d) An express total return unitrust may or may not provide a mechanism for changing the unitrust percentage similar to the mechanism provided under § 3527 of this title, based upon the factors noted therein, and may or may not provide for a conversion from a unitrust to an income trust and/or a reconversion of an income trust to a unitrust similar to the mechanism under § 3527 of this title.
- (e) If an express total return unitrust does not specifically or by reference to § 3527 of this title deny a power to change the unitrust percentage or to convert to an income trust, then the trustee shall have such power.
- (f) The distribution of a fixed percentage of not less than three (3) percent nor more than five (5) percent reasonably apportions the total return of an express total return unitrust.
- (g) The trust instrument may grant discretion to the trustee to adopt a consistent practice of treating capital gains as part of the unitrust distribution, to the extent that the unitrust distribution exceeds the net accounting income, or it may specify the ordering of such classes of income.

(h) Unless the terms of the trust specifically provide otherwise, a distribution of the unitrust amount from an express total return unitrust shall be considered to have been made from the following sources in order of priority:

- (1) from net accounting income determined as if the trust were not a unitrust;
- (2) from ordinary income not allocable to net accounting income;
- (3) after calculating the trust's capital gain net income as described in I.R.C. § 1222(9), from net realized short-term capital gain as described in I.R.C. § 1222(5) and then from net realized long-term capital gain described in I.R.C. § 1222(7); and
- (4) from the principal of the trust.

(i) The trust instrument may provide that:

- (1) assets for which a fair market value cannot be readily ascertained shall be valued using such valuation methods as are deemed reasonable and appropriate; and
- (2) assets used by a trust beneficiary, such as a residence property or tangible personal property, may be excluded from the net fair market value for computing the unitrust amount.”

Section 14. This Act shall be effective upon enactment and shall apply to trusts whenever created.

SYNOPSIS

This Bill revises 12 Del. C. §3527 based on recently issued Treasury Regulations and nearly three years of experience with Delaware's total return unitrust statute and adds new 12 Del. C. §3527A based on those regulations.

Section 1 of the Bill deletes a sentence in 12 Del. C. §3527(a)(2) that no longer is required due to the issuance of the above regulations and adds a clarifying phrase to the remaining sentence of such provision.

Sections 2 and 4 of the Bill amend 12 Del. C. §§3527(b)b3 and 3527(c)c3 to clarify notice requirements for trusts that will not terminate when the interests of the current beneficiaries cease.

Sections 3 and 5 of the Bill amend 12 Del. C. §§3527(b)d and (c)e to reduce the notice period from 60 days to 30 days.

Section 6 of the Bill amends 12 Del. C. §3527(e) to provide that the value of property used by a trust beneficiary does not have to be included in the computation of the unitrust distribution.

Section 7 of the Bill deletes 12 Del. C. §3527(g) because it no longer is required due to the issuance of the above regulations and replaces it with a provision that enables a trustee to convert a wholly charitable trust to a unitrust under the statute.

Section 8 of the Bill revises 12 Del. C. §3527(h) to ensure that, together, a trust that is converted to a unitrust and the current beneficiary or beneficiaries of such trust will pay the lowest possible amount of Federal income tax.

Section 9 through 12 of the Bill amend 12 Del. C. §3527(l) to extend its applicability to trusts that are governed by Delaware law for matters of construction or administration, to clarify the types of trusts for which the statute is not available due to Federal tax concerns, to delete a superfluous provision, and to make clarifying changes.

Section 13 of the Bill adds a new §3527A to Title 12 of the Delaware Code that provides recognition under Delaware law for newly created total return unitrusts. It is intended to clarify the Federal tax treatment of such trusts. Section 14 provides effective dates.

Author: Senator DeLuca