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TOTAL RETURN TRUSTS—A DECADE OF PROGRESS, BUT ARE WE THERE YET?

by Robert B. Wolf

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I. BACKGROUND AND INTRODUCTION

Ten years ago, when the greatest bull market in U.S. stocks had only just begun, this author and Bill Hoisington of California[2] began to write about the critical need to fundamentally reexamine the way we drafted trusts. Despite tremendous changes during the 20th century in how we live and work, there were relatively few changes in the way we drafted trusts, and the majority of those changes were driven by changes in the tax laws. Apart from drafting changes driven by our desire to pursue tax benefits or avoid tax pitfalls, most trusts remained remarkably unchanged in their fundamental directive to hold the principal and distribute the income to the current beneficiary. These traditional trusts which tell the trustees to hold the principal and pay the income are subject to a primary distribution rule based on the distinction between principal and income and are referred to in this article as "income rule trusts."

Those who lived through the Great Depression knew the importance of never spending the principal. Even before that, the concept of income came from our agrarian past, in which the "income" was growing crops, and the "principal" was the land itself, and the advice was passed from generation to generation to "never sell the land." And that was good conservative advice that stood the test of time. Without the land, there were no crops, and without the crops, the security of the family, and perhaps even life itself, might be lost.

As time went by, the concept of income as growing crops changed to profits from businesses, and as more and more businesses took on the corporate form, to the dividends from those businesses. So income often came from equity or ownership assets. Income could also come from lending money, in which case the interest on such lending was the "income" on a lending investment asset. And again in that context, as long as only the interest was spent, and the principal were maintained, the means to produce that income was preserved.

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* Copyright 2007 Robert B. Wolf. All rights reserved.
[1] Partner/Shareholder, Tener, Van Kirk, Wolf & Moore, P.C., Pittsburgh, PA. A.B., Yale University, 1968; J.D., University of Virginia, 1971. This is an updated and expanded version of an article of the same name published in two parts at 32 ACTEC Journal 5 (Summer 2006) and 32 ACTEC Journal 101 (Fall 2006). It is the fourth major article written by the author on the topic of trust design for total return. Robert B. Wolf, *Defeating the Duty to Disappoint Equally - The Total Return Trust*, 32 REAL PROP. PROB. & TR. J. 46 (1997) [another version appeared in 23 ACTEC NOTES 46 (1997)], *Total Return Trusts - Can Your Clients Afford Anything Less*, 33 REAL PROP. PROB. & TR. J. 131 (1998) [another version appeared in 24 ACTEC NOTES 45 (1998)], and *Estate Planning with Total Return Trusts,* 36 REAL PROP. PROB. & TR. J. 169 (2001). The author acknowledges and appreciates the substantial contribution of Stephen R. Leimberg, Esquire for his support and insights, and his former associate, J. Dustin Barr, Esquire for his skillful contributions to the author's current computer program used to research these issues and to produce the computer-generated graphs that illustrate this work.
[2] William L. Hoisington, *Modern Trust Design: New Paradigms for the 21st Century,* 5-5, 5-6 (Materials for Miami Institute, Jan. 1997).

A. SO WHAT'S THE PROBLEM?

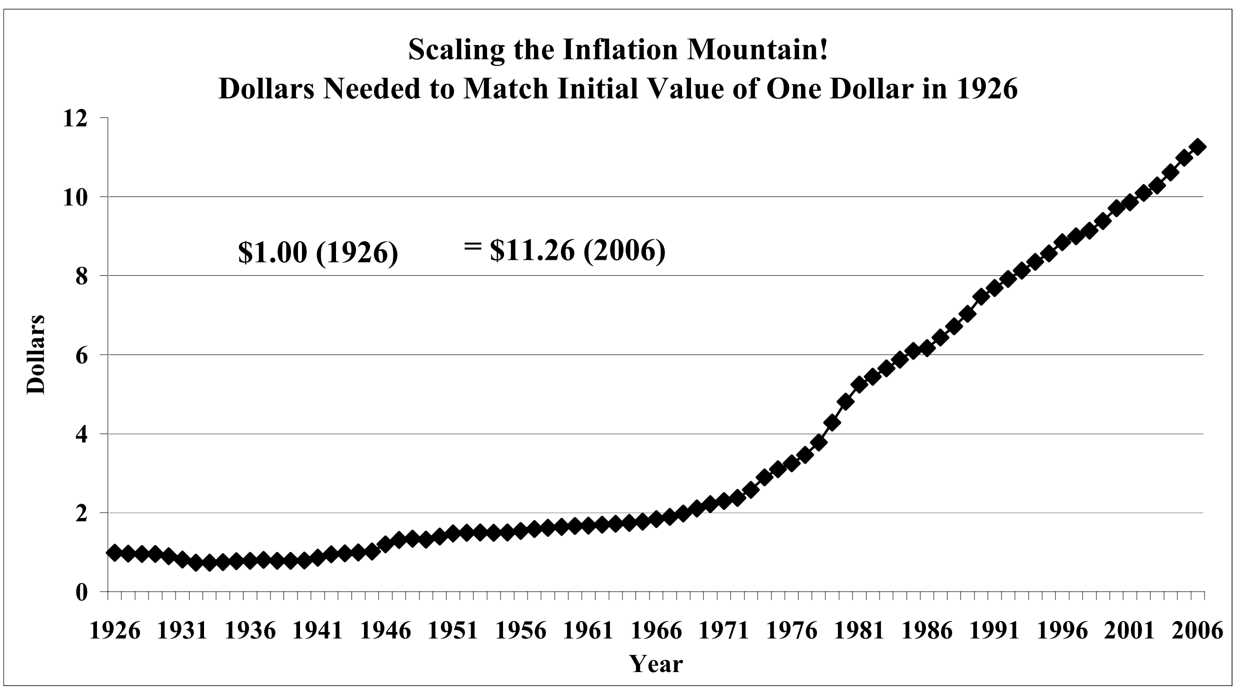
In the context of personal saving and trusts, all was well with this distinction that gave the trust the opportunity to provide support in the form of continuing income over a long period of time, perhaps for generations, but it rested upon several key assumptions as it was applied to stocks and bonds:

1. With respect to bonds, it assumed that when the bond matured, that the dollars paid back to the trust for reinvestment were worth the same as those when the bond was issued.

2. With respect to equity stocks, it assumed that the dividends from stocks represented a reasonable payout from the "total return" of those stocks, including both dividends and principal appreciation.

While periodic bouts with inflation occurred in the 19th century and earlier, systemic inflation really only came about during the latter portions of the 20th century. From 1802 to 1870, consumer price inflation averaged only 1/10th of 1%, and from 1870 to 1925, only 6/10th of 1%[3]

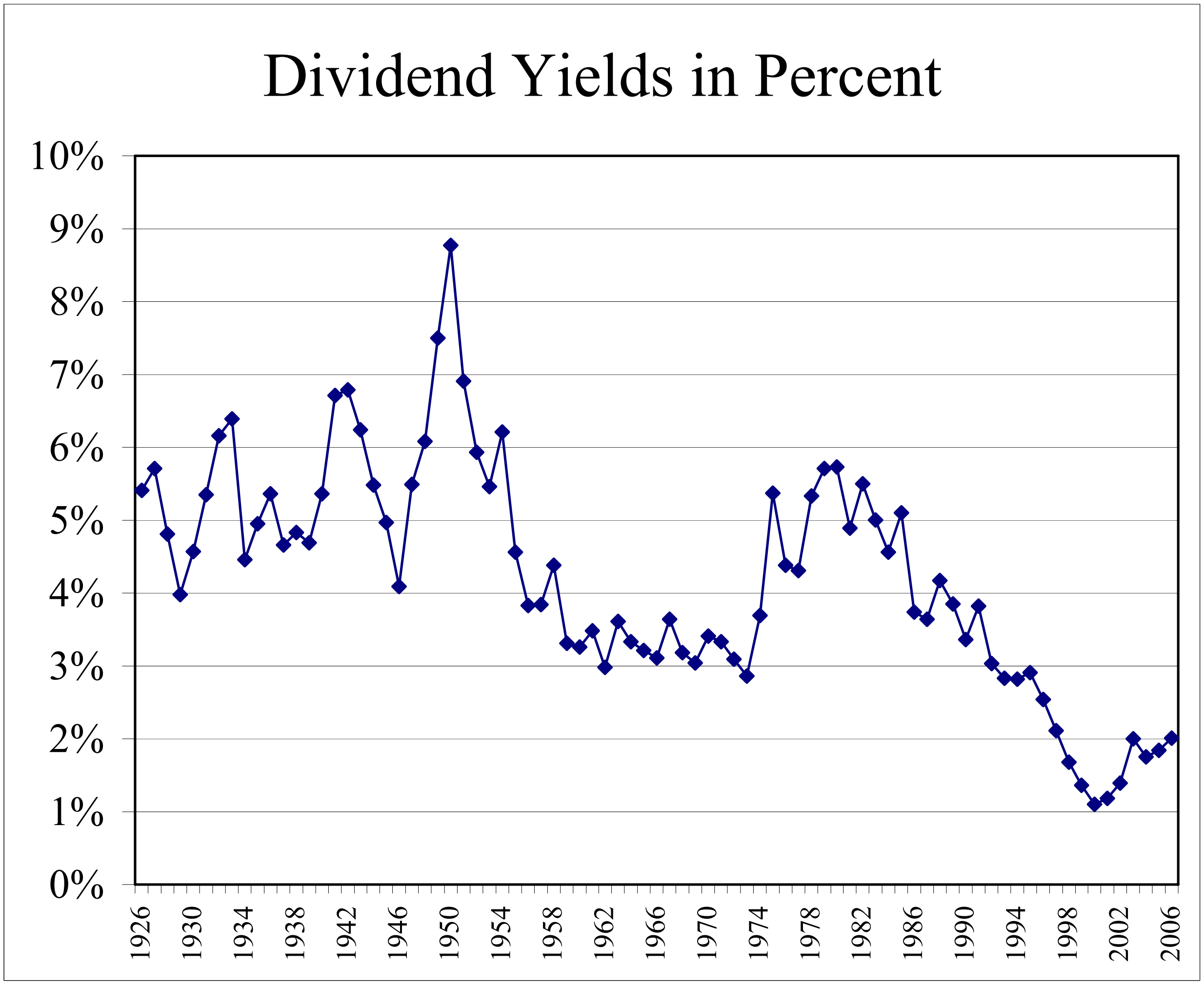
As the graph below illustrates, while there was significant inflation post World War II, real systemic inflation began in the mid-to-late 1960s and has been with us ever since.



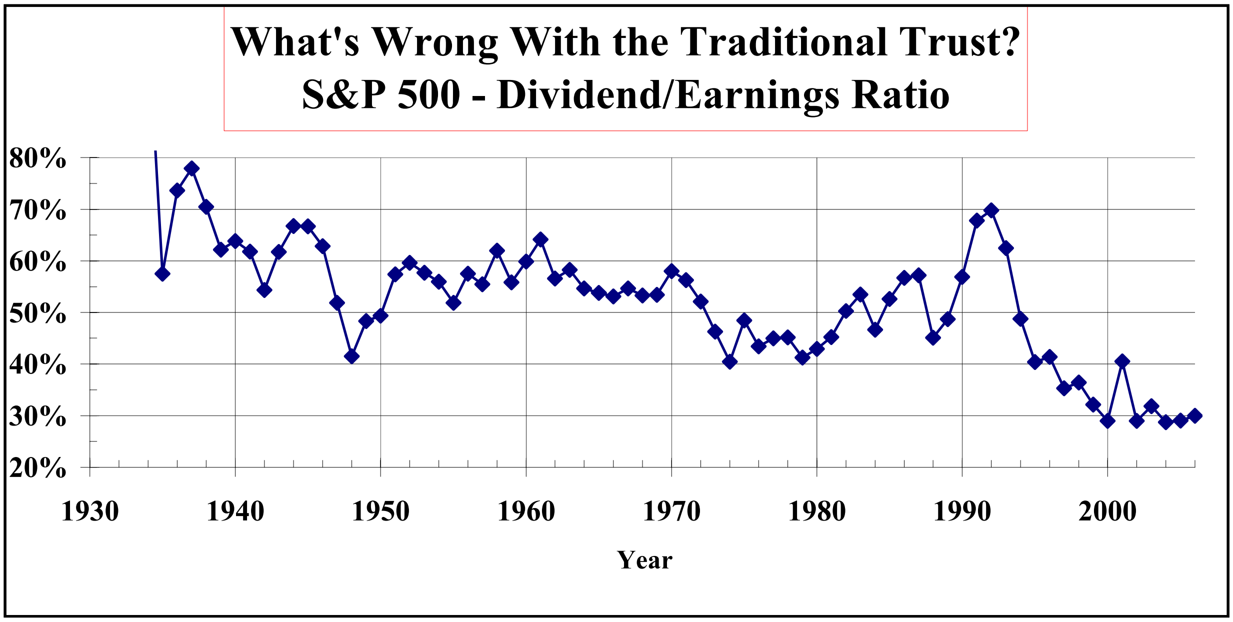
[3] John C. Bogle, COMMON SENSE ON MUTUAL FUNDS: NEW IMPERATIVES FOR THE INTELLIGENT INVESTOR, 9, 13 (1999), compiled from the research of Professor Jeremy Siegel in J. J. Siegel, STOCKS FOR THE LONG RUN (2d ed. 1998).

So, all else aside, a long-term bond might return dollars to the investor that were worth only a very small portion of what they were worth in spending power at the time that the investment was made. Consequently, spending all of the interest received from a bond investment would leave the investor markedly poorer over time.

With respect to stocks, the dividend yield on the Standard & Poor's 500 Index was once a very good proxy for the income one could spend from stock investments, but over time, dividend yields became smaller and smaller, making this a less and less sensible proxy for “income” on this form of investment, as the following graph illustrates:



While some of this loss in yield was a result of the great bull market of the 1990s and gradually expanding price/earnings ratios, not all of it can be explained that easily. Indeed, the proportion of the reported earnings paid out in dividends appears to have undergone a long-term decline as well.

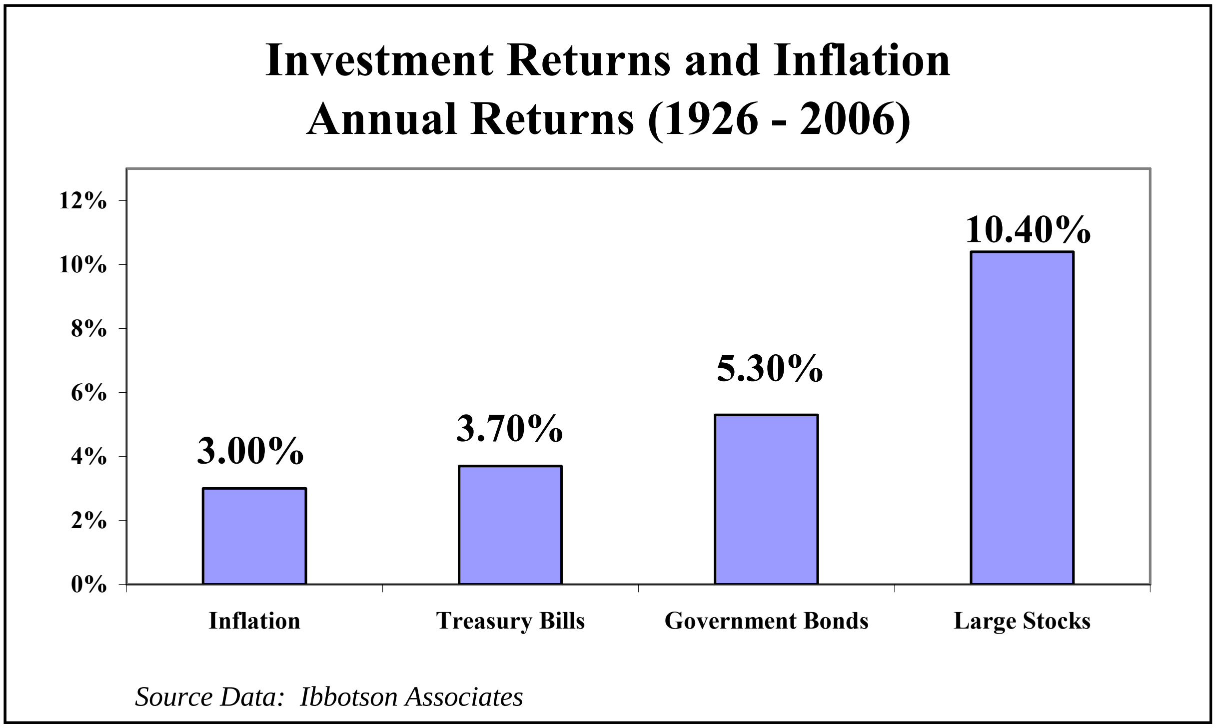


Difficult as it may be to believe, the S & P 500 Index had a dividend yield at the start of the 1950s of almost 9% while an intermediate Government Bond yielded only 1.4%.[4] There was a reason for that at the time: the need for "safety" in a generation that had seen the bank failures of the 1930s and the Great Depression, but it is a far cry from the investment markets of the last 10 to15 years, in which the trustee was torn between the desire from the income beneficiary to invest in bonds so that she could receive more income, and the desire of the remainder beneficiary to invest in stocks, so that she could profit from more growth, which would not in the ordinary course have been distributed on a current basis.

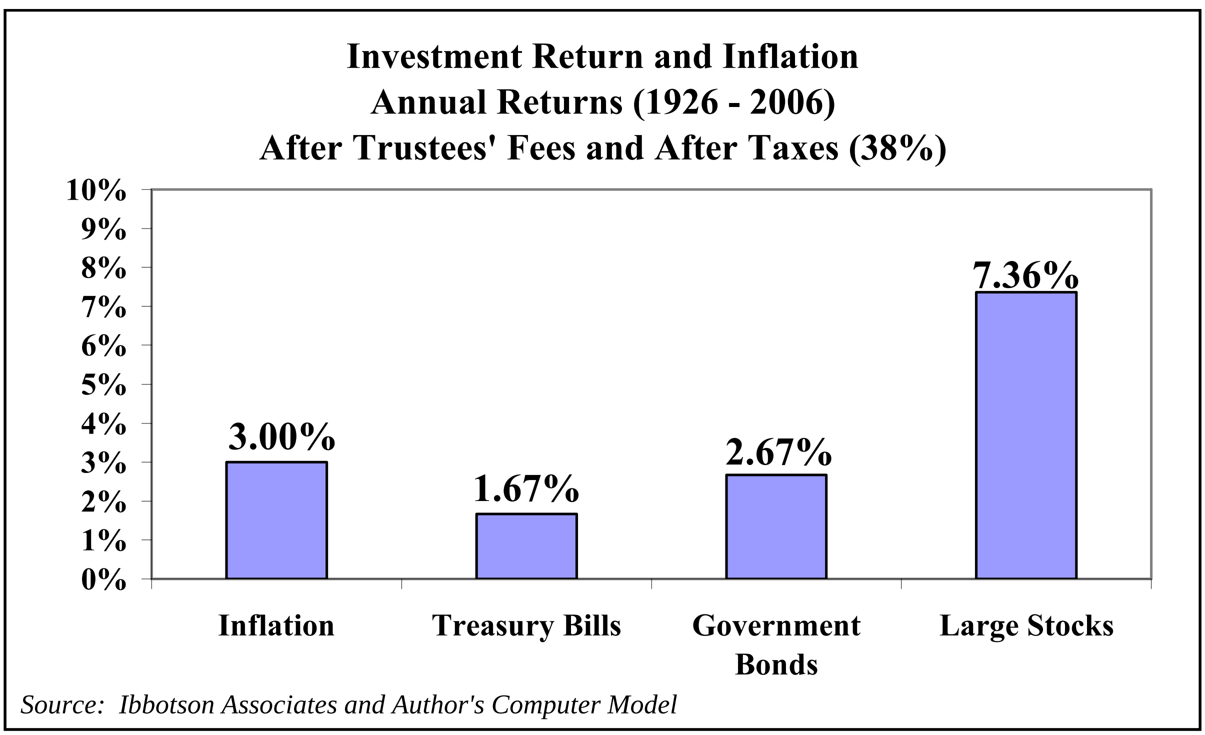
Much of this decline in payout may have been the result of bad tax policy, discussed later, which essentially "punished" a liberal dividend policy with double taxation, a policy that has been significantly reversed as discussed later in this article. But the problem is still very much with us.

The bottom line on the decision of bonds versus stocks actually becomes very clear when we take into account taxes, expenses and inflation. Consider the following series of charts:

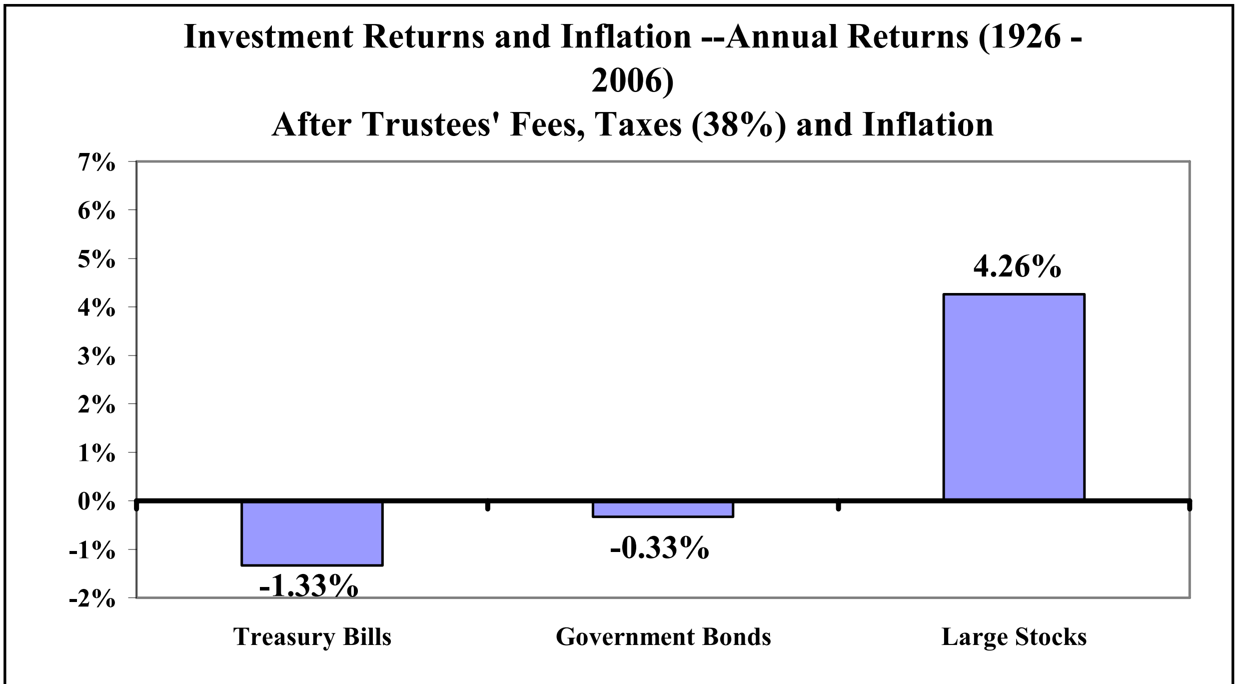
[4] IBBOTSON ASSOCIATES, STOCKS, BOND, BILLS, AND INFLATION 2004 YEARBOOK AT 226, 244 (2004).



And this all looks pretty rosy until we subtract 1% in trustees' fees and the effects of income taxes on the trust, which, even assuming very low turnover of 5% per year, reduces the return available for the beneficiaries and to offset inflation considerably:



And once we take into account inflation, the difficulty of our selection task becomes clear indeed.

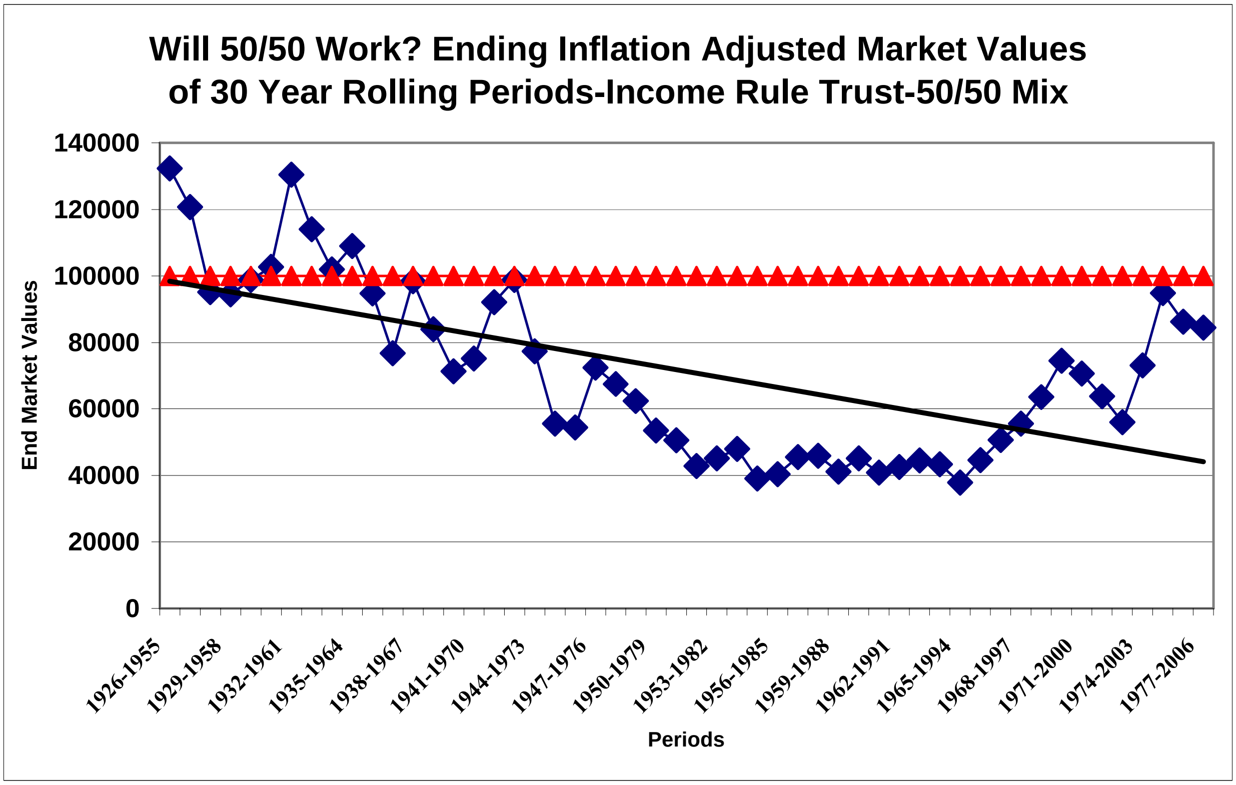


Source: Ibbotson Associates and the Author's Computer Model

When you combine all of these statistics, it is clear that equity investments in stocks or other investments with a similar return are needed to be able to maintain the value of a long-term trust, but at the same time, with dividend yields still at 1.79% for the S & P 500 Index, clearly a trust invested entirely in equities will not be able to distribute any significant amount of income to the trust beneficiary if the trustee is limited to the traditional definition of income. The gross income on a $1,000,000 trust invested in the S & P 500 Index would be $17,900, and if ½ of 1% of the trustee's fees are charged to income, that income would drop to $12,900 per year on a $1,000,000 trust. A "balanced" portfolio of 50% 10 year U.S. Treasury Notes and 50% in the S & P 500 Index would yield about 2.8% on a net income basis, likely not enough income to satisfy the income beneficiary, nor enough growth to satisfy the remainder beneficiaries. Using the author's computer model the assumptions and mechanics of which have been described in prior published materials,[5] the inflation adjusted results of a 50/50 mix of stocks and bonds over long 30-year investment periods is nothing short of disastrous, with the last 30-year period in

[5] Fall Meeting of the American College of Trust and Estate Counsel, SI-156-158 RBW (2004). In short, the Standard & Poor's 500 Index is used as a proxy for the equity portion of the trust and the Intermediate US Government Index for the bond portion of the trust portfolio, 1% trustees' fees, a 1% cost roundtrip on turnover, and an index like turnover of 5% for the portfolio is assumed, as well as a cost basis starting at current market value, and ordinary income tax rates of a total of 38% in federal and state income tax and 22% in capital gains tax rates. The current income tax rates, which are more favorable to equity investing, are not used in this analysis in light of the uncertainty of the permanency of those lower rates. A more detailed description of the exact computational methodology is omitted here, as it has already been published on a number of occasions to expose it to critical discussion.

which the trust would have preserved real value having ended in 1964, the year this author graduated from high school and Barry Goldwater and Lyndon Banes Johnson squared off in a U.S. presidential election!



Since 1964, a trust invested 50/50 in stocks and bonds would have failed to protect the real value of the trust in 42 successive 30-year periods because of the effects of taxes, expenses and inflation. So the coupling of low stock and bond yields with the need to invest mostly in equity stocks or other equity investments, such as real estate or alternative investments with comparable total return, produced a huge problem for investors in general and for trustees of long-term trusts in particular.

Addressing the challenge of investing trust portfolios in a way that acknowledges modern financial theory, the *Restatement (Third) of Trusts* specifically endorsed the use of total return investing and adopted what has come to be known as "modern portfolio theory" where the appropriateness of a trust investment is not viewed in isolation, but rather as its impact on the portfolio as a whole.[6] Shortly thereafter the Uniform Prudent Investor Act was adopted by the National Conference of Commissioners on Uniform State Laws on August 5, 1994. Incorporating modern portfolio theory into the Uniform Prudent Investor Act abrogates all categorical restrictions on types of investments. The trustee can invest "in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other

[6] RESTATEMENT (THIRD) OF TRUSTS § 227(d)(1990).

requirements of prudent investing."[7] Section 2 of the Act also states a number of circumstances that the trustee must consider in investing and managing trust assets:

(1) general economic conditions;
(2) the possible effect of inflation or deflation;
(3) the expected tax consequences of investment decisions or strategies;
(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely-held enterprises, tangible and intangible personal property, and real property;
(5) the expected total return from income and the appreciation of capital;
(6) other resources of the beneficiaries;
(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
(8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.[8]

In addition, the Act creates an express duty of impartiality in connection with investments in Section 6:

> If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.[9]

This duty of impartiality implies a shift away from the general favoring of the life income beneficiary, often what the testator might prefer, in favor of an even-handed duty between the current and remainder beneficiaries. In the context of the investment imperatives and the traditional income and principal distinctions, this duty of impartiality increases the tension and burden on the trustee attempting to function in the context of the conventional income rule trust. The Prudent Investor Act or a variation of it has been adopted in some form in the District of Columbia, the U.S. Virgin Islands and 44 states.[10]

B. THE "SOLUTIONS" TO THE PROBLEM.

Primarily two solutions to this thorny problem have arisen and taken hold. The first is integrated into the Revised Uniform Principal and Income Act.

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[7] UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 280, 300 (2000) (prefatory note).
[8] *Id.* at 290.
[9] *Id.* at 300.
[10] *See* Fact Sheets at website for National Conference of Commissioners on Uniform State Laws http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upria.asp; Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, U.S. Virgin Islands, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.

1. The Uniform Principal and Income Act. A third version of a Uniform Principal and Income Act was approved by the National Conference of Commissioners on Uniform State Laws in July 1997. The primary purposes of this newest revision, reflecting six years of labor, was to update the prior Principal and Income Acts, *i.e.,* to recognize new forms of investments, to reflect the modern portfolio theory of investing, and to allow fiduciaries the means for making the best investment decisions to conform with the prudent investor rules in the *Restatement (Third) of Trusts* and in the Uniform Prudent Investor Act.[11]

The Uniform Principal and Income Act reflects acceptance of total return investing and gives the trustee the power to reallocate or adjust returns between income and principal under certain circumstances. It has been adopted in the District of Columbia and 41 states.[12]

Section 104 of the Act, titled "Trustee's Power to Adjust," addresses the tension between the duty of impartiality and the duty to give due regard to the interests of both the income and remainder beneficiaries.[13] The critical language of Section 104 reads as follows:

> (a) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines that, after applying the rules in Section 103(a), the trustee is unable to comply with the rule in Section 103(b).

Section 103 of the Act provides that:

> (a) In allocating receipts and disbursements to or between principal and income, and in any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given the fiduciary by the terms of the trust or the will even if the fiduciary exercises that power in a manner different from a provision of this [Act];

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[11] UNIF. PRINCIPAL AND INCOME ACT § 104, 7B U.L.A. 131 (2000) (prefatory note).

[12] Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

[13] UNIF. PRINCIPAL AND INCOME ACT, *supra* note 11.

(3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) In exercising the power to adjust granted by Section 104(a) or a discretionary power of administration regarding a matter within the scope of this [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

In essence, Sections 103 and 104 of the Act, taken together, direct the fiduciary to allocate first according to the instrument, then according to any discretionary powers under the instrument, and then according to the Act. If the result still does not allow the fiduciary to comply effectively with its duty of impartiality, Section 104(a) allows the trustee to adjust between principal and income to carry out the purposes of the trust.

The foregoing language allows a trustee to distribute a portion of the total return arising from appreciation of principal by adjusting from principal to income under appropriate circumstances. The Uniform Act also permits accumulation of income under other circumstances to be fair and impartial to both beneficiaries.[14] If the document does not call for impartiality, such as by stating that the welfare of the current beneficiary is of primary importance, the power might be used to best effectuate the intent of the settlor given the economic conditions and investment alternatives available.

The Uniform Act also strives to preserve the critical tax benefits and to avoid creating any new tax problems, particularly with respect to the marital deduction, by denying the trustee the power to reduce the income interest of a trust that otherwise qualifies for the marital deduction[15] and by denying the power to adjust if possessing it would cause the trust to be included in the estate of the power holder, if it would otherwise not have been so included, or which would impose the grantor trust rules on the trust if they would otherwise not apply, or cause the annual gift tax exclusion on a gift of an income interest to be lost.[16] And the power to adjust would be denied if the source of the deduction were assets permanently set aside for

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[14] *Id.*
[15] *See id.* § 104(c)(1).
[16] *See id.* § 104(c)(2), (5) and (6).

charity, again intended to protect tax benefits.[17] A more detailed discussion of the effects of these protections under the Final Regulations under Section 643 is contained later in this article.

Section 104 of the revised Uniform Principal and Income Act would deny this power to a trustee who is an interested party to such an adjustment, whether the trustee is a beneficiary or otherwise, but would allow a disinterested co-trustee[18] to exercise the power if this approach would eliminate the difficulty.

Finally, the Uniform Act would allow the trustee with a tax concern to release all or part of the power provided by Section 104, either permanently or for a specified period, including a period measured by the life of an individual.[19]

The terms of Section 104 would apply to all trusts that distribute based upon the distinctions between principal and income "unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment."[20] It is unlikely that many existing trusts would have such clear language, and hence retroactive applicability is almost universal, except where the application might cause a tax problem, or where the settlor has specifically dealt with the question of how much the current beneficiary is to receive by providing for a unitrust or an annuity interest.[21]

UPAIA and Section 104 reflect a very significant and useful development in the law of trusts. It provides an escape valve when the pressure and inflexibility of our income and principal rules becomes too great. ***But the need for Section 104 itself, after the application of all of the detailed income and principal rules contained in the updated Act, is an implicit recognition that the concept of income and principal, at least as it has been traditionally defined, is a failed concept. It is failed because the concept does not take into account inflation and the need to preserve real value, and because there is no absolute correlation between traditional income and total return.***

2. The Total Return Unitrust ("TRU"). The second solution to the problems encountered by a trustee attempting to invest prudently and distribute fairly is to distribute a percentage of the fair market value of the trust, regardless of whether the payment is made from what is traditionally considered to be principal or what is traditionally considered to be income. This idea is not new, in the sense that it was proposed and discussed in the 1960s[22], and was adopted in substitution for the more suspect and manipulable traditional notion of

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[17] *See id.* § 104(c)(4).
[18] *Id.* § 104(d).
[19] *Id.* § 104(e). If the trustee continues to retain some interest in the trust which might make the release a transfer with a retained interest, that trustee would not be able to effectively release a power of appointment considered to be general if the trustee is trying to avoid death tax includability. *See* Rev. Rul. 86-39, 1986-1 C.B. 301. For this reason, a disclaimer qualified under I.R.C. § 2518 might be needed within nine months of the creation of the power. *See* I.R.C. § 2518 (1997).
[20] UNIF. PRINCIPAL AND INCOME ACT, *supra* note 11, § 104(f).
[21] *Id.* § 104(c)(3).
[22] Robert M. Lovell, *The Unitrust: A New Concept to Meet an Old Problem,* TR. & ESTATES, March 1966, at 215; Del Cotto and Joyce, *Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code*, 23 TAX L. REV 257 (1968).

"income" for charitable split interest trusts by the 1969 Tax Reform Act, which required either a unitrust and an annuity interest for a charitable deduction to be allowed.[23]

Oddly, though, this relatively simple concept of paying out a percentage of a trust's fair market value in place of income did not catch on for the purely private trust until almost 30 years later. At almost the same time, charitable endowments and foundations were being freed from the chains of the income rule by the Uniform Management of Institutional Funds Act, passed in 1972[24]("UMIFA"). UMIFA allowed fund managers to utilize a portion of realized or unrealized gain on their investments to supplement traditional income in order to allow their investment managers to invest prudently for total return, including both traditional income and capital gain.[25] The charitable endowment field has long invested and distributed using a total return approach, and perhaps most frequently using a percentage of the market value as a common methodology for determining payout. The most thorough treatment of the development of the law in the charitable and university endowment arena is undoubtedly Professor Dobris' 1993 article on the subject.[26]

A unitrust design responds to several important goals in determining how we might construct a distribution rule for the modern trust.

- The trust must enable the trustees to invest for the highest total return consistent with the level of risk acceptable to the trust and its beneficiaries.
- If possible, it should create an identity of interest between the current beneficiary, the trustee and the remaindermen relative to investment decisions.
- It should allocate returns well and fairly in all types of markets, even when there are times of unusual volatility, whether up or down.
- The flow of distributions to the current beneficiary should be as smooth as practicable while maintaining the identity of interest among the parties to the trust.
- The distribution rule should be simple enough for most clients to understand.

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[23] CRATs, Charitable Remainder Annuity Trusts, allowed by I.R.C. § 664(d)(1); CRUTs, Charitable Remainder Unitrusts, allowed by I.R.C. § 664(d)(2); CLATs, Charitable Lead Annuity Trusts, allowed under Treas. Reg. § 20.2055-2(e)(2); CLUTs, Charitable Lead Unitrusts, allowed under Treas. Reg. § 25.2522(c)-3(c)(2)(vii).

[24] UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT, 7A Part II U.L.A. 475 (1999).

[25] The UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT was adopted in 2006 and has been adopted in Nebraska, Idaho, South Dakota and Utah, passed the legislature in Montana and has been introduced in 14 other states. *See* the Final Act with Comments at http://www.law.upenn.edu/bll/ulc/umoifa/2006final_act.htm.

[26] *See* Joel C. Dobris, *Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules,* 28 REAL PROP. PROB. & TR. J. 49 (1993). *See also* Joel C. Dobris, *New Forms of Private Trusts for the Twenty-First Century—Principal and Income,* 31 REAL PROP. PROB. & TR. J. 1 (1996).

For the most part, the unitrust with a three-year smoothing rule addresses all of the foregoing criteria. Its greatest strength is the fact that it creates a true identity of interest between the current income beneficiary on the one hand and the remainder beneficiary on the other. No other method of distribution does this as well as the unitrust. Its greatest weakness is a direct result of its greatest strength. During protracted volatile bear markets, the income beneficiary will suffer right along with the market value of the trust corpus. Its simplicity and predictability makes it much more transparent to the trust beneficiaries, but that very predictability means that the trustee cannot change the distribution method or rate in its discretion.

In short, the Power to Adjust and the Power to Convert to a Unitrust are reverse images of each other and will be best suited to different circumstances depending upon the identity of and relationship between the trustee, the current beneficiary and the remainder beneficiary.

A great deal has been written about the unitrust, both in scholarly and professional journals[27] and in the mainstream financial press,[28] but more importantly, into the laws of a great

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[27] *See* Robert B. Wolf, *Estate Planning with Total Return Trusts,* 36 REAL PROP. PROB. & TR. J. 169 (2001) ("Wolf 3"); Robert B. Wolf and Stephen R. Leimberg, *Total Return Unitrust: The (TRU) Shape of Things to Come,* RESEARCH INSTITUTE OF AMERICA, ESTATE PLANNER'S ALERT (December 1998); Robert B. Wolf, *Total Return Trusts - Can Your Clients Afford Anything Less*, 33 REAL PROP. PROB. & TR. J. 131 (1998) (another version appeared in 24 ACTEC NOTES 45 (1998) ("Wolf 2") and *Defeating the Duty to Disappoint Equally - The Total Return Trust*, 32 REAL PROP. PROB. & TR. J. 45 (1997) (another version appeared in 23 ACTEC NOTES 46 (1997) ("Wolf 1"); William L. Hoisington, *Modern Trust Design: New Paradigms for the 21st Century,* 31 U. MIAMI INST. ON EST. PLAN. 5-5, 5-6 (1997); Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration including the "Give-Me-Five" Unitrust*, 33 REAL PROP. PROB. & TR. J. 1 (1998); Joel C. Dobris, *Why Five? The Strange, Magnetic and Mesmerizing Effect of the Five Percent Unitrust and Spending Rate on Setllors, Their Advisors and Retirees,* 40 REAL PROP. PROB. & TR. J. 38 (2005); Joel C. Dobris, *New Forms of Private Trusts for the Twenty-First Century Principal and Income*, 31 REAL PROP. PROB. & TR. J. 1 (1996).; Mark Edwards, *Trusts for the New Century: The Third Paradigm,* THE WILL AND THE WAY, No. 1 (November 1998); William L. Hoisington, *Fiduciary Principles, Modern Financial Theory and Practical Implications for Trust Design and Administration,* ACTEC 1998 Annual Meeting Symposium (February 1998); Holding and Reid, *The Private Unitrust vs. The Discretionary Trust as a Paradigm for the New Century,* THE WILL AND THE WAY, No. 2 (Feb. 1999); Arthur Sherwood, *Tax Aspects of Using a Unitrust Amount to Define Appropriate Benefit Currently Distributable from Non-Charitable Trusts,* 70 NEW YORK STATE BAR JOURNAL 70 (September/October 1998); Edward Polisher, *From Classic to Innovative - - The Total Return Unitrust,* ATLANTA BAR ASSOCIATION SECTION ON TAXATION NEWSLETTER (Spring 1999); David A. Diamond, *Trust Design and Investment Strategy for the Next Millennium: Pulling the Plug on Income Rule Trusts,* 5 CALIFORNIA Trusts AND ESTATES QUARTERLY, No. 3 (Fall 1999); James Garland, *Long Duration Trusts and Endowments,* J. OF PRIVATE PORTFOLIO MANAGEMENT, (Spring 2005); James Garland, *The Problem With Unitrusts,* J. OF PRIVATE PORTFOLIO MANAGEMENT, (Spring 1999); Harrison Gardner, *The Income-Only Trust: Rest in Peace,* 8 NJL 1943, September 13, 1999; James Garland, *A Market-Yield Spending Rule Revisited*; (Update through 1998); J. OF PRIVATE PORTFOLIO MANAGEMENT, (Winter 1999); Robert B. Wolf, Stephen R. Leimberg, and Susan Porter, *The Total Return Trust (TRU) Revolution - An Introduction,* 34 U. MIAMI INST. ON EST. PLAN (2000) ("Wolf Miami"); Robert B. Wolf and Bruce A. Guiot, *Case Study - Total Return Trusts: Techniques and Applications,* 34 U. MIAMI INST. ON EST. PLAN (2000); James Dam, *Should Estate Planners Be Revising Their Trusts,* 2000 LWUSA 101 (February 7, 2000); Jonathan A. Levy, *The Total Return Unitrust: Is it Time for High-Fives?,* TR. & ESTATES (June 2000); James W. Rockwell, *Total Return Trusts,* 26th ANNUAL PROBATE & TRUST LAW CONFERENCE, MINNESOTA BAR ASSN. (June 2, 2000); Michel W. Nelson, *In Support of a Unitrust Distribution Concept,* 127th ANNUAL CONVENTION, IOWA STATE BAR ASSOCIATION, (June 22, 2000); Linda B. Hirschson, *The Unitrust Alternative: A Framework for Total Return Investing,* TAX MANAGEMENT MEMORANDUM, Vol. 42, No. 23, 483 (Bureau of National Affairs, November 5, 2001); Alvin J. Golden *'Total Return': Is this How Trusts Are to Be Structured in the New Millennium? Can You*

many of our states, to allow traditional income rule trusts to be converted into unitrusts, even after they have become otherwise irrevocable, and recognizing the unitrust concept as an acceptable alternative to the traditional notion of dividends and interest as "income".

II. WHAT'S NEW AND TRU?

A. BORN IN THE U.S.A.—TOTAL RETURN STATUTES TURN THE CORNER DESPITE A BULL TURNING INTO A BEAR.

1. The engine of change. Total return statutes, which intend to provide for a definition of income which will permit the trustee to invest prudently and distribute fairly and impartially, are the result of more than a decade of progress in trust thinking. The *Restatement (Third) of Trusts* first forced open the door to modern investment thinking for trusts, and the Uniform Prudent Investor Act gradually found its way into state laws across the country. Once the duty to invest for total return and the duty to invest taking into account an obligation of fairness to both the current beneficiaries and the remainder beneficiaries were in play, the trustee was thrust into a substantial dilemma as to how to invest the trust if the trust provided for the distribution of income and income only on a non-discretionary basis. The Uniform Principal and Income Act with its Section 104 Power to Adjust, discussed earlier in this article and statutory powers to convert income trusts to unitrusts were a necessary and natural reaction to this

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Afford Not to Recommend Them?" (2000); Edward Jay Beckwith, *Distribution Issues For Substantially Appreciated Trusts – Is It Possible To Provide A Fair Return to both Current And Future Beneficiaries?*, SF68 ALI-ABA 555 (2001). Lyman W. Welch, *Committee Report: The Fiduciary Professions, Progress of Total Return Legislation,* TR. & ESTATES 12 (December 2001); Patrick J. Collins and Josh Stampfli, *Promises and Pitfalls of Total Return Trusts*, 27 ACTEC JOURNAL 205 (2001); Barry L. Kohler, *TRU or False, An Introduction to the Total Return Unitrust*, MAINE BAR J. 94, Spring 2001; Lyman W. Welch, *Policy Differences in Total Return Laws*, TR. AND ESTATES (June 2001); Richard W. Nenno, *Where the Rubber Meets the Road: Implementing Total Return Trust Statutes*, 36 U. MIAMI INST. ON EST. PLAN. 1400 (2002); Gerard J. Monchak, *The TRU Debate: The Pros and Cons of Using Total Return Unitrusts*, J. OF FINANCIAL SERVICE PROFESSIONALS (April 2003); Sidney Kess and Martin M. Shenkman, *Total Return Trusts: What Practitioners Should Know*, ESTATE PLANNING REVIEW (May 22, 2003); *Managing Trusts: Better Decisions in An Uncertain World*, Bernstein Wealth Management Research, June 2003.

[28] *See A Welcome New Twist in Trusts*, STANDARD & POOR'S OUTLOOK, Feb. 10, 1999, at 8-9; Jan Alexander, *Harmonious Inheritance,* WORTH, December 2001, at 30; Brad Burg, *Will Your Trusts Keep Your Heirs Poor—and Fighting?*, MED. ECON., Sept. 18, 2000, at 63; Carrie Coolidge, *In Growth We Trust*, FORBES, Mar. 8, 1999, at 166; Frank Croke, *Total Chaos*, FIN. PLAN., May 2000, at 95; Ashlea Ebeling, *New Cash from Old Trusts,* FORBES, September 17, 2001, at 144; Brian Hindo, *Making Trust Funds Do Double Duty,* BUSINESS WEEK, April 8, 2002, at 80; Michael L. M. Jordan, *Implementing MPT In an Allocated Total Return Trust*, J. OF FIN. PLAN., June 1998, at 78; Donald J. Horn, *Balancing Act,* FINANCIAL PLANNING INTERACTIVE, September 2003; Lynn O'Shaughnessy, *Seven Trust Trip-Ups*, MUTUAL FUNDS, June 2000, at 88; Barbara Gilder Quint, *How a Unitrust Could Keep the Whole Family Happy*, 17 PHYSICIANS FIN. NEWS, Apr. 15, 1999, at 8, *available at* http://pediatrics.medscape.com/PFNPublishing/PhysiciansFinancialNews/1999/v17.n5/pfn1705.08.01.html (last visited Jun. 26, 2001); Dan Rottenberg, *Wealth Preservation Liberated Trust*, BLOOMBERG PERS. FIN., 1998, at 101; Rachel E. Silverman, *Can You Trust Mom With Your Trust?,* WALL ST. J., April 30, 2003; Ruth Simon, *New Laws May Lift Trust-Fund Returns,* WALL ST. J., July 22, 1999; Grace K. Weinstein, *Untying the Knots of Total Returns*, FINANCIAL TIMES, July 31, 2001; Robert Lowes, *Haven't Updated Your Estate Plan Lately? Uh-Oh*, MEDICAL ECONOMICS II, November 5, 2001. Donald Jay Korn, *Balancing Act,* FINANCIAL PLANNING INTERACTIVE (September 1, 2003); Marshall Loeb and Brendan January, *Protect retirement nest egg by living off 4 percent a year,* Pittsburgh Post-Gazette, (Feb. 16, 2004); Ashlea Ebeling, *Opening the Income Tap,* FORBES (Feb. 16, 2004); Suzanne Baillie Schmitt, IRS *revises the definition of trust income to reflect changing state law concepts,* Leimberg Services (April 2004); Deborah L. Jacobs, *Weatherproofing,* BLOOMBERG WEALTH MANAGER (May 2004).

dilemma. There was one driving force and one triggering event at work during that time. The driving force was the most powerful bull market in history from 1995 through 1999; an unprecedented time of returns for large capitalization U.S. stocks:

Year	Total Return
1995	37.43%
1996	23.07%
1997	33.36%
1998	28.58%
1999	21.04%

Total return over the five year period was a sizzling 251.04%. Expectations came in two sizes: big and bigger. But the portion of that return that came from dividends during the same period only came in small and extra small:

Year	Dividend Return
1995	2.91%
1996	2.54%
1997	2.11%
1998	1.68%
1999	1.36%

Total return over the five year period from dividends was a mere 11.05%. So 96% of the return during that period of tremendous bull market was represented by principal appreciation and potential capital gain, and only 4% of the return was represented by the dividends on those equities. Worse yet, those dividends, small as they were, were taxed at rates up to 38% for federal purposes, while long-term capital gains were taxed at 20%. So in an all-equity portfolio, the income beneficiary was really suffering while the portfolio market value was growing tremendously. No wonder that trust beneficiaries and investors in general were turning away from dividend income as a significant source of return. This was the engine of change that forced trustees, practitioners and, ultimately, state legislatures to change their income and principal laws to provide for some relief, either by adopting the Uniform Principal and Income Act with Section 104 Power to Adjust, or a unitrust conversion statute, or both.

The triggering event was the adoption on February of 2001 of the Proposed Regulations broadening and updating the definition of income for tax purposes, as will be discussed in more detail in the following section of this article.[29] Up to that point in time quite a few states had adopted the Uniform Act, but, while a number of states, notably New York, Missouri, Pennsylvania and Delaware were studying the unitrust alternative, none of them had adopted it, at least in part out of concern that the IRS would not honor a unitrust definition of income, and might disqualify trusts for marital deduction purposes, endanger grandfathering for generation skipping tax purposes, or consider such a conversion to be a gift or a taxable event for income tax purposes. The Proposed Regulations relieved those worries substantially, and kick started a revolution in state legislation.

[29] Proposed Reg-106513-00, FED. REG., February 15, 2001, Vol. 66, No.32, at 10396-10402 ("Proposed Reg.").

2. The broad brush. On June 21, 2001, Delaware became the first state in the country to enact a statute expressly allowing trustees of income trusts to convert their income trusts to a unitrust. While both New York, which passed its statute the day before Delaware, and Missouri, which passed its statute at the end of May 2001, were ready to put their laws into effect, Delaware's Governor had the quickest pen.[30] New York played a very significant role in critically examining the state law definition of income and issuing a substantial legislative report recommending the adoption of a unitrust definition of income,[31] which lent focus and weight to those arguing for such a change to be considered by state legislatures. The combination of the New York initiative and the IRS acceptance of the unitrust and the power to adjust in its Proposed Regulations led to an explosion of state legislative activity. In the four years since the promulgation of the Proposed Regulations basically saying that a unitrust definition of income was fine as long as it was pursuant to a state statute, and as long as the percentage specified was between 3 and 5%, a total of 24 states have adopted unitrust legislation, and about the same number of states during that period adopted the Uniform Act and the Section 104 power to adjust. Section 104 of the Uniform Act is now in effect in 41 states

Today only four states have no form of total return legislation:

Mississippi
North Dakota
Rhode Island
Vermont

All of the rest of the states have adopted the power to adjust, the power to convert to a unitrust, or both, and the largest number of states that have enacted such legislation since the Proposed Regulations approved both approaches, enacting statutes with both the power to adjust and the power to convert to a unitrust, a total of 20 states to date. This gives those states the richest set of options for the trustee to match the remedy to the situation, the trust assets and the trust beneficiaries. All of this is even more remarkable in light of the fact that the raging bull market turned into a growling bear with the following total returns for the S & P 500 for the years 2000 through 2002:

Year	Total Return
2000	-9.11%
2001	-11.88
2002	-22.10%

Lawyers, trustees, legislators and investors all share the human trait of being influenced by the most recent events, so the fact that the development of the law continued despite the turning of

[30] http://www.legis.state.de.us/ The Act amends Title 12 of the Delaware Code, by adding a new section 3527 entitled "Total return unitrusts." Those of you with an historical bent may remember that Delaware has always been quick to act on good ideas, being the first to sign the new United States Constitution as well on December 7, 1787. See http://www.legis.state.de.us/Legislature.nsf/?Opendatabase.

[31] STATE OF NEW YORK, EPTL-SCPA LEGISLATIVE ADVISORY COMMITTEE, *Proposed Changes to the Definition of Trust Accounting Income, to Redefine Appropriate Benefit Currently Distributable*, Supplement to Fifth Report, May 26, 2000 (on file with author).

the worm in the markets is a good thing and a sign of the maturity of thought that has gone into the entire process. The law of trusts must change over time with changes that occur in the underlying long-term conditions of the markets, of trustees, settlors and beneficiaries, but not with every twist and turn of the market.

3. **Unitrust statute models and trends.** While for the most part the states adopting the power to adjust in Section 104 of the Uniform Act did so without many changes to the Uniform Act, the states had no one model to use for a unitrust conversion statutes. They have tended to follow several of the state statutes that were discussed and passed early on in the process; most significantly the statutes of Pennsylvania, Delaware and Illinois.

(a) **The Pennsylvania model.** The Pennsylvania statute served as a base model for a number of other state statutes, particularly Alaska, Georgia, Iowa, Maine, New Hampshire, Oregon, and Washington. The Pennsylvania statute,[32] drafted before the release of the Proposed Regulations, provided for both the power to adjust and a unitrust conversion statute, but the options were mutually exclusive. It adopted a 4% unitrust rate,[33] a three-year "smoothing" provision[34], an "ordering" provision for the payout of the unitrust amount from ordinary income first, then short-term capital gains, then long-term capital gains, and then from the principal of the trust.[35] The method of conversion was by a relatively simple process of written notice by the trustee to the current and remainder beneficiaries without court approval unless someone disagreed within the 60-day notice period.[36] Court approval was required however, to select a unitrust rate different from 4%, to require traditional accounting income to be distributed if greater than the unitrust amount, to select a smoothing period different from 3 years, to force a trustee to convert a trust into a unitrust, or to reconvert a unitrust to an income trust.[37] The adoption of a default unitrust rate of 4% was partly to strengthen the case that the distribution could be considered "income" for tax purposes, since it was uniform, and also to make the choices of the trustee less difficult, since this was an entirely new set of decisions for the trustee. And the choice of rate has no aspects of a "win-win" choice. Higher is better for the current beneficiary, and lower is better for the remainderman.

One of the aspects of the Pennsylvania statute that was copied by many states was the discretionary power it gave to the trustee to make the less major administrative decisions, such as the payout dates, how to handle short years, how frequently to value illiquid property, what valuation dates to use, how to treat property that is used by the beneficiary, and how to handle other distributions from or contributions to the trust.[38] The Pennsylvania statute also made it clear that trust provisions that gave the trustee power to distribute principal would not be affected by the conversion to a unitrust,[39] and expenses that would ordinarily be subtracted from income would not be subtracted from the unitrust amount.[40] In the ordinary income trust, the portion of

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[32] 20 PA.C.S. § 8101 et seq.
[33] 20 PA.C.S. § 8105 (d)(3).
[34] *Id.*
[35] 20 PA.C.S. § 8105 (f)(2).
[36] 20 PA.C.S. § 8105 (a).
[37] 20 PA.C.S. § 8105 (g).
[38] 20 PA.C.S. § 8105 (e).
[39] 20 PA.C.S. § 8105 (h).
[40] 20 PA.C.S. § 8105 (f)(1).

the trustee's fee and other income expenses often make the income distribution quite unpredictable on a month to month or quarter to quarter basis, which is undesirable for the income beneficiary.

(b) The Delaware model. The Delaware statute, despite being the first one actually enacted into law, had a number of features that were desirable and which were emulated by other states. The most important distinguishing feature was the trustee's ability to choose a unitrust rate in the range from 3% and 5%. This was largely a function of the speed with which the Delaware committee and legislature were able to react to the Proposed Regulations, which specifically indicated that range as acceptable.

In making its decision as to the rate, the trustee is directed to take into account:

(1) the intentions of the trustor, as reflected in the governing instrument,

(2) general economic conditions,

(3) projected current earnings and appreciation for the trust, and

(4) projected inflation and its impact on the trust.[41]

The trustee has discretion to determine the effective date of the conversion, the timing of distributions, and the valuation dates or the averages of valuations dates as are deemed appropriate.[42]

The Delaware law specifically grants the trustee the power to allocate short- and long-term capital gains to income for purposes of determining DNI.[43] As discussed later in connection with the Proposed and Final Regulations, this is important because it may both lower the total tax burden and make a higher payout rate prudent. Delaware's unitrust statute gives the trustee significant flexibility in administering their new total return unitrusts, particularly the flexibility of choosing a unitrust rate between 3% and 5%. This is favorable, provided that the trustees do not mind making some important choices in the process.

The Delaware law also had specific provisions for allowing a disinterested third party to be selected and make the decision as to the conversion and the rate of a unitrust.[44] The most important distinguishing feature of the Delaware law was to give the trustee the choice of rate within the permitted range, and this feature, with a twist added by the Illinois statute, as discussed below, has been followed frequently in states adopting their statutes more recently, along with the ability of the trustee to employ the same process to reconvert the trust to an income trust. Giving the trustee both flexibility and informality of process is very important.

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[41] 12 DEL. CODE § 3527 (f).
[42] 12 DEL. CODE §3527 (i).
[43] 12 DEL. CODE §3527 (h)(2).
[44] 12 DEL. CODE §3527 (c).

Trustees and beneficiaries do not like to go to court, so the ability to act without court activity was quite important.

(c) The Illinois model. Illinois adopted its unitrust statute on August 22, 2002 and drew upon both the Pennsylvania and the Delaware statutes in the process. Like Pennsylvania, a conversion by notification of the trustee was specified to be a 4% unitrust payout.[45] But like Delaware, a rate of not less than 3% nor more than 5% was possible, where the conversion was by agreement of the trustee and all of the beneficiaries of the trust entitled to notice under the statute.[46] This ability of the trustee and all of the beneficiaries to choose a rate by consensus was an important development that has been followed by a number of other states, including California, Indiana, Colorado, Nebraska New Mexico and Wisconsin. It shifts the power and obligation to make the decision as to rate either to the court or to a consensus, which by nature must include the current beneficiary and one or more future beneficiaries.

Notice, while similar to the procedure in Pennsylvania and elsewhere, is given to the current eligible income beneficiaries and to the beneficiaries who would be next in line to receive benefits if the interests of all of the current beneficiaries were terminated.[47] This is quite different from all of the other state statutes, since the beneficiaries who are the "next takers" are often not the "remaindermen." For example, what if the trust provides income for life to spouse, and then on spouse's death in trust for the children, and then on the children's deaths, to the grandchildren? The Illinois statute would require notice to the decedent's spouse and also to the decedent's children, but not to the decedent's grandchildren. So one can argue that the Illinois statute ignores the remaindermen's interests where the next beneficiaries are not the remaindermen. On the other hand, the provisions of the Pennsylvania statute seem to ignore the interests of the beneficiaries in the middle; in the hypothetical case, the decedent's children.

The Illinois statute contains an ordering rule which starts with regular net income (accounting income of the trust), then ordinary income not included within regular net income,[48] before distributing short- and long-term capital gains. Unique to the Illinois statute is the ability of the trustee to release the power to convert to a unitrust just because the trustee feels that it is in the best interests of the trust to do so. In virtually all of the other state laws involving either the power to adjust or the power to convert to a unitrust, the power to release either remedy was based upon tax concerns or difficulties, whereas this statute allows the release just because the trustee thinks that the release is a good idea.[49]

Another area where the Illinois statute was different was in the area of trustee protection. The trustee is protected from claims made against him for any actions taken, or not taken, provided the trustee acts in good faith. In addition, the exclusive remedy is

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[45] *See* 760 ILCS 5/5.3(a).
[46] *See* 760 ILCS 5/5.3(b).
[47] *Id.* at 5/5.3(a)(3).
[48] *See* 760 ILCS 5/5.3(f)(2).
[49] Do we want to give the trustee the power to avoid these choices that are so central to investing and distributing the trust? It would clearly increase the comfort level of trustees not wanting to exercise the powers in certain trust situations, but is it a good idea to give them the power to release themselves from considering their options on a continuing basis? This is an easier question to phrase than it is to answer, in the author's opinion.

the conversion or reconversion to or from a unitrust, whichever is appropriate.[50] The action or inaction of a trustee under the act is presumed further to be reasonable and in good faith, and is barred by the statute of limitations of 2 years from the date that the trustee gave written notice of an action such that the objector knew or should have known of the action of which they complain. The Illinois statute did not follow the lead of the Delaware statute in dealing with a situation where all of the trustees are interested by appointing a new disinterested party, but instead relied upon the court procedure to "cleanse" any decision made by an interested trustee.[51]

(d) Other directions—the Ohio TRU safe harbor and the Texas Unitrust definition of income. Ohio provides an interesting twist which combined the features of the power to adjust and the unitrust in its unique safe harbor provision.[52] Ohio did not adopt either the power to adjust or the power to convert to a unitrust or both in their purest forms, but chose instead a hybrid with the power to adjust as provided in the UPAIA with the strongest possible safe harbor provisions for upward adjustments of income not to exceed a 4% unitrust distribution. The power to adjust is contained in O.R.C. § 1340.42, with the typical operative language, factors, qualifications, and exclusions, but the most critical language is contained in § 1340.42(G), which provides perhaps the strongest protective language for the benefit of the trustee of any of the total return statutes:

> (G) The liability of a trustee relative to the exercise of adjustment authority conferred by divisions (A) to (F) of this section shall be limited in the following manner:
>
> (1) Unless a court determines that a trustee has acted in bad faith, no trustee shall be held liable for damages for choosing not to make an adjustment.
>
> (2) Unless a court determines that a trustee has acted in bad faith with respect to an adjustment, the sole remedy to be ordered by a court shall be a prospective correction of the adjustment.
>
> (3) <u>For purposes of this section, and subject to division (C) of this section, from time to time a trustee may make a safe-harbor adjustment to increase net trust accounting income up to and including an amount equal to four per cent of the trust's fair market value determined as of the first business day of the current year. If a trustee determines to make this safe-harbor adjustment, the propriety of this adjustment shall be conclusively presumed. Nothing in division (G)(3) of this section prohibits any other type of adjustment authorized under any provision of this section. (Emphasis inserted)</u>

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[50] *See* 760 ILCS at 5/5.3(k).

[51] *Id.* at 5/5.3(c).

[52] H.B.No. 522, enacting O.R.C. §§ 1340.40-1340.42, 1340.46, 1340.47, 1340.51-1340.53, 1340.57-1340.59, 1340.63-1340.66, 1340.70-1340.77, 1340.80-1340.86, 1340.90, 1340.91 and repealing various sections.

In a number of ways, the Ohio statute grants trustees far greater protection than Section 105 of the UPAIA.[53] First, Section 105 of the Uniform Act uses a general abuse of discretion standard. This is likely the standard under the Ohio statute as well for the court to grant *some remedy*, but for the trustee to be liable *in damages* for choosing not to make an adjustment, the court must affirmatively find bad faith, an extremely tough standard; and again, if an adjustment is made, the sole remedy for an adjustment that is allegedly improper is a prospective correction of the adjustment unless a bad faith finding has been made.[54] Section 105, on the other hand, expressly allows damages from the trustee's own funds if the parties cannot otherwise be placed in the position they would have been but for the abuse of discretion.[55] In addition to the foregoing, a trustee can, from time to time, make a "safe-harbor" adjustment to increase the "net trust accounting income" up to and including an amount equal to 4% of the fair market value of the trust as of the first business day of the current year, and if such an adjustment is made, the "propriety" of the adjustment shall be conclusively presumed. Taken as a whole, the power to

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[53] **SECTION 105. JUDICIAL CONTROL OF DISCRETIONARY POWERS.**

(a) A court may not order a fiduciary to change a decision to exercise or not to exercise a discretionary power conferred by this [Act] unless it determines that the decision was an abuse of the fiduciary's discretion. A fiduciary's decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power.

(b) The decisions to which subsection (a) applies include:

(1) A decision under Section 104(a) as to whether and to what extent an amount should be transferred from principal to income or from income to principal.

(2) A decision regarding the factors that are relevant to the trust and its beneficiaries, the extent to which the factors are relevant, and the weight, if any, to be given to those factors, in deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a).

(c) If the court determines that a fiduciary has abused the fiduciary's discretion, the court may place the income and remainder beneficiaries in the positions they would have occupied if the discretion had not been abused, according to the following rules:

(1) To the extent that the abuse of discretion has resulted in no distribution to a beneficiary or a distribution that is too small, the court shall order the fiduciary to distribute from the trust to the beneficiary an amount that the court determines will restore the beneficiary, in whole or in part, to the beneficiary's appropriate position.

(2) To the extent that the abuse of discretion has resulted in a distribution to a beneficiary which is too large, the court shall place the beneficiaries, the trust, or both, in whole or in part, in their appropriate positions by ordering the fiduciary to withhold an amount from one or more future distributions to the beneficiary who received the distribution that was too large or ordering that beneficiary to return some or all of the distribution to the trust.

(3) To the extent that the court is unable, after applying paragraphs (1) and (2), to place the beneficiaries, the trust, or both, in the positions they would have occupied if the discretion had not been abused, the court may order the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust or both.

(d) Upon [petition] by the fiduciary, the court having jurisdiction over the trust or estate shall determine whether a proposed exercise or non exercise by the fiduciary of a discretionary power conferred by this [Act] will result in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income and remainder beneficiaries will be affected by the proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion." UNIF. PRINCIPAL AND INCOME ACT § 105, 7B U.L.A. (2000).

[54] O.R.C. §1340.42(G)(1)-(2).

[55] UNIF. PRINCIPAL AND INCOME ACT §F105(c)(3), 7B U.L.A. (2000).

adjust can be used safely by the trustee subject only to a bad faith standard, and if it is within the safe harbor territory up to 4%, the adjustment would be safe from any ordinary attack.

The relative safety and security granted to the Ohio trustee is clearly a positive, as it should encourage the trustee to use the power to adjust. One of the greatest risks for all of the total return trust legislation is that the trustees may feel sufficiently vulnerable that they take no action either under the power to adjust, or, where available, the power to convert to a unitrust. This is precisely the opposite effect from what is intended by such legislation, universally intended to provide greater flexibility of approach for the trustee attempting to invest prudently and distribute fairly. But there are downsides to this approach as well:

1. A safe harbor range will tend to discourage adjustments outside of the safe harbor range. It seems likely that most adjustments will in fact be to a 4% unitrust distribution, because that is the safe harbor. While that may be a good result in some of the cases; in others, a different more flexible adjustment policy may be preferable. For example, a long-term trust that is exempt from GST tax may find a 3% distribution pattern preferable, by allowing the investment for total return, and encouraging long-term growth in value in the trust. And, by the same token, an adjustment somewhat in excess of 4% may be optimal for a shorter term trust for an older beneficiary where enjoyment of a healthy current return may be more important and more consonant with the settlor's intent than long-term growth encouraged by a lower payout rate.

2. While an adjustment to 4% should be very secure for the trustee, the beneficiary is not assured of a consistent payout from year to year, precisely because the trustee is largely safe from attack on the exercise of discretion. The unitrust provides an assurance of payout policy that is not equaled by any trustee power. In theory, the trustee can change his mind from year to year, depending upon market conditions, and while this is an advantage in some circumstances, that very flexibility entails uncertainty, which is not a positive for the beneficiary.

3. It is unclear whether under the Ohio statute, a marital trust drafted as a 4% unitrust would qualify for the marital deduction under the Final Regulations.

4. The Ohio statute only provides a safe harbor for an *upward adjustment,* not a downward adjustment, and while this is the more pressing need at present, there may come a time when this is unduly limiting. For example, if a trustee had the prescience to sell her equity holdings in February of 2000 and invest entirely in bonds, one would hope that the power to adjust would allow the trustee to allocate at least a little bit of the yield to principal, presumably at least down to 4%, since otherwise the asset allocation would seem prejudicial to the remainder beneficiaries (although in hindsight, it would have been helpful to both the current and

remainder beneficiaries). And it is well to remember that interest rates always take into account inflationary expectations that are effectively built into the interest rates themselves. In the period from 1977 to 1980, inflation as measured by the consumer price index actually exceeded the very high interest rates in those years,[56] and in such an environment, it is particularly critical that the trustee be able to adjust down, as well as up.

For states desiring hybrid legislation of the safe harbor unitrust standard, Ohio's statute may be a better starting point than the New Jersey legislation, which provides much less protection for the trustee, with only a presumption that an adjustment within the safe harbor limits is fair and reasonable to the parties involved.[57]

Texas adopted its own version of the Prudent Investor Act and the Uniform Principal and Income Act with an interesting twist, in that while it did not contain a unitrust conversion feature for existing trusts, it did contain a clear definition of a unitrust amount between 3% and 5% of the net fair market value of the trust's assets as an alternative definition of income which may be adopted by a drafter:

(b) In this section:

(1) "Unitrust" means a trust the terms of which require distribution of a unitrust amount.

(2) "Unitrust amount" means a distribution mandated by the terms of a trust in an amount equal to a fixed percentage of not less than three or more than five percent per year of the net fair market value of the trust's assets, valued at least annually. The unitrust amount may be determined by reference to the net fair market value of the trust's assets in one year or more than one year.

(c) Distribution of the unitrust amount is considered a distribution of all of the income of the unitrust and shall not be considered a fundamental departure from applicable state law. A distribution of the unitrust amount reasonably apportions the total return of a unitrust.

(d) Unless the terms of the trust specifically provide otherwise, a distribution of the unitrust amount shall be treated as first being made from the following sources in order of priority:

(1) from net accounting income determined as if the trust were not a unitrust;

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[56] Intermediate Government Bond Yields 1977-1980 were 6.49%, 7.83%, 9.04% and 10.55%, respectively, while inflation totaled 6.77%, 9.03%, 13.31%, 12.40%, respectively. *See* IBBOTSON ASSOCIATES, *supra* n. 4, at Table 2-6, pp. 40-41 and Table A-15, pp. 252-253.

[57] N.J.S.C.3B:19B-4.

(2) from ordinary accounting income not allocable to net accounting income;

(3) from net realized short-term capital gains;

(4) from net realized long-term capital gains; and

(5) from the principal of the trust estate.[58]

By providing a statutory unitrust definition of income, Texas' statute should allow a drafter to use a unitrust in drafting a marital QTIP trust, which, particularly in the context of second marriages, may be uniquely helpful to all concerned.

(e) A "Stealth" Unitrust Conversion Statute Argument? As discussed previously in the detailed section examining the Uniform Act and the Power to Adjust, the Comments added to Section 105 are clearly intended to broaden and empower trustees seeking to use the power to adjust and limit the actions which might be deemed unreasonable so as to give the power to adjust its greatest latitude and flexibility. Those comments make it quite clear that the power to adjust may be utilized in the manner of a unitrust:

> [the trustee] may consider the amount that would be distributed each year based on a percentage of the portfolio's value at the beginning or end of an accounting period, or the average portfolio value for several accounting periods, in a manner similar to a unitrust, and may select a percentage that the trustee believes is appropriate for this purpose and use the same percentage or different percentages in subsequent years.[59]

Does this give sufficient support for a unitrust definition of income to allow a drafter in a state with only the Uniform Act to draft a unitrust without an "income if greater" provision and claim qualification for the marital deduction? Is there support within the Uniform Act for the proposition that a court approved conversion to a unitrust in a Uniform Act state is "pursuant" to an applicable state statute, and thus protected by the Final Regulations from concerns of loss of the marital deduction, GST grandfathering or sale or exchange treatment under *Cottage Savings*[60]? Letter Ruling 200448001 issued July 21, 2004 represents a very liberal ruling lending support to that point of view. In that ruling, the beneficiary co-trustee of an income only trust petitioned the Court to modify the trust so as to provide for a payout of the net income or a unitrust amount, whichever is greater:

> Daughter 1 as co-trustee of Trust, petitioned County Court requesting the modification of Paragraph 7 of Trust governing the administration of Trust A. Under Paragraph 7 as modified, the trustee will pay Daughter 1, annually a "Unitrust Amount" equal to f% of the average of the fair market value of the total

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[58] TEX. PROP. CODE ANN. § 116.006.
[59] UNIF. PRINCIPAL AND INCOME ACT, *supra* n. 11, § 105, comment.
[60] *Cottage Savings Association v. Commissioner,* 499 U.S. 554, 111 S. Ct 1503 (1991).

Trust A assets as of the close of the most recent calendar year and the close of the previous two calendar years. If in any year the net income generated by the Trust A assets exceeds the Unitrust Amount, the excess amount is to be paid to Daughter 1. The Unitrust Amount is to be paid first from income, then from short-term capital gains, then from long-term capital gains, then, to the extent necessary, from principal.

Three rulings were requested on these facts:

1. That there was no loss of grandfathering for GST purposes;
2. That capital gains would be allocated to Distributable Net Income under Section 643; and
3. That the conversion of an "income-only" trust to a "total return" trust will not result in a sale or exchange under section 1001 with respect to Daughter 1.

Favorable rulings were obtained on all three questions. The first issue was clear enough, inasmuch as the payment of income or unitrust amount, whichever was greater, could "only operate to increase the amount distributable to A and decrease the amount distributable to A's issue" just as illustrated in the final GST Regulations governing modification of grandfathered trusts.[61]

The second issue was also resolved favorably:

> Section 1.643(a)-3(a) of the Income Tax Regulations provides generally that gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not considered paid, credited, or required to be distributed to any beneficiary unless they are (i) allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary, (ii) allocated to corpus and actually distributed to the beneficiaries during the taxable year, or (iii) utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount that is distributed or required to be distributed. Accordingly, we conclude that, capital gains that are distributed to the income beneficiary will constitute distributable net income under section 643.[62]

The governing instrument and local law did not so provide, authority being drawn only as a result of the decision of the local court (not the highest court in the state under *Bosch*[63]), and yet the letter writer approved this treatment. It is difficult to reconcile the highly technical wording of the Final Regulations discussed later with this liberal ruling. And the inclusion of the capital gains into DNI was as a result of an ordering rule (by a local court), and not a power. Hopefully this reflects a more liberal view of inclusion of capital gains in DNI, which sensibly should not require either a state statute or a high court ruling. When it gets down to it, after all, 15% is 15%!

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[61] Treas. Reg. § 26.2601-1(b)(4)(E), Ex. 8.
[62] PLR 200448001(July 21, 2004).
[63] *Comm'r v. Estate of Bosch,* 387 U.S. 456, 87 S Ct 1776 (1967).

And the ruling on the *Cottage Savings* issue was just as liberal, though the rationale was more clearly stated:

> The administration of a trust in conformance with applicable state law 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 be treated as a taxable exchange for federal income tax purposes by either the trust or the beneficiaries. Because State Law provides the trustee the power to administer Trust A in the same manner as proposed in the modification, the modification is not treated as an exchange of trust interests by the beneficiaries or the trust.

This is a very generous ruling also. There is no doubt that a trustee in a state that has adopted the power to adjust has the ability to implement the power to adjust in a manner similar to a *de facto* unitrust, but if the court converts the income trust into a unitrust, they have actually created something quite different than the *power* given by the power to adjust, because the trustee is then *required* to distribute the trust as a unitrust. Only in Kentucky does the law regarding the power to adjust require court approval before any exercise of the power to adjust.[64] While the power to adjust can be employed in a unitrust manner, it may also be employed in other manners, such as using other types of distribution rules as explained in the comment to Section 105, discussed previously. There is no doubt that from the beneficiary's point of view a unitrust wherein the trustee is *required* to pay out 4% annually is very different from a trust where the trustee has the *discretion* to pay out 4% annually. This is a very liberal ruling, but helpful to trustees and beneficiaries in states without a unitrust conversion statute. There seems no reason not to try such an approach on a court and the IRS again. It worked well once at least! But it would, of course, be unwise to rely upon this Letter Ruling for any other client or trust in the absence of clear authority, which is not present at the moment.

If a trustee wished to follow the tracks in the snow left by 200448001 in a state with no unitrust conversion statute, the strongest way to frame the issue would be for the trustee to petition the court for an advance determination under Section 105(d) of the reasonableness of a prospective adjustment. And that prospective adjustment to the income of the trust would be to adjust principal to income, or income to principal, as necessary to form an income interest that is equal to a unitrust interest calculated as 4% of the value of the trust fund averaged over a three year period, such prospective adjustment to be made for as long as the trust shall continue, or until the trustee were to again petition the court for a determination of the reasonableness of a change to that method of adjustment. Now that is certainly getting closer to our goal of having a state unitrust statute, as it would be a court approval of a method of exercising the power to adjust under a state statute that would be a unitrust method.

Much as the writer might like to find that authorization within the Uniform Act that would pass muster with the IRS, skepticism wins the day, based upon a few distinctions. First, even if such a court proceeding were brought and approved, the trustee would still have the power to adjust differently from the unitrust method, since the advance determination under

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[64] *See* KRS 386.454.

Section 105(d) would simply rule that such a method would be a reasonable exercise of the power to adjust. The court is not authorized under any statute of which the writer is aware to mandate that method of adjustment. So if the trustee is still free to exercise the power to adjust in a manner different from a unitrust, then it would seem that the court hasn't actually approved a conversion to a unitrust, and if it has, then it is not pursuant to the more or less plain words of the Uniform Act, even with the addition of the more expansive comments added to Section 105.

And if the Uniform Act were considered to be sufficient, would it pass muster with the Service without any boundaries to the percentage payouts on the unitrusts to be created? It is clear enough that 3% to 5% is as far as Treasury was going on this score, but if the payout rate suggested were within the 3% to 5% range, it would not necessarily be different in this regard from a number of the statutes where a court might choose a different rate from the default rate chosen in the statute. Perhaps this is not critical, since the power to adjust itself has no high and low limits beyond the imposition of an abuse of discretion standard under Sections 105 and the criteria in 104 itself.

Whether this approach may find some success in states without a unitrust statute is difficult to say at this point. It seems, however, that if a court proceeding were brought under these auspices, and the court were to *really convert an income trust to a unitrust*, so that the trustee would be *required* to distribute a unitrust amount henceforth, a private letter ruling request should be submitted as well to protect those involved from possible loss of GST exemption (unless like 200448001, it also ordered the payout of "income if greater" to the highest generation), or from a possible sale or exchange treatment.

The following is a current chart of the total return legislation in the United States as of the time of this writing. For the most part, the legislative references for the power to adjust are not included, inasmuch as the wording in most of the states tracks the Uniform Act discussed previously, but for reference to any specific trust situation, obviously the statute itself should be reviewed with care for deviations from the Uniform Act, as such changes, though not common, may be important. Pennsylvania, for example, does not track the language in the Uniform Act with respect to prohibiting adjustments from property set aside for charitable purposes, because it would prohibit adjustments for trusts with a partially charitable remainder, which really don't receive any income or death tax benefits which might be threatened by the power to adjust.[65] In the "Notes" column a reference is included to the unitrust statute rate and who has power to select a choice of rate if there is a choice, whether there is tax ordering for capital gains tax purposes, and whether there is specific statutory trustee protection, as well as other important distinguishing characteristics of a state statute in a few cases.

[65] 20 PA.C.S. § 8104 (c)(3).

Jurisdictions With Uniform Principal and Income Act Section 104 and/or Unitrust Conversion Option					
Jurisdiction	**Sec 104**	**Unitrust**	**Notes**	**UNITRUST CITATION**	**Unitrust Conversion URL Citation**
Alabama	Yes	No			
Alaska	Yes	Yes	Effective 9/01/03 Adapted from PA Statute w/Modifications, Tax Ordering	Alaska Stat. Section 13.38.200 et seq.	http://www.legis.state.ak.us/basis/get_bill_text.asp?hsid=SB0087Z&session=23
Arizona	Yes	No			
Arkansas	Yes	No			
California	Yes	Yes	Effective 1/1/2006 4% unitrust, or with agreement or Court Order, 3-5% Unitrust, Tax Ordering Tax Updated for Express Unitrusts	Cal. Probate Code Section 16336.4 et seq.	http://www.leginfo.ca.gov/cgi-bin/postquery?bill_number=sb_754&sess=CUR&house=B&author=poochigian
Colorado	Yes	Yes	Eff. 5/22/2003 4% unitrust, or 3-5% w/agreement or Court Order Tax Ordering Strong Trustee Protections	Col. Rev. Stat.15-1-402	http://198.187.128.12/colorado/lpext.dll?f=templates&fn=fs-main.htm&2.0
Connecticut	Yes	No			
Delaware	Yes	Yes	Eff. 6/21/2001 3-5% Rate at Trustee's Option-Tax Ordering Tax Updated for Express Unitrusts	Title 12 Delaware Code Section 3527 & 3527A and 6113	http://www.delcode.state.de.us/title12/c035/sc02/index.htm#TopOfPage
District of Columbia	Yes	No			

Florida	Yes	Yes	Eff. 1/01/03 –Only available when no Power to Adjust 3-5% Rate Option or 1/2 7520 rate b/t 3% & 5%, Tax Ordering Power, Updated for Express Unitrusts	Section 738.101 et. seq.; Sec. 738.1041	http://www.leg.state.fl.us/Statutes/index.cfm?App_mode=Display_Statute&Search_String=&URL=Ch0738/SEC1041.HTM&Title=->2005->Ch0738->Section%201041#0738.1041
Georgia	Yes	Yes	Eff. 7/1/2005, 4% Modeled After PA Law, Tax Ordering, Trustee Protection	GA. Code Ann. 53-12-220 and 221	http://www.legis.state.ga.us/legis/2005_06/search/hb406.htm
Hawaii	Yes	No			
Idaho	Yes	No			
Illinois	No	Yes	Eff. 8/22/2002 4% Default, 3-5% w/consent of Benies & Trustees. Tax Ordering, Trustee Protection, Updated for Express Unitrusts	760 Illinois C.S. 5/5.3 et. seq.	http://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=2117&ChapAct=760%26nbsp%3BILCS%26nbsp%3B5%2F&ChapterID=61&ChapterName=TRUSTS+AND+FIDUCIARIES&ActName=Trusts+and+Trustees+Act%2E&Print=True
Indiana	Yes	Yes	Effective 7/1/03-5%Default 3-5% With Agreement, Tax Ordering, Trustee Protection	IC 30-2-14-15	http://www.in.gov/legislative/ic/code/title30/ar2/ch15.pdf
Iowa	No	Yes	Eff. 4/5/2002-4%, 3-5% By Court Order, Tax Ordering	15 Iowa Code Section 637-601 et seq.	ttp://nxtsearch.legis.state.ia.us/NXT/gateway.dll/moved%20code/2005%20Iowa%20Code/1/23055/24253/25022?f=templates$fn=defaultURLQueryLink.htm$q=[field%20folio-destination-name:'ch_637']$x=Advanced

Kansas	Yes	No			
Kentucky	Yes	Yes	Effective 1/1/05. No separate unitrust statute. Unitrust method of exercising power to adjust if 3-5%. Power to adjust allowed only with Court Approval	KRS 386.454	http://www.lrc.state.ky.us/KRS/386-00/454.PDF
Louisiana	Yes	No	Just Section 104 - not the rest of UPAIA		
Maine	Yes	Yes	Eff. 3/22/02 4% Default- very similar to PA Statute Tax Ordering	Chap. 544 Sec. 1 18-A MRSA Sec. 7-705	http://janus.state.me.us/legis/statutes/18-a/title18-Asec7-705.html
Maryland	Yes	Yes	Eff. 10/1/02,4% Unitrust, tax Ordering Power, Some Trustee Protection	Chapter 478 Section 15-502.1 et seq.	http://198.187.128.12/maryland/lpext.dll?f=templates&fn=fs-main.htm
Massachusetts	Yes	No	HB740/SB962		2pub501%2D5501/pub 501%2D550%2D43.htm
Michigan	Yes	No		Act No. 159, Public Acts of 2004, eff. 9/1/04	
Minnesota	Yes	No		Minnesota Statutes Section 501B.705	http://www.revisor.leg.state.mn.us/stats/501B/705.html
Mississippi	No	No			
Missouri	Yes	Yes	Eff. 8/28/2001 Revised 11/8/2004 3-5% No Tax Ordering, Tax Updated	Chapter 469.411 et seq.	http://www.moga.state.mo.us/statutes/c400-499/4690000411.htm
Montana	Yes	No			

Nebraska	Yes	Yes	Eff. Sept.4,2005, 4% Default, 3-5% w/consent of Trustees and Ben, Tax Ordering, Trustee Protection	Nebraska Revised Statutes 30-3119.01	http://srvwww.unicam.state.ne.us/Statutes2005.html
Nevada	Yes	No			http://www.leg.state.nv.us/ 72nd/Bills/SB/SB196.html
New Hampshire	No	Yes	Eff 1/1/2003 5% Rate-Patterned after PA Statute Tax Ordering	Chapter 544A RSA Section 564-A:3-c	http://www.gencourt.state.nh.us/rsa/html/LVI/564-A/564-A-3-c.htm
New Jersey	Yes	Unitrust Safe Harbors	Adjustment up to 4% or down to 6% presumed reasonable		http://www.njlawnet.com/njstatutes.html
New Mexico	Yes	Yes	4% Default Rate-3-5% w/agreement or Court Order Tax Ordering Some Trustee Protections	N.M. Stat. Ann. Secs. 46-3A-105--46-3A-113	http://www.conwaygreene.com/nmsu/lpext.dll?f=templates&fn=main-hit-h.htm&2.0
New York	Yes	Yes	4% Default Rate, Conversion for old trusts expires 12/31/2005	Article 11 Section 11-2.1 et seq.	http://public.leginfo.state.ny.us/menugetf.cgi?COMMONQUERY=LAWS
North Carolina	Yes	Yes	Eff. 1/1/2004 Delaware Style Unitrust Statute (3-5%),Tax Ordering Power, Trustee Protection	N.C. Gen. Stat. Sec. 37A-1-101 et seq.	http://www.ncga.state.nc.us/gascripts/Statutes/StatutesSearch.asp?searchScope=All&searchCriteria=unitrust&returnType=Section
North Dakota	No	No	Adopted the Uniform Act without Section 104		
Ohio	Yes	4% Unitrust Safe Harbor	Eff. 1/1/ 2003-Adjustment Up to 4% Conclusively Presumed To Be Proper	RC 1340.42	http://onlinedocs.andersonpublishing.com/oh/lpExt.dll?f=templates&fn=main-h.htm&cp=PORC
Oklahoma	Yes	No			
Oregon	Yes	Yes	Eff. 1/1/2004,4% Unitrust patterned	ORS 129.225	http://www.leg.state.or.us/cgi-

			after PA Statute, Tax Ordering Rule		bin/searchMeas.pl
Pennsylvania	Yes	Yes	Eff. 7/15/02,4% Default Rate-Tax Ordering, Tax Updated for Express Unitrusts	20 Pa. C.S.A. Section 8105	http://www.legis.state.pa.us/CFDOCS/Legis/PN/Public/btCheck.cfm?txtType=HTM&sessYr=2005&sessInd=0&billBody=S&billTyp=B&billNbr=0660&pn=1969
Rhode Island	No	No			
South Carolina	Yes	No			
South Dakota	No	Yes	Eff. 7/1/2002 3% Rate-Tax Ordering-Trustee Protection	15 SD Codified Laws Sec. 55-15-1 et seq.	http://legis.state.sd.us/ statutes/Index.cfm?Fuse Action=Display Statute&FindType=Statute&txtStatute=55-15
Tennessee	Yes	No			
Texas	Yes	No (but TRU Inc. def.)	Tax Updated Definition of Income for Express Unitrust, Tax Ordering	Tex. Prop. Code Ann. Sec. 116.001 et seq.	http://www.capitol.state.tx.us/statutes/docs/PR/content/htm/pr.009.00.000116.00.htm#116.007.00
Utah	Yes	No			
Vermont	No	No			
Virginia	Yes	Yes	Eff. 7/1/2004 3-5% Unitrust Rate, Tax Ordering Power, Trustee Protection, Does not Prohibit Power to Adjust	Va. Code Sec. 55-277.4:1	http://leg1.state.va.us/cgi-bin/legp504.exe?000+cod+55-277.4C1
Washington	Yes	Yes	4% Default-Patterned after PA Bill, Tax Ordering Provisions	RCW11.104A.040	http://www.leg.wa.gov/ RCW/index.cfm?fuseaction =chapterdigest&chapter= 11.104
West Virginia	Yes	No			
Wisconsin	Yes	Yes	Eff. 5/17/2005 3-5% Unitrust	Wisc. R. Statutes	http://www.legis.state.wi.us/rsb/Statutes.ht

			chosen by Trustee or Court, unanimous consent of Ben required unless by Court	701.20(4),(4)(g)	ml
Wyoming	Yes	No			
Total In Force w/Section 104	41 + D.C.				
Total Unitrust	24	+OH& NJ Have Unitrust Safe Harbors	Total Both 20		
Total Pending	1				
Total Pending States	In Bill Form	Pending 104 Only	Pending Unitrust Only	Pending Both	Pending 104 Safe Harbor
2(Rhode Island and Minnesota)	2	2	0	0	0

4. Non-Tax Technical Issues and Fixes. These total return statutes, and particularly the unitrust statutes that have been enacted in the last four years, represent a revolution in the way we approach the investment and distribution of trusts. While the approaches that have been used in different states are in part due to differences in trust policy as to what the legislatures and the legislative advisory committees thought was best for their trusts, trustees and beneficiaries, they (we) were breaking new ground, and in hindsight, we didn't get it all right in the first go around. The following offers a few thoughts for consideration of non-tax fix-ups that might be desirable in the unitrust legislation that does not have to do with technical tax matters.

(a) Notice to Parties in Interest. A number of the state statutes followed the form of legislation in Pennsylvania and while the statute read well, we didn't get it quite right. Under the Pennsylvania statute, the notice would be given to the current income beneficiary and to the remaindermen if the trust were to terminate at the time of the giving of notice. What is missing is the person or persons in between. For example, a trust for mother, and then for daughter, and then for grandchildren, terminating when the grandchildren reach age 30, should require notice to all three classes of beneficiaries representing the three generations, but Pennsylvania's current statute does not clearly require notice to the daughter. The following, drawn from language in the Uniform Trust Act, was suggested and was passed in 2006:

> (2) The trustee gives written notice of the trustee's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including what initial decisions the trustee will make under this section, to all the *sui juris* beneficiaries who:
>
> (i) are currently eligible to receive income from the trust; [and]

(ii) would be eligible to receive, if no powers of appointment were exercised, income from the trust if the interest of all those eligible to receive income under subparagraph (i) were to terminate immediately prior to the giving of notice; and
(iii) would receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately prior to the giving of notice.

However, if all three classes are required to have representatives who are *sui juris*, there may be more need for court activity than is desirable, and hence the following phrasing is suggested:

(3) There is at least one *sui juris* beneficiary under paragraph (2)(i) and at least one *sui juris* beneficiary under either paragraph (2)(ii) or (2)(iii).[66]

The second class of beneficiaries, the "next" income beneficiaries, is thought to be sufficient to represent the remainder beneficiaries, and in any event it seems that such a more flexible requirement will eliminate what are likely to be unnecessary court proceedings. States which have used the same language as Pennsylvania would do well to make this correction, and in the absence of such correction, counsel would do well to notify the "mezzanine generation" as well as the current beneficiary and the remaindermen. They are clearly parties in interest.

(b) And Speaking of Court Proceedings. 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.[67] 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. This was remedied by amendment in 2006, and a URL link to the amendatory statute is in the preceding table.

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.[68]

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[66] This suggestion, made by Bob Freedman and Ted Watters of Philadelphia, is the best solution the author has seen as to who should receive notice and who must be *sui juris* for court activity to be avoided. The deficiency was pointed out by Lyman Welch of Chicago, whose Illinois version contained the first two classifications, but not the remaindermen, out of concern that guardians ad litem and court activity would be too frequently required if this class were inserted.
[67] 20 PA.C.S. § 8105 (g).
[68] *See* text at nn. 41-44, *supra*.

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,[69] 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.[70] For reasons that will become clear after our discussion of further research on the "best" smoothing rule, this flexibility may well be of value.

B. STOCK PRUNING, CAPITAL GAINS TAX AND JGTRRA - MAKING MORE INTO EVEN MORE

Another relatively new development that critically affects total return trusts is the change brought by the Job Growth and Tax Revenue Reconciliation Act of 2003 ("JGTRRA"), which taxes qualified dividend income and long term capital gains at a maximum of 15%[71]. JGTRRA, the effects of which have been extended through 2010 by the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA")[72] should encourage both the use of the TRU and the use of a greater proportion of stocks and other equity investments, as opposed to fixed income, by virtue of the flexibility the TRU provides and the fact that equity securities over longer periods tend to produce a higher total return. As we will see, the use of equities that produce qualifying dividend income and long term capital gains dramatically increases net after tax total return.

In addition, recent financial markets with a TRU invested primarily in equities would inevitably lead to the periodic use of a small amount of the principal every year to meet the distribution payouts required by the trust. Traditionally this practice, which the author has called "stock pruning," would seem aggressive or even speculative, but the investment data presented in these materials and the author's prior works tends to show otherwise. In fact, the use of a little bit of the growing portfolio to make up a portion of the distribution is not just a necessity, it is actually a tax planning opportunity. And this tax planning opportunity, which was tremendous before JGTRRA, is just amazing after JGTRRA!

To demonstrate the tax advantages, two different portfolios of $100,000 each will be created, one invested in taxable fixed income and the other in a widely diversified group of individual stocks with a current level of dividends of 2% and appreciation of 6% per year.[73] To level the playing field, the same total return of 8% will be assumed for both trusts as well as a constant trust payout of 4% per year. The rate of tax inside the trust for any reinvested ordinary

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[69] *See* text at n. 46,*supra*
[70] 12 DEL. CODE § 3527 (i).
[71] P.L. 108-27.
[72] P.L. 109-222, § 102.
[73] And all of these assumptions are reasonably in line with current economic conditions and prognostications. The current dividend rate on the Vanguard Index 500 Admiral Shares has a 30-day SEC yield of 1.7%, whereas the historical average of that same index has been a bit over 4%. There are many who believe that future returns will be several percent lower than historical returns, in no small part because of a loss in the dividend component of stock returns.

income will be 31%.[74] A 31% tax bracket will be assumed for the trust beneficiary as well. Both the fund balance and the after-tax distribution to the trust beneficiary appreciate significantly in this all fixed income model but the tax does its damage. Every dollar of return is taxed every year. See Table 1 which follows.

[74] This rate is a conservative assumption (one likely to cut against the proposition proposed by the author) considering that for estates and trusts, the 35% bracket begins at $10,450 for 2007. *See* http://www.irs.gov/formspubs/article/0,,id=112782,00.html#estate_tax_rate_2007.

TOTAL RETURN TRUST-TAXABLE FIXED INCOME RETURN OF 8% PER YEAR AND A 4% PAYOUT TAX RATE OF BENEFICIARIES AND TRUST 31%

Year	Balance	Total Return	Pre-Tax Dist.	After Tax Dist.	Year-end Balance
1	100,000	8,000	4,000	2,760	102,760
2	102,760	8,221	4,110	2,836	105,596
3	105,596	8,448	4,224	2,914	108,511
4	108,511	8,681	4,340	2,995	111,506
5	111,506	8,920	4,460	3,078	114,583
6	114,583	9,167	4,583	3,162	117,746
7	117,746	9,420	4,710	3,250	120,995
8	120,995	9,680	4,840	3,339	124,335
9	124,335	9,947	4,973	3,432	127,766
10	127,766	10,221	5,111	3,526	131,293
11	131,293	10,503	5,252	3,624	134,916
12	134,916	10,793	5,397	3,724	138,640
13	138,640	11,091	5,546	3,826	142,467
14	142,467	11,397	5,699	3,932	146,399
15	146,399	11,712	5,856	4,041	150,439
16	150,439	12,035	6,018	4,152	154,591
17	154,591	12,367	6,184	4,267	158,858
18	158,858	12,709	6,354	4,384	163,243
19	163,243	13,059	6,530	4,505	167,748
20	167,748	13,420	6,710	4,630	172,378

Total distributions after tax = 72,378
Trust balance after 20 years = 172,378

The 4% payout in Table 1 after 31% tax gives an after-tax return of 2.76% and the 4% income earned in the trust yields the same 2.76% compounded. This result still seems appealing until it is compared to the use of the TRU with equities. For purposes of showing the effect of JGTRRA on the effective tax rate, we have provided both pre- and post-JGTRRA tax rates and results. See Table 2, which follows on the next full page.

TABLE 2
TOTAL RETURN TRUST - 100% EQUITY -
DIVIDENDS OF 2% AND CAPITAL GROWTH OF 6% - 4% PAYOUT -
THE TAX EFFICIENCY OF STOCKS AND STOCK PRUNING MULTIPLIES RETURNS

Year	Trust Fund Balance	Taxable Dividend	Growth	Distribution	Stock "Pruned" & Distributed	Cost Basis Used	Remaining Cost Basis	Pre JGTRRA after tax Distribution	Post JGTRRA after tax Distribution	Year End Fund Balance	Pre-JGTRRA Effective tax rate on Pruned Principal	JGTRRA Effective tax rate on Pruned Principal	JGTRRA Increase in after tax income
1	100,000	2,000	6,000	4,000	2,000	1,887	98,113	3,357	3,683	104,000	1.1%	0.8%	9.7%
2	104,000	2,080	6,240	4,160	2,080	1,851	96,262	3,469	3,814	108,160	2.2%	1.7%	9.9%
3	108,160	2,163	6,490	4,326	2,163	1,816	94,446	3,586	3,950	112,486	3.2%	2.4%	10.1%
4	112,486	2,250	6,749	4,499	2,250	1,782	92,664	3,708	4,092	116,986	4.2%	3.1%	10.3%
5	116,986	2,340	7,019	4,679	2,340	1,748	90,915	3,836	4,240	121,665	5.1%	3.8%	10.5%
6	121,665	2,433	7,300	4,867	2,433	1,715	89,200	3,969	4,394	126,532	5.9%	4.4%	10.7%
7	126,532	2,531	7,592	5,061	2,531	1,683	87,517	4,107	4,555	131,593	6.7%	5.0%	10.9%
8	131,593	2,632	7,896	5,264	2,632	1,651	85,866	4,252	4,722	136,857	7.5%	5.6%	11.1%
9	136,857	2,737	8,211	5,474	2,737	1,620	84,246	4,402	4,896	142,331	8.2%	6.1%	11.2%
10	142,331	2,847	8,540	5,693	2,847	1,590	82,656	4,559	5,078	148,024	8.8%	6.6%	11.4%
11	148,024	2,960	8,881	5,921	2,960	1,560	81,097	4,723	5,267	153,945	9.5%	7.1%	11.5%
12	153,945	3,079	9,237	6,158	3,079	1,530	79,566	4,894	5,464	160,103	10.1%	7.5%	11.6%
13	160,103	3,202	9,606	6,404	3,202	1,501	78,065	5,071	5,669	166,507	10.6%	8.0%	11.8%
14	166,507	3,330	9,990	6,660	3,330	1,473	76,592	5,257	5,882	173,168	11.2%	8.4%	11.9%
15	173,168	3,463	10,390	6,927	3,463	1,445	75,147	5,449	6,104	180,094	11.7%	8.7%	12.0%
16	180,094	3,602	10,806	7,204	3,602	1,418	73,729	5,650	6,336	187,298	12.1%	9.1%	12.1%
17	187,298	3,746	11,238	7,492	3,746	1,391	72,338	5,860	6,577	194,790	12.6%	9.4%	12.2%
18	194,790	3,896	11,687	7,792	3,896	1,365	70,973	6,078	6,828	202,582	13.0%	9.7%	12.3%
19	202,582	4,052	12,155	8,103	4,052	1,339	69,634	6,305	7,089	210,685	13.4%	10.0%	12.4%
20	210,685	4,214	12,641	8,427	4,214	1,314	68,320	6,541	7,360	219,112	13.8%	10.3%	12.5%

	Pre-JGTRRA	JGTRRA	Pre-JGTRRA increase Over Fixed Income Trust	JGTRRA Increase Over Fixed Income Trust
Total After Tax Distributions	95,075	105,997	31.4%	46.4%
Trust Balance After 20 Years	219,112	219,112	27.1%	27.1%
Trust Cost Basis After 20 Years	68,320	68,320		
If all Trust Securities sold at that time - Tax	30,158	22,619		
Would still leave remaining after tax assets of	188,954	196,494	9.6%	14%
Total Net After Tax After 20 Years	284,029	302,491	16.0%	23.6%

These dramatically improved results come as a result of several critical tax effects. The largest effect, particularly in the early years of the analysis, is the fact that the equity portfolio allows for tax deferral that applies to most of the gain in the stock values for the 20-year period. While the pre-tax distributions to the beneficiary begin as the same size as the distributions from the fixed-income total return trust, the equity TRU distributions are largely tax sheltered because each share of stock sold is entitled to use its individual per share cost basis. Thus, the original trust portfolio investment cost minimizes the amount of capital gain realized each year. In the first few years, the stock holdings which are pruned are primarily a recovery of the cost basis, so the effective tax rate is very low, 1.1% in the first year, prior to JGTRRA, and .8% after JGTRRA. If the process is continued long enough, the tax bracket would approach 20% prior to JGTRRA and 15% after JGTRRA, but as one can see, even after twenty years, the rate is still substantially discounted by the use of cost basis.[75] The cumulative after-tax distributions for the first twenty years are 31.4% larger prior to JGTRRA, even using the same total return from each form of investment.[76] The cumulative after-tax distributions taking JGTRRA into account are actually 46.4% higher than the taxable fixed income portfolio over a 20-year period. And at the same time, the equity TRU after twenty years has built up its value over 27% more than the fixed income model while wearing down its cost basis to a bit under $70,000.

In a QTIP trust, this capital gains tax would never be paid because it is includable in the life beneficiary's estate under I.R.C. Section 2044 and there would be a new cost basis at death.[77] Consequently, this type of investment program with pruning may be just as valuable for older trust beneficiaries as it is for young ones and in the marital trust as well as the credit shelter trust, where growth oriented investments are generally preferred.

But what if all of that deferred capital gain had to be recognized at the end? Would the trust be worse off with this “pruning” and the reduction of cost basis? Even if all of the trust securities that now had a relatively low remaining cost basis were sold at once and income tax paid, the after-tax assets would still exceed the value of assets under the fixed-income trust by 9.6% in the pre-JGTRRA world and 14% after JGTRRA. At the same time, the beneficiary would have received a huge increase in after-tax distributions by using the all equity trust with stock pruning.

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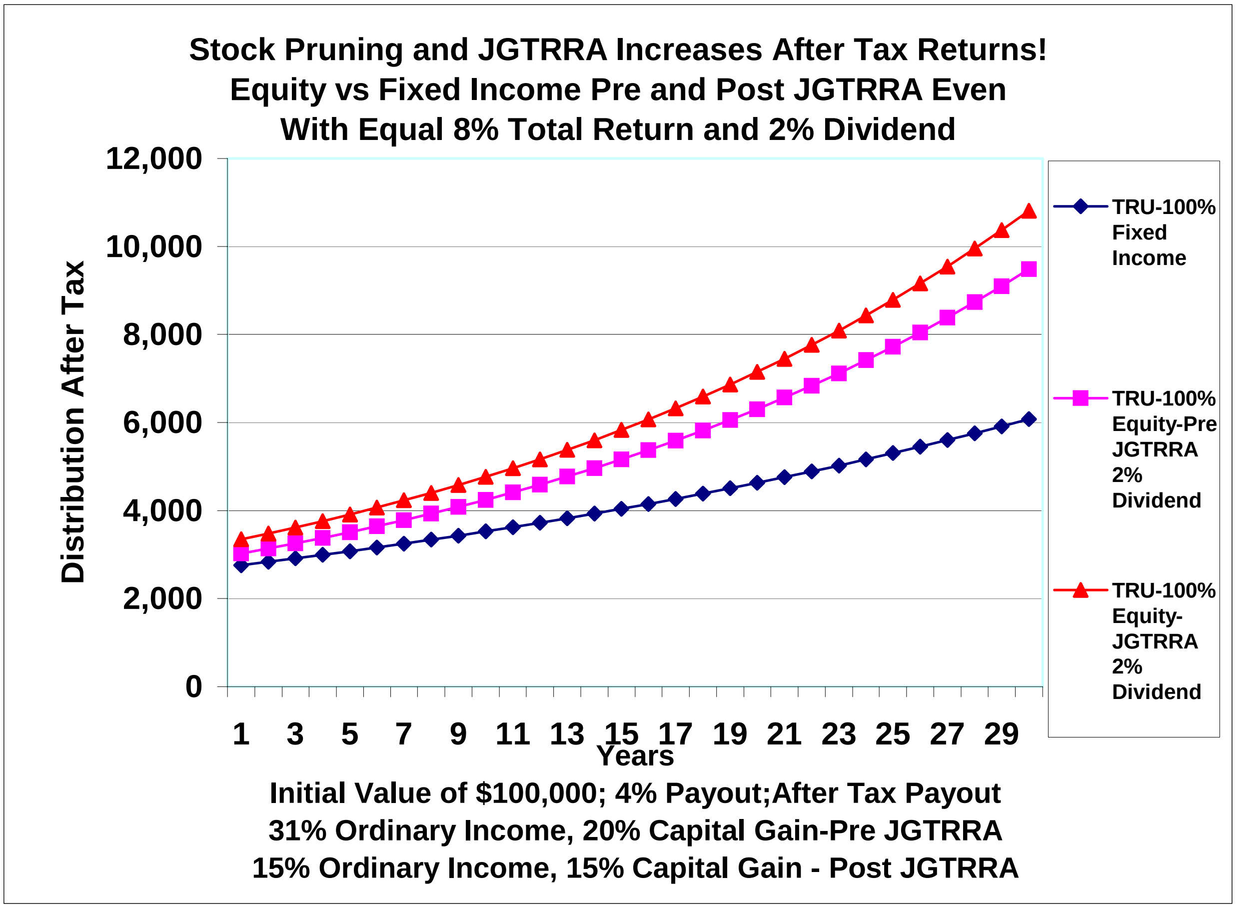
[75] Note that in this simple model, there is no turnover in the trust, except for that needed to pay the beneficiary her 4%. The portfolio is transparent, with no separate tax calculations inside the trust portfolio, expenses or other tax events that occur within the real trust portfolio, particularly one that is not a grantor trust. The author’s computer model of historical returns does take the many complexities that actually occur in a real trust into account, and the effects of JGTRRA can be studied with this more refined model as well, but the effects will be similar, and in the same direction. Using historical returns has its limitations, however, particularly where the effect to be studied is a direct result of low dividend yields, which have only occurred very recently.

[76] This analysis implies the damage that occurs when equities are held in high-turnover mutual funds. If a fund with 100% turnover is used instead of individual stocks, almost all of this advantage is lost (leaving only the rate differential between 15% and the ordinary income tax rate). No deferral remains, and this deprives the investor of much of the 46% increase in value. *See* I.R.C. § 1(h)(1).

[77] I.R.C. § 1014(a).

Assuming a full payment of capital gains taxes at the end of the twenty year period, the total net after tax to the beneficiaries, including both after tax income and after tax corpus would be 16% greater before JGTRRA and 23.6% greater after JGTRRA.

The graph which follows shows the dramatic increase in after-tax income generated by the use of this stock pruning. In the first year there was 21% higher after-tax income prior to JGTRRA. But JGTRRA increases the benefit to over 33% in the first year! By the twentieth year the gap widens to over 41% in the pre-JGTRRA world and a 59% differential after JGTRRA. By the thirtieth year, the TRU approach pre-JGTRRA is producing 56% more after tax income while after JGTRRA the difference is an amazing 78%. Clearly, the longer the comparison goes on, the greater the difference the TRU approach, equity investing and capital gains makes to our income beneficiary. While some of our trusts continue far longer than this, perhaps the majority of them are likely represented by part or all of the following graph:



The multiplication of after-tax income using the stock pruning TRU approach with equity investments, increasing the after-tax returns from 33% in year one to 59% in year twenty is a tremendous advantage of the total return trust pruning methodology and equity investing. Now all of these calculations would be rosy indeed were it possible to know in advance the returns and taxes on trust investments. And of course, we haven't taken into account the trust expenses, inflation, or the damage done by turnover in a trust portfolio. As will be demonstrated later in these materials, the higher the turnover, the more difficult it will be to accomplish the trust's objectives.

The multiplication of after-tax returns by the deferral of income taxes inherent in a low turnover equity portfolio is a surprisingly large factor, and JGTRRA increases those benefits in a material way, even in a lower return environment as illustrated above. Importantly, the preceding tables also assume that stocks and bonds have the same total return. Historically, this has never been the case over long periods of time. Once all of those points are considered together and taken into account, the results are truly dramatic.

Clearly, JGTRRA and TIPRA favor the total return trust and equity securities, but in the context of an irrevocable trust, they also tend to favor taxable fixed income as opposed to non-taxable municipal bonds, no doubt an unintended by-product of the legislation. The primary reason for this is the fact that in order for the maximum rate on qualified dividends to be 15%, deductions are taken first against other ordinary income, thereby displacing high bracket taxable income. Assume therefore an individual tax bracket of 35% for the trust beneficiary and the trust, which for 2007 only requires $10,450 in estate and trust income. Assume further 1% in trustees' fees and an 80% equity/20% fixed income asset allocation and an equity qualified dividend yield of 2%. One would normally assume that with a 35% tax bracket, the trust and the beneficiary would be better off with municipal bond income rather than taxable fixed income such as Treasuries or corporate bonds. The reasoning is simple enough. A 4% yield on a AAA 10-year municipal bond is equivalent to 4% divided by 65% (the reciprocal of the tax rate) which in this case equals 6.15%. Since you can't get an equivalent credit that will generate 6.15% with the same maturity, you choose the municipal bond.

But there are two effects which make the calculation more complex than we might have thought. First, there is the proration factor that requires that our trustees' fee deduction be reduced by that portion of the trustees' fees that represents the proportion of the income that is tax free. That doesn't literally affect the tax free income. It is still tax free. But it does affect the actual tax on the taxable bond. If we were able to find a AAA 10 year bond with a yield of 6.15%, it would produce taxable interest of 6.15% times the 20% of the portfolio or 1.23% of the portfolio. The equities would produce 2% times the 80% of the portfolio, or 1.6%. This means that 43.46% of the deductible trustees' fees would be deducted from the taxable bond interest. As a result, only 5.72% of the taxable bond interest is taxable. So the after tax income on the taxable bond turns out not to be 4%, but 4.15%. Because of this, the crossover point as between taxables and non-taxables is not exactly what we think it is. But, based upon that factor alone, it isn't all that far away either. Usually our decisions do not rest upon 15 basis points of after tax difference. In addition, if the trustee includes capital gains in the proration calculation, the dilution effect on the benefit of the deduction for trustees' fees will be smaller, depending upon the extent of the capital gains.

There is a second and larger factor which I would call the displacement factor which significantly affects the taxable/tax free decision in the search for the highest after tax fixed income return. To the extent that there is no income against which the trustees' fees can be taken on the trust level at ordinary income tax rates, the trustees' fees are taken against the qualified dividend income, otherwise taxed at 15%. The combination of these two factors is very significant. Let us examine our 80% equity/20% fixed income portfolio more closely, and assume that we were to invest alternatively in a 4% tax free municipal bond or a 10-year Treasury Note at 4.7%.

80/20				Trustee's	Taxable		After Tax
Portfolio A		Yield	Income	Fees (1%)	Income	Tax	Income
Equities	80%	2.0000%	1.6000%	0.6667%	0.9333%	0.1400%	1.4600%
Municipal Bonds	20%	4.0000%	0.8000%	0.3333%	0.0000%	0.0000%	0.8000%
			2.4000%				2.2600%
Portfolio B							
Equities	80%	2.0000%	1.6000%	0.0600%	1.5400%	0.2310%	1.3690%
Treasuries	20%	4.7000%	0.9400%	0.9400%	0.0000%	0.0000%	0.9400%
			2.5400%				2.3090%

What we see is that the portfolio with the taxable treasuries actually has a higher after tax yield than the portfolio with the municipal bonds, and this is because there is no tax at all on the Treasury interest, which "soaks up" almost all of the deduction for trustees' fees. The tax generated by the Treasury interest is actually the increase in tax on the qualified dividend income which totals .091%. Effectively, the tax rate on the Treasury interest is .091% divided by the .94% interest, or 9.68%! So the effective after tax yield on the Treasury is an unexpected 4.25%, significantly more than the municipal bond. And this is an illustration that would seem to be a "no-brainer" in the other direction, favoring the municipal bond choice. A tax free money market fund yielding 3.5% is clearly going to be a second choice to a taxable fund paying around 5% at present.

The "crossover point" where a taxable security is equal to the tax free security reflects the same tax anomaly.

80/20				Trustee's	Taxable		After Tax
Portfolio A		Yield	Income	Fees (1%)	Income	Tax	Income
Equities	80%	2.0000%	1.6000%	0.6667%	0.9333%	0.1400%	1.4600%
Municipal Bonds	20%	4.0000%	0.8000%	0.3333%	0.0000%	0.0000%	0.8000%
			2.4000%				2.2600%
Portfolio B							
Equities	80%	2.0000%	1.6000%	0.1176%	1.4824%	0.2224%	1.3776%

Treasuries	20%	4.4120%	0.8824%	0.8824%	0.0000%	0.0000%	0.8824%
			2.4824%				2.2600%

Is there a simple rule of thumb in all of this, or does each case have to be examined on it's own? The simple rule of thumb would be to always have enough ordinary taxable income in a trust to "soak up" the trustees' fees and other deductions before tax free bonds are used, unless the tax free bonds are expected to have a total return greater than the taxable fund taking into account the tax accounting anomaly just described. Now once there is enough ordinary taxable income to soak up the deductions, the marginal effective rates of tax increase, and there are more complicated formulas that may apply if the fixed income is composed of both taxable and tax free interest bearing securities. Also note that the foregoing does not apply to grantor trusts. It applies only to irrevocable non-grantor trusts.

C. FINAL REGULATIONS-WHAT WE NEEDED AND WHAT WE GOT

(1) But First, a Preliminary Word. The Proposed Regulations,[78] issued on February 15, 2001, were a remarkable achievement by the Treasury Department and the Internal Revenue Service. While they had been in the year 2000 business plan, they arrived while the first of the unitrust statutes were still being considered, and provided extremely useful guidance to practitioners, to the state legislatures and to state legislative advisory committees across the country concerning the all important tax effects of changing the state law definition of income. As a result, there was a torrent of legislation once the Proposed Regulations gave everyone a better sense about where Treasury stood on these new creatures—the power to adjust, and the power to convert to a unitrust. What were these questions, and what guidance did the Proposed Regulations provide?

1. First, and perhaps most importantly, a transfer to a trust for a spouse is required to distribute *all of the income* to the spouse during his or her lifetime in order to obtain the benefit of the gift and estate tax marital deduction.[79] Does a unitrust interest or an income interest subject to the power to adjust qualify for that all-important deduction?

2. Generally speaking, capital gains realized by a trust do not form a part of distributable net income that is passed out and taxed to the beneficiary. When might such realized capital gains be included in distributable net income and therefore passed out to the beneficiary in the context of the power to adjust and the non-charitable unitrust?[80]

[78] Proposed Reg-106513-00, Fed. Reg., February 15, 2001, Vol. 66, No.32, at 10396-10402 ("Proposed Regulations.").
[79] I.R.C. §§ 2523(e) and (f) and 2056(b)(5) and (b)(7).
[80] *See* Wolf 2, *supra* n. 27 at 153-154*;* Wolf Miami, *supra* n. 27 at I-C-47–I-C-48; R.J. Rosepink, *The Total Return Trust - Where and How to Tax Capital Gains,* TR. & ESTATES 12 (October 1998).

3. How does the addition of the power to adjust or a conversion to a unitrust regime under state law affect the grandfathered status of older trusts for generation-skipping transfer tax purposes?[81]

4. How does a state law change to allow the power to adjust or a unitrust definition of income affect net income charitable remainder trusts and pooled income trusts under IRC Sections 664(d)(3) and 642(c)(5)?[82]

5. How does a state law change in the definition of income affect the tax treatment of distributions in kind?[83]

The answers to the first three questions were all favorable to the taxpayer seeking to employ modern investment techniques in a new or existing trust. The Proposed Regulations limit the effect of such changes in state law definition within the context of charitable split interest trusts, and required the recognition of gain and loss on the distribution in kind of assets in satisfaction of the obligation to distribute the new "income".[84]

There were other questions that the Proposed Regulations did not answer directly which were commented on to Treasury. Among the most important were the following:

1. Would the exercise of the power to adjust or the conversion of an income trust to a unitrust constitute a taxable gift from someone to someone, since they both would seem to affect the economic value of the income interest?
2. Would the conversion of an income trust to a unitrust under a state statute be a sale or exchange under the so-called "Cottage Savings" doctrine?

Certainly the inference from the Proposed Regulations was that neither of these questions would be answered negatively where the exercise of the power to adjust or the power to convert was pursuant to a state statute within the parameters suggested in the Proposed Regulations, but more direct authority was needed to allow practitioners to be at ease with these issues. The Cottage Savings Issue is of continuing interest, however, in a number of contexts, and is worth some discussion, even though the question is answered in this context by the Final Regulations provided that there is an applicable state statute within the direct scope of the Final Regulations.

One specific private letter ruling was chiefly responsible for the concerns of commentators in regard to the *Cottage Savings* doctrine. In PLR 200231011, decedent created a trust for his grandson, giving him an annuity interest for life, and leaving the remainder at his death to three charities.[85] Within a year after decedent's death, the trust was restructured with the consent of the court and the beneficiaries to provide annual income distributions to the grandson instead of

[81] *See* Wolf Miami, *supra* n. 27 at 102-103.
[82] PROPOSED REG., *supra* n. 78, Explanation of Provisions at 10397-10398.
[83] *Id.* at 10398.
[84] For the most thorough review of the prior law and changes brought by the Proposed Regulations, S*ee* George L. Cushing, *Income Tax Treatment of "Total Return Trusts"*, 2001 Annual Meeting Materials, American College of Trust and Estate Counsel, at B-1-GLC (2001).
[85] The trust apparently was not a charitable remainder annuity trust, however.

the annuity set forth in the will, but with a minimum and maximum yield as specified in a "performance chart" agreed to by the parties, in part in exchange for partial payments from the trust to the charities. Differences arose among the parties as to the continued administration of the trust, and a global settlement was reached, whereby the charities' interests in the trust were cashed out, and grandson's interest in the trust was significantly reformed. He would now receive a 7% unitrust distribution; the trustee would have authority to distribute additional funds to him if needed for his "reasonable support". In addition, he was given a general power of appointment over the trust corpus exercisable by will, the latter inserted in order to obtain a favorable ruling for generation-skipping transfer tax purposes. Grandson then applied for a private letter ruling that there was no loss of GST exemption, that there was no taxable gift as a result of the transaction, and that the implementation of the proposed agreement and court order would not result in capital gain or loss or taxable income to any party to the order.

The ruling was favorable for purposes of generation skipping transfer tax, since the general power of appointment assured that no beneficial interest of a transfer to a skip person would be increased, nor the transfer extended.[86] The gift tax part of the ruling was also favorable, since the dispute and resolution of the differences concerning the interests of the charities and grandson were based on arms-length negotiations. But the income tax part of the ruling was highly unfavorable to taxpayer, holding that grandson's interest in the trust had been "exchanged" in a taxable transaction pursuant to *Cottage Savings Association v. Commissioner,* 499 U.S. 554 (1991). *Cottage Savings* involved the exchange of mortgage loans made to different obligors and secured by different homes that in the opinion of the court embodied sufficiently different legal entitlements that the taxpayer was entitled to realize losses when it exchanged interests in the loans.

The ruling contrasted *Evans v. Commissioner, 30 T.C. 798 (1958)* where an exchange was held to occur when the taxpayer exchanged her income interest in a trust for an annuity, with *Silverstein v. United States, 419 F.2d 999 (7th Cir. 1969),* where annual payments from a trust were exchanged for equivalent payments from the remainderman of the trust. The letter writer found the ruling request situation closer to *Evans* than to *Silverstein,* because taxpayer's interests in the trust were fundamentally changed from what they were previously. And indeed they were: Prior to the change on which guidance was requested, the taxpayer had an income interest with a maximum and a minimum in accordance with the performance chart, had no right to any additional principal, had no control over the property at his death, and shared his interest with the charities as parties in interest in the trust. After the modification he was the only party to the trust, he had a unitrust, rather than an income interest in the trust, the trustee was empowered to distribute additional portions of the trust as were needed under certain circumstances, and the trust was his to dispose of under his will. He really couldn't have changed the character of his interest in the trust much more thoroughly. Other than the names, one would hardly recognize the new trust as being related to the old trust. The ruling held that the interest he received was a taxable exchange under Code Section 1001, and that since his interest was a term interest, he would have no basis in that interest under Section 1001(e)(1).

The question raised in the minds of commentators by this PLR is whether conversions to a unitrust under the express provisions of a state statute, and as approved in the Proposed

[86] Treas. Reg. § 2601-1(b)(4)(i)(D).

Regulations might be a gift or transfer or a sale or exchange under *Cottage Savings?* Could the mere passage of a state statute granting the trustee the power to adjust entail such a risk? Neither argument should hold water, in this author's opinion, but the issues will retain vitality in states where there is no unitrust conversion statute, and more broadly in the expanding context of trust modifications which are likely as the Uniform Trust Code[87] makes progress in state law. This PLR is highly distinguishable from a state law authorized unitrust conversion for the following reasons:

(1) The effect of a unitrust conversion statute and a unitrust definition of income are to give the unitrust interest a legal equivalency. For example, under the Pennsylvania statute, after the conversion,

> "The term 'income' in the governing instrument shall mean an annual distribution (the unitrust distributions) equal to 4% (the payout percentage) of the net fair market value of the trust's assets, whether such assets would be considered income or principal under the provisions of this chapter [averaged over the lesser of the last three years, or the period during which the trust has been in existence]".[88]

Hence under Pennsylvania law, the interest of the beneficiary has not been changed. It is still an income interest under state law. But this argument is not just one of legal equivalency; rather one grounded upon independent developments in the financial marketplace that forced a remedial response in the law of principal and income. The onset of the Prudent Investor Rule, modern portfolio theory, and total return investing, coupled with a secular decline in dividend and interest rates, required a reformulation of the principal and income rules to reinstate their original meaning. In other words, these changes in state law were in furtherance of the intent behind the trust vehicle, and the change to a unitrust payout was meant to carry out the intentions behind the creation of the trust's beneficial interests, not to change the course of that intent.

(2) Under the Proposed Regulations, a state law which allows an election into a unitrust definition of income should be respected for marital deduction purposes both for federal estate tax and gift tax purposes. The premise of the Proposed Regulations in this regard is that the marital interest is not affected in such a way that it is no longer a fair income interest entitled to the marital deduction and "consistent with the value of the trust corpus and with it's preservation."[89] So for this tax policy purpose, the marital interest, if converted into a unitrust interest, particularly within the range of 3-5% mentioned specifically in the Proposed Regulations, has not

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[87] *See* UNIFORM TRUST CODE §§ 410, 417, 7C U.L.A. (2000). The Uniform Trust Code has been adopted in 19 states plus the District of Columbia at the time of this writing. *See* the nccusl legislative fact sheet at http://nccusl.com/Update/uniformact_factsheets/uniformacts-fs-utc2000.asp.
[88] 20 PA.C.S. § 8105(d)(3).
[89] *See* Treas. Reg. § 20.2056(b)(5)(f)(1)(1994).

been diminished in such a way as to cause its character for tax purposes to be changed.

(3) Under the Proposed Regulations, a state law which allows an election into a unitrust definition of income will not cause a previously grandfathered trust for generation-skipping transfer tax purposes to lose its grandfathered status. In Proposed Regulation 26.2601(b)(4)(i)(D)(2), the administration of a trust in conformity with a state statute that grants the power to adjust or the power to convert to a unitrust will not be deemed to constitute a shift of a beneficial interest in the trust.

(4) Under the Proposed Regulations, if an income distribution is now defined as a unitrust interest or is subject to the power to adjust under applicable state law, and if that income distribution requirement is satisfied with property in kind, a gain or loss is realized by the trust under Proposed Regulation 1.661(a) 2-(f). Here again, and this time for income realization purposes, the unitrust interest is proposed to be the legal and tax equivalent of the prior income interest.[90]

In short, the application of the *Cottage Savings* doctrine to a state law sanctioned unitrust conversion would be a complete anomaly when juxtaposed to the tax and legal equivalence intended under both state statutes and the Proposed Regulations.

It was therefore the author's opinion that it was highly unlikely that the reasoning of PLR 200231011 would be extended to attack a state law sanctioned unitrust conversion,[91] or the state law sanctioned power to adjust between principal and income. But we couldn't know that for sure until the publication of the Final Regulations.

The entire concept of applying the *Cottage Savings* doctrine to the modification of trusts is highly problematic from a technical and conceptual, as well as from a practical, point of view. If a unitrust conversion were a realization event, how would one measure the gain? Would it be based upon the actuarial value of the unitrust interest? And if so, even if there were a realization event, the beneficiary would not have received the value, and presumably would receive it for recognition purposes only a little at a time, each year, as an installment sale under Section 453.[92] And with those installments would presumably come imputed interest under Section 483 based upon the Applicable Federal Rates. And how would the trustee report the trust's income, deductions and distributions under Subchapter J? Would the beneficiary be taxed twice on the income, once as an installment sale with imputed interest, and once as a recipient of DNI? If not, where would the DNI go?

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[90] Whether this actually makes sense, in light of the fact that a unitrust distribution, in essence, is more fractional by its inherent nature, than truly pecuniary, is less clear. But the Proposed Regulation in this regard is clear enough.

[91] Barbara A. Sloan, *Consequences of PLR200231011: Cottage Savings or Cottage Industry?*, 29 ACTEC JOURNAL 102, 105, Fall 2003.

[92] Professor Kenneth Joyce of the University of Buffalo, one of the early unitrust pioneers, provided this insight.

2. Treasury gives its "Final" answers and leaves us with a few questions. On December 30, 2003, Treasury announced its Final Regulations governing the definition of income, largely affirming the Proposed Regulations, but with many additional points of clarification. [93] The Final Regulations represented the culmination of what was an unusually open exchange between practitioners, the Internal Revenue Service and Treasury. While the Final Regulations were a bit longer in coming than we might have thought likely after the Proposed Regulations were issued on February 15, 2001, Treasury obviously put the time to good use in considering the many comments submitted. The Summary provided with the Regulations is particularly helpful in discussing many of the comments submitted and why Treasury either did or did not embody them in the Final Regulations. These comments are very helpful in a number of areas in providing insight into the thinking and policy behind the Regulations. The Regulations are a very thorough and well reasoned response to a veritable sea change in the concept of "income".[94]

Overall, the Final Regulations clear up some major questions, give us guidance in some other areas, and leave certain areas largely untouched. In some areas, there are contradictions in the guidance they provided that will not yield to any amount of analysis.[95] But for the most part, the areas in which the Regulations are not clear are of far less importance than the areas in which they are clear, so we as practitioners, and those involved in the legislative process have a pretty good idea about what we can do and what we cannot do, and an educated guess about what is in between.

1. The Broad Picture—what we know for sure.

As previously described in detail in these materials, there are a total of 45 states plus the District or Columbia that have enacted total return legislation providing either the power to adjust under the Uniform Act, the power to convert to a unitrust or both.

The big question presented was whether the use of, or perhaps even the existence of, all of this state law change would be respected for federal tax purposes? Is it safe for a trustee to use these statutes? The Final Regulations resoundingly answer that question in the affirmative. So the conversion of a classic "hold the principal and pay the income" trust into a total return unitrust ("TRU") or a trustee's exercise of a power to adjust pursuant to a state statute will **NOT:**

1. Cause a loss of the federal estate tax marital deduction,

2. Trigger a taxable transfer for gift tax purposes,

[93] Treas. Reg. § 1.643(b)-1, T.D. 9102, 69 Fed. Reg. 12 I.R.B. 2004-5.
[94] Robert B. Wolf and Steven R. Leimberg, *Total Return Trusts Approved By New Regs., but State Law Is Crucial*, ESTATE PLANNING, April 2004 Vol. 31/No. 4, 179; Jonathan G. Blattmachr and Mitchell M. Gans, *The Final 'Income' Regulations: Their Meaning and Importance*, TAX NOTES, SPECIAL REPORT, May 17, 2004, 891, 895; Barbara A. Sloan, *§ 643 Regulations: Use of Non-Charitable Unitrusts and other Issues Raised under the Final Regulations*, 30 ACTEC JOURNAL 33, 46(Summer, 2004); Linda B. Hirschson, *Final 643 Regulations Issued at Last Permitting Total Return Investing*, NEW YORK LAW JOURNAL, May 1, 2004, Trusts and Estates Special Section 1.
[95] *See* Blattmachr and Gans, *supra* n. 94 for an exhaustive analysis of the Regulations, particularly with reference to the inclusion of capital gains in Distributable Net Income, at 898-907.

3. Result in a taxable sale or exchange (ala *Cottage Savings*), or

4. Undo GST grandfathering.

Particularly with respect to trusts which were GST grandfathered, and for marital trusts, because the Proposed Regulations were not final and in effect, and by their express terms they could not be relied upon until the year after they were made final, much of the process of review and response had been delayed pending the final answers provided by the Regulations.[96] The reason for this is simple enough. The consequences of losing a marital deduction, or GST grandfathering, or the possibility of a sale or exchange treatment was sufficiently threatening that even a low level of concern was sufficient to keep many trustees from applying these new statutes to the majority of their existing trusts. The Final Regulations alleviated these concerns and protect the tax benefits under recent state law changes providing for a unitrust definition of income and/or the power to adjust between principal and income.

There are therefore no more reasons for trustees and practitioners not to fully implement the changes afforded by the legislatures of almost every state, and perhaps even more importantly, integrate a total return investment and distribution philosophy into their daily professional lives.

2. The Main Thing-the Final Definition of Income under Section 643(b)

The most important change brought about by the Final Regulations is the change in the definition of income under Section 1.643(b)-1, which begins as follows:

> <u>1.643(b)-1 Definition of income</u>. For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For 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). <u>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</u>. (New language underlined.)

This first part of the Regulation reaffirms the statutory requirement that the tax law will recognize the meaning of "income" for Subchapter J to be that which is determined under the terms of the governing instrument and applicable local law, but trust provisions that depart fundamentally from traditional principles of income and principal will *generally* (the term is

[96] According to Suzanne Ross, former Senior Vice President of PNC Bank, N. A., her trust division had a total of 6,000 of such trusts upon which final decision had been delayed pending the Final Regulations.

used quite a few times in the Regulations) not be recognized. The emphasized portion of the Regulation above is new language in response to comments that observe that the prior language, which talked of "ordinary income" and "capital gain" did not actually relate to state trust law concerning income and principal. Ordinary income and capital gain are tax concepts, not concepts of principal and income. The writers added some language to describe in a general way what is intended to be considered as "traditional principles of income and principal". The word "traditional" was newly inserted in the Proposed Regulations and was retained in the Final Regulation. The prior language was to exclude those notions which "depart fundamentally from concepts of local law"[97] but local law has undergone an extremely thoroughgoing change with the advent of the unitrust and the power to adjust. It appears that the term "traditional" was inserted to allow the Service to reject local law which it thinks goes too far in redefining income in a way that might be altogether too convenient and flexible to the taxpayer and the trustee.

But on with our income definition story. This portion of Regulation Section 1-643(b)-1 is the heart of the change in the law.

> 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. 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. 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. 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. 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

[97] *See* discussion, Blattmachr and Gans, *supra* n.94, at 895.

trust's grantor and beneficiaries, based on the relevant facts and circumstances. 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. This section is effective for taxable years of trusts and estates ending after January 2, 2004. (New language underlined.)

This new definition of income does a number of really important things:

a. **3% to 5% Unitrust Statutes Approved.** It identifies as appropriate unitrust statutes that allow a 3% and 5% rate, or anything in between, and specifically allows the use of a multiple year smoothing rule, which is important because a three year smoothing rule is provided or allowed in all of the states with a unitrust conversion statute or a unitrust definition of income. Note that for such states, the unitrust amount is determined to be a reasonable apportionment of total return. There is no "generally" qualification.

b. **Power to Adjust Statutes Approved.** Perhaps concerned with differing state versions of the power to adjust, they retain the qualification from the Proposed Regulations that a state statute providing for the use of the power to adjust is "generally" a reasonable apportionment of total return. This isn't particularly comforting, but the qualification is likely inserted to curtail state law variations which differ substantially from the Uniform Act in their power to adjust, with which the Service has concluded that it is comfortable. The Final Regulation more helpfully inserted the word "Generally" before the description of the preconditions of the use of the power to adjust. Here, the Summary explains that because some states do not condition the use of the power to adjust on the trustee technically acting as a "prudent investor" or the lack of the word "equitable" in the state statute, should not prevent the power to adjust from being an acceptable exercise under the Regulations.[98]

c. **Discretionary Trusts Included.** The Regulations make it quite clear that sprinkle and spray trusts and other discretionary trusts which refer to "income" can be included in the new definitions of income.

d. **No Sale or Exchange If Under State Statute.** A switch between methods of determining income will not be a sale or exchange under Section 1001 and will not be considered a gift, provided it is done pursuant to the provisions of a state statute.

e. **But if no State Statute, No Assurance.** However, a switch in the method of determining income which is valid under state law, such as by a judicial decision, but is not pursuant to a state statute, may constitute a sale or exchange, or may constitute a gift.

f. **Allocation of Gains to Income by Trustee Approved.** Lastly, an allocation of gains from the sale of a capital asset to income will generally be respected if it is done pursuant to the terms of the governing document and applicable local law, or by the reasonable and impartial

[98] 69 FED. REG. 12, 13 (2004).

exercise of a power given to the trustee by applicable local law, or in the governing instrument if not prohibited by applicable local law. This means that one could grant the power to apportion gains to income, provided it were exercised reasonably and impartially and this power would not disqualify the "income", so defined, as income for federal tax purposes. This should not be confused with the power to adjust, however, since the Uniform Act and all state statutes of which the author is aware do not speak of the allocation of gains to income, but rather principal to income, and income to principal. It remains to be seen whether this last provision is going to be all that useful a provision, except perhaps in the context of a net income Charitable Remainder Unitrust, as discussed later.

3. What the New Income Definition Did Not Do

The new Regulation did a lot, and answered a lot of questions in one overly long paragraph; but there are some important things it did not do:

a. State Statutory Authority Still Needed. Because the power to adjust is contained in a uniform act and particularly with respect to the unitrust where Treasury announced in the Proposed Regulations that it would respect a unitrust conversion statute that provided for the payment of a unitrust amount from 3% to 5%, a number of commentators[99] suggested that the payment of a unitrust amount between those boundaries should be acceptable to the Service even if there were no state unitrust statute. Here again, it is very helpful to see the reasoning provided in the Summary:

> Some commentators suggested that, even in those states that have not enacted legislation specifically authorizing powers to adjust or a unitrust definition of income, trust instruments containing such provisions should be respected as defining income for purposes of section 643(b). . . Accordingly, the IRS and the Treasury Department believe that an allocation to principal of traditional income items should be respected for Federal tax purposes only if applicable state law has specifically authorized such an allocation in certain limited circumstances, such as when necessary to ensure impartiality regarding a trust investing for total return. Under the regulations, a state statute specifically authorizing certain unitrust payments in satisfaction of an income interest or certain powers to adjust would satisfy that requirement. Further, the IRS and the Treasury Department acknowledge that other actions may constitute applicable state law, such as a decision by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under the laws of that state. However, a court order applicable only to the trust before the court would not constitute applicable state law for this purpose. (Emphasis inserted)[100]

While the last sentence would allow applicable local law to add the power to adjust or the power to convert to a unitrust by a decision of the highest court of the state applicable to all trusts, this *Bosch* [101]

[99] *See* Blattmachr and Gans, *supra* n. 94, at 897.
[100] *See* n. 98 *supra* at 13.
[101] *See* n. 63, *supra.*

standard is very unlikely to be met, since a state court is very likely to conclude that such a change in the law should be made by the legislature, and not the courts. And while they didn't say so in this context, there is Section 643(b) itself that states that "income" is to be "determined under the terms of the governing instrument and applicable local law." (emphasis inserted). On this point, this author thinks that Treasury had good grounds to insist on a high level of state law support, despite the fact that this adds confusion to the administration of trusts; particularly in light of the functioning of many corporate trustees in many different states. A consistent federal standard would be easier, but it would be less consistent with the language of the statute.

b. And Not Just Any State Statute-3% to 5% is the Safe Harbor. Treasury approved of the trend in the unitrust statutes and what they understood about the power to adjust in the Uniform Act, but there was an overriding requirement for tax recognition that the statute provide for a "a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year." Two commentators suggested that any percentage provided by state statute should be O.K. but Treasury didn't take the bait, stating in the Summary: "The IRS and the Treasury Department believe that when establishing a unitrust percentage that attempts to yield the equivalent of income over a long period of time that may encompass wide variations in economic conditions, a range of 3% to 5% will be considered a reasonable apportionment of a trust's total return."[102] Treasury was obviously aware that while they were comfortable with the legislative trends which had altered the traditional notions of income and principal in a fundamental way, there were limits to that comfort. While there is nothing that states that a 2.8% unitrust or a 5.3% unitrust might not pass muster, unitrust statutes which provide for payouts of less than 3% or more than 5%, and unitrusts drafted in that manner, are simply not within the safe harbor of the Regulation.

c. What Did We and They Forget? How About a Trust Drafted as a Unitrust? 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 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

[102] *See* n. 98 *supra*.

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 confirm this opinion,[103] 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 a 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. And there are other matters, such as providing state law support for the treating of capital gains as part of a unitrust distribution or part of a distribution pursuant to the power to adjust or a discretionary principal distribution, which will be useful additions to our legislative menu. The next section following the detailed discussion of the Final Regulations discusses suggestions for legislative updates in light of the Final Regulations, with Delaware's amendment, once again the first in the nation, as a worthwhile template.

d. What is "Income" in a Retirement Account Payable to a Trust? <u>Questions Asked--</u> Where a retirement account is payable to a trust, the issue of what portion of a distribution from the retirement account is "income" for trust accounting purposes can be particularly thorny. Some retirement benefits, such as from a defined benefit plan are simply a stream of retirement income. There is no discrete investment account or sum of money from which the income for that benefit is paid. The 1962 Uniform Act prescribed that for deferred compensation, 5% of the inventory value of the asset was income, and anything received in excess of that was principal. Since the inventory value would typically be the present value of the future income stream, the inventory value would depend upon interest rates at the time the asset was being valued.[104] That rule, while sharing a similarity or two with a unitrust rule, was viewed as too rigid, in light of the fact that the amount of the income did not change with the rise and/or fall of the amount actually distributed to the trust.[105] The "New" Act took a very different, but perhaps even more rigid, approach. Section 409 of the Act broadly applies to private, commercial and employer-paid annuities, deferred compensation, IRA's, profit sharing, stock bonus and other qualified plan benefits.[106] Section 409(b) provides that where payments from such a plan are characterized as interest or dividends, then they are to be treated as income for purposes of the trust as well, and the balance of such payments are principal. This provision, is, however, primarily to take into account plans such as ESOPs, which are

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[103] Cathy Hughes of Treasury was kind enough to discuss this with the author.
[104] UNIF. PRINCIPAL AND INCOME ACT, *supra* n. 11, § 409, comment.
[105] *Id.*
[106] *Id,* § 409(a).

required to make such distributions, and not the more common and important (from the point of view of estate planners) individual retirement accounts.[107] Section 409(c) provides the general rule for retirement account payments as follows:

> (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.[108]

In the context of the required minimum distribution regulations under Section 401(a)(9), this rule produces some very strange results. If the sole beneficiary of the trust is considered to be the surviving spouse of the participant, there is no required distribution at all until the deceased participant would have reached 70 ½.[109] And where there is a required distribution, the amount that is required is entirely dependent upon the age of the beneficiary, and not the "return", in any sense of the word, from the underlying investment assets in that retirement account. For example, a 20-year old beneficiary has a life expectancy of 63 years, so that the required distribution would be 1.58% of the IRA balance as of the end of the prior year. Under the Uniform Act Rule, this would mean that .158% ($158 on $100,000) would be considered to be "income" from the IRA. A 63-year old, on the other hand, would have a life expectancy of 22.7 years, and a required distribution of 4.4%, of which 10%, or .44% ($440 on $100,000) would be considered to be income. As Natalie Choate succinctly put it,

> [t]he amount of a required distribution from a retirement plan, under the rules of IRC Section 401(a)(9), has nothing to do with any traditional concept of income or principal of the plan.[110]

This is a significant problem, because under the Final Regulations, in order for an amount to be treated as "income" it must either be income under traditional notions of income or principal, or, if supported by state statute, a non-traditional notion such as the unitrust or the power to adjust may be available if the approach is considered to be a reasonable apportionment of total return. And the regulations clearly define what they think is a "safe" distribution percentage, 3-5% when income is to be determined based upon the market value of the trust. In order for Section 409(c) to produce a distribution equal to 3% of the value of the retirement account, the beneficiary would have to be 98 years of age![111] Since the age of the beneficiary cannot have anything to do with what the investment "income" might be on an Individual Retirement Account in an economic sense, this 10% of the distribution rule seems very unlikely to qualify as "income"

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[107] Natalie B. Choate, *Trustees' Dilemma With Section 643*, TR. AND ESTATES, 26, 27 (July 2004).
[108] UNIF. PRINCIPAL AND INCOME ACT, *supra* n. 11, § 409(c).
[109] Choate, *supra* n. 107, at 28.
[110] *Id.*
[111] *Id* .

under the Final Regulations. If it does not qualify as "income" under the Final Regulations, then the IRA payable to a QTIP trust will not qualify for the marital deduction!

Fortunately, Section 409(d) provides a safeguard

> (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.[112]

The only difficulty with this provision is that it does not tell the trustee what to allocate in order to obtain the benefit of the marital deduction. The Comment to the rule does suggest that the trustee should look back to Revenue Ruling. 89-89, 1989-2 C.B. 231, (obsoleted by Rev. Rul. 2000-2, 2000-1 C.B. 305) which would direct that the income and dividends inside the IRA should be the amount that would define the income from an IRA distribution. In the opinion of this author, and others[113] the 10% rule simply did not qualify as income under Section 643, and hence would not qualify for the marital deduction without the safe harbor provision, which must take us back to the old rule or in a different acceptable direction. Will the savings provision and the power to adjust save the day, and the marital deduction?

Some uncertainty also arises where an IRA is payable to a trust that has been converted to a unitrust under applicable state statute. How is the "income" to be defined for the IRA payable to a unitrust? The approach first blessed by Revenue Ruling 89-89 and carried forward into Rev. Rul. 2000-2 treated the IRA as a separate trust both for qualification and election purposes. Does the fact that a QTIP trust itself defines income as a unitrust amount carry over to the IRA? Does this happen automatically, or must there be supportive language in the trust, the IRA and applicable state law? Looking inside a separate account IRA or qualified plan itself to determine traditional "income" follows the Revenue Ruling 89-89 and 2000-2 approach, and is similar to that which has been incorporated into the Pennsylvania Principal and Income Act, discussed later. If consistent with obtaining the marital deduction, we might want to give the settlor or a trustee converting to a unitrust the option to prescribe either a unitrust approach for both the trust and the IRA, or maintain a traditional income and principal approach for that IRA. In the current investment climate, the use of a unitrust distribution payout of "income" will in some situations require a greater payout than might otherwise be necessary as a required minimum distribution or a distribution of "income" under traditional income and principal notions, and in those cases might be less desirable. In most cases involving the marital deduction, where the surviving spouse is elderly, the minimum required distribution is going to be more than a unitrust distribution of 3-5% and more than the "income" earned inside the IRA under traditional notions of income and principal.

e. What is "Income" in a Retirement Account Payable to a Trust? Questions Answered—Revenue Ruling 2006-26. On May 4, 2006, the Service issued Revenue Ruling 2006-26[114], superseding Revenue Ruling 2000-2 and addressing all of the

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[112] UNIF. PRINCIPAL AND INCOME ACT, *supra* n. 11, 409(d).
[113] Choate, *supra* n. 107, at 28.
[114] IRB 2006-22, May 30, 2006, 2006 C.B. ------; Currently available at http://www.irs.gov/pub/irs-drop/rr-06-26.pdf.

federal tax questions raised in the previous section ("Ruling"). The Ruling addressed the situation of a 68 year decedent A whose IRA account was payable to a marital trust for A's spouse B for life, with the remainder passing to A's children at B's death. The Ruling recites that the IRA is currently invested in productive assets and B has the right (directly or through the trustee of Trust) to compel the investment of the IRA in assets productive of a reasonable income. The IRA document does not prohibit the withdrawal from the IRA of amounts in excess of the annual required minimum distribution amount under § 408(a)(6). The recitation of the foregoing provisions is likely important despite the favorable rulings discussed below for the unitrust and for the power to adjust, and they will need to stick around in our boilerplate for QTIP trusts and IRA beneficiary designations. Further, as in Rev. Rul. 2000-2, 2000-1 C.B. 305, the trust gives B the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income of the IRA for the year and to distribute that income to B, and requires the trustee to withdraw the greater of the income or the minimum required distribution, distribute the income to B and hold the excess, if any, in the trust as principal. "Under the trust instrument, no person other than *B* and *A*'s children has a beneficial interest in Trust (including any contingent beneficial interest)." The trustee elects to take advantage of the exception to the five year distribution rule of Section 409(a)(9)(B)(iii) because all of the potential beneficiaries are individuals, and since B is the oldest, it is over B's life expectancy that the IRA must be withdrawn. Since distributions from the IRA in excess of the "income" are held in the trust, B is not considered the sole beneficiary for purposes of Section 409(a)(9)(B)(iv) allowing B to defer B's required distributions until A would have reached A's required beginning date. Again, this recitation underscores the problem of having to provide that all contingent beneficiaries must be individuals, and perhaps as well, that no contingent beneficiary shall take any share of the IRA who is *older* than B.

The Ruling sets out three situations for consideration under the above fact pattern:

1. **Power to Adjust State With Section 409(c) and (d).** The first situation is one in which the trust is governed by the laws of a state with the power to adjust "similar" to that set forth under Section 104(a) of the Uniform Act, and with the 10% rule and "savings" provisions "similar" to those provided under Section 409(c) and (d) of the Uniform Act.

2. **Unitrust State Law.** The second situation is one in which "Under State Y law, if the trust instrument specifically provides or the interested parties consent" the income of the trust means a unitrust amount equal to 4% of the value of the trust.

3. **Traditional Income and Principal Law.** The third situation is one in which the trust is governed by state law that has neither the Uniform Act with the power to adjust, nor a provision similar to Section 409(c) and (d), nor does it have the alternative unitrust definition of income.

All three scenarios are found to qualify for the marital deduction, provided that there are appropriate provisions in the trust, and the IRA. As to Situation 1, with the power to adjust, the Ruling provided that

> under section 104(a) of the UPIA as enacted by State *X*, the trustee of Trust allocates the total return of the assets held directly in Trust (i.e., assets other than those held in the IRA) between income and principal in a manner that fulfills the trustee's duty of impartiality between the income and remainder beneficiaries. The trustee of Trust makes a similar allocation with respect to the IRA. The allocation of the total return of the IRA and the total return of Trust in this manner constitutes a reasonable apportionment of the total return of the IRA and Trust between the income and remainder beneficiaries under § 20.2056(b)-5(f)(1) and § 1.643(b)-1.

Since the income, once determined for the Trust and the IRA, is subject to the spouse's annual withdrawal right, it qualifies for the marital deduction. But what is the effect and interpretation of Section 409(c)?

> 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 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. Cf. Rev. Rul. 75-440, 1975-2 C.B. 372, using a savings clause to determine testator's intent in a situation where the will is ambiguous, but citing Rev. Rul. 65-144, 1965-1 C.B. 422, for the position that savings clauses are ineffective to reform an instrument for federal transfer tax purposes. 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. <u>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</u>

> 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.(emphasis inserted)

And this would mean that sections 409(c) and (d) do no good but do no harm, as long as we require the distribution of all of the "income" from the IRA to the trust and from the trust to the trust beneficiary, the surviving spouse *B.* In a state with the power to adjust, the Ruling infers a proactivity on the part of the trustee in allocating the total return of the trust and the IRA between income and principal in a manner which satisfies the duty of impartiality between the current and remainder beneficiaries. This explicit "income" distribution requirement could be set forth in the trust, or in both the trust and in the IRA beneficiary designation, depending upon one's preference for belts and suspenders. What we clearly cannot do is simply make the IRA payable to the marital trust and say nothing specific about the distribution of the income determined to be earned in the IRA, assuming that section 409(c) and a general direction in the trust to distribute the "income" will get it done.

Situation 2, applying a 4% unitrust statute to the Trust and to the IRA is held to qualify for the marital deduction without difficulty, but the interesting part is whether different definitions of "income" can be applied to the IRA and the trust into which it flows:
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> The result would be the same if State *Y* had enacted both the statutory unitrust regime and a version of section 104(a) of the UPIA and the income of Trust is determined under section 104(a) of the UPIA as enacted by State *Y*, and the income of the IRA is determined under the statutory unitrust regime (or *vice versa*). Under these circumstances, Trust income and IRA income are each determined under state statutory provisions applicable to Trust that satisfy the requirements of § 20.2056(b)-5(f)(1) and § 1.643(b)-1, and therefore *B* has a qualifying income interest for life in both the IRA and Trust.

So the definitions of income can be different for the IRA and the assets held in the trust apart from the IRA, and this is so because the qualification of each is separate and does not depend upon the other. However, if the state law contains section 409(c), the provision must be completely ignored in the analysis, as it does not define the income earned *in the IRA* and is irrelevant as to the income earned in the trust.

Situation 3, where the state law uses a traditional definition of income without the power to adjust or the power to convert to a unitrust, the analysis would be the same, requiring the payout of income, or the right to demand the payout of income from both the marital trust and the IRA.

In all three of the Situations, the "income" of the IRA and the "income" of the rest of the trust are determined separately from one another, and the portion of the IRA payment to the trust which is considered "income" becomes irrelevant:

> In *Situations 1*, *2*, and *3*, the income of the IRA and the income of Trust (excluding the IRA) are determined separately and without taking into account that the IRA distribution is made to Trust. In order to avoid any duplication in determining the total income to be paid to *B*, the portion of the IRA distribution to Trust that is allocated to trust income is disregarded in determining the amount of trust income that must be distributed to *B* under § 2056(b)(7).

So the Ruling completely eludes the problems presented by 409(c), while requiring the separate QTIP qualification for the trust and the IRA.

What does the Ruling imply as to the provisions of the marital trusts and the IRA beneficiary designations that we draw? Conservative practice will demand that the requirement that income be distributed or available for distribution on demand at least annually be placed in the trust, and it may not hurt to put it in the IRA beneficiary designation as well, though the latter may be only an additional precaution, reminding the IRA custodian of the requirement as well. It appears to be wise to continue to include a provision that the surviving spouse be able to demand that the trust and the IRA be invested so as to productive of a reasonable income. Now in the context of a unitrust, this "productivity" should not matter, but it seems unwise to take a chance that the Service would question the marital deduction on this basis, since the recital of that fact is unbroken through the chain of Revenue Rulings. In addition, it is still required that nothing in the IRA or the trust may prohibit the trustee from withdrawing more than the minimum required distribution from the IRA.

Where we are free to choose a unitrust definition of income for the marital trust and a traditional definition of income for the IRA, subject to the power to adjust, this may be an attractive combination, because it may allow a smaller flow of distributions from the IRA than would be required from a unitrust distribution formula if the surviving spouse is relatively young (crossover point is 73 years of age for a 4% unitrust). However, this will predictably have the effect of reducing the income payout to the surviving spouse, so if a 4% distribution is desired from the marital trust including the IRA, it may be simpler to use the same definition of income in the trust and in the IRA.

The Ruling is stated to be prospective:

> Under the authority provided by § 7805, the principles illustrated in *Situations 1* and *2* of this revenue ruling will not be applied adversely to taxpayers for taxable years beginning prior to May 30, 2006, in which the trust was administered pursuant to a state statute described in §§ 1.643(b)-1, 20.2056(b)-5(f)(1), and 20.2056(b)-7(d)(1) granting the trustee a power to adjust between income and principal or authorizing a unitrust payment in satisfaction of the income interest of the surviving spouse.

It is difficult to see how the Ruling would be applied to "taxable years beginning prior to May 30, 2006" in respect to its main holdings which concern the marital deduction. Perhaps the most sensible interpretation of the prospective nature of the Ruling is that the administration of the trust in taxable years after the death of a decedent but before the publication of the Ruling would not be used as ammunition to attack the marital deduction. Presumably, since the principles of the Ruling are not to be applied "adversely" retroactively, they might be relied upon if they support the taxpayer's position, even if the date of death was prior to the date of the Ruling's official publication on May 30, 2006.

One additional potential complication would be the question of choice of state law for an IRA or other retirement plan account, the agreement for which often purports to adopt the law of the state where the custodian has its primary offices. One would hope that a Pennsylvanian with a Fidelity Investments IRA would be able to use a unitrust definition of income under Pennsylvania law, despite Fidelity's selection of Massachusetts law in its IRA agreement. Work may still be needed to tie state law and beneficiary designations in as closely as possible to the Ruling, now that we have it.

f. How do We Value an Income Interest Subject to the Power to Adjust or the Power to Convert to A Unitrust? One additional area that does not seem to have been addressed is how to correct and synchronize the method of valuing income interests in light of the power to adjust and the power to convert to a unitrust. If one converted an "income" trust to a 4% unitrust, would the value of the income interest change, or remain the same? If it did change, then does the value change only if the power is exercised or if it is merely possessed? An income interest normally is valued using the 7520 tables, so if the 7520 rate were 4.6%, then for a 50 year old beneficiary, the income interest would equal 68.7% of the whole. A 4% unitrust, on the other hand, would be valued at 64.1% for a Charitable Lead Unitrust if the payment were made annually (the same assumption that is used in the valuation of income interests). There is nothing wrong with the method of valuation of the unitrust, but of course the income interest is likely overvalued. This issue needs to be considered for a variety of purposes where the "income" interest must be valued, such as for the previously taxed property credit under Section 2013, under Section 2702 and otherwise.[115] It is ironic that the Final Regulations require that an alternative state statute produce a "reasonable apportionment between the income and remainder beneficiaries of the total return of the trust," while its own tax tables assume that the total return (the 7520 rate) is allocated entirely to the income beneficiary of the trust!

It is submitted that the power to adjust should not produce a similar problem with valuation, since the power in most cases, apart from a marital deduction trust, is a power to adjust either up or down, and therefore it should not in theory affect the valuation of the interest, even though at the present time it probably makes the income interest more valuable under current market conditions. And if it were to affect the value of the income interest, it is altogether uncertain how one could quantify that change in value in any event.

4. Much Discussion About Ordering and Capital Gains

As contrasted with the relatively short portion of the new Regulations that deals with the core definition of income under Section 643(b), there is a lot more written about when capital gains can be included in distributable net income under Section 643(a), both in the Regulations themselves and in Commentary on the Regulations in the published articles on the

[115] *See* Blattmachr and Gans, *supra* n. 94, at 913.

Regulations.[116] What is more, there are *14* examples of when the Regulations allow capital gains to be included in DNI as opposed to *0* under the definition of income. For the most part, it is the author's opinion that the emphasis in and on this portion of the Regulations is overblown. First of all, the difference that having the power to adjust or the power to convert to a unitrust can be the difference between a payout of 2% from a trust and 4%, and the difference between having a 50/50 stock and bond asset allocation and having an 80/20 asset allocation. Any income beneficiary will tell you that doubling their income is a big deal, and any investment advisor worth her salt will say that the difference between an 80% equity and 20% bond portfolio and a 50/50 portfolio is likely to be huge over time. But whether the additional distribution to the current beneficiary pulls out with it capital gain as part of DNI will matter much, much less. We will examine the importance and effects of including capital gains in distributable net income in some detail later, but suffice it to say that the use of an "ordering rule" is more likely to be equivalent to a difference in payout rate of 25 to 40 basis points, not nearly the difference involved between a 2% payout and 4%! What it really reflects upon more than anything is the choice of an appropriate payout used by the unitrust or accomplished through the power to adjust. Clearly, if the capital gains are not part of DNI, it would be prudent to select a somewhat lower rate for a unitrust or for a transfer of slightly less principal to income under the power to adjust. Then too, the consequences of getting it wrong are less likely to be draconian than the loss of GST grandfathering, loss of the marital deduction or the treatment of a change in the definition of income as being a "sale or exchange" of the income interest under *Cottage Savings* discussed in detail previously.

b. The Regulation Itself. The regulation language itself is as follows:

> 1.643(a)-3 Capital gains and losses.
>
> (a) In general. Except as provided in 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

So the general rule is as it always was since we began to wrestle with Form 1041. Capital gains are usually not part of Distributable Net Income.

> (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 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

[116] *Id.* at 900-907.

> 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.

So there are three ways in which capital gains may be included in distributable net income, but in each case, there is a precondition relating to state law and the governing instrument. However, the structure of the sentence and its meaning is very difficult to parse. Capital gains can be included in distributable net income to the extent that they are

a. pursuant to the terms of the governing instrument <u>and</u> applicable local law, or

b. 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 <u>or</u> by the governing instrument if not prohibited by applicable local law.)(emphasis added)

This inconsistency between the language that applies to an ordering *rule*, as opposed to a discretionary ordering power was present in the Proposed Regulations, and was pointed out to Treasury in Comments:

> One commentator suggested that in the phrase "pursuant to the terms of the governing instrument and applicable local law," the term "and" be replaced with "or". The phrase with the term "and" is consistent with the statutory language of section 643(b), and, therefore, no change has been made.

Well, that sounds like a good answer, except that section 643(b) starts out by defining the word “income”, as applicable when <u>not</u> preceded by the words, “taxable”, “distributable net”, “undistributed net,” or “gross” means. . . And what we are describing here is not “income” but the composition of income for distribution purposes—distributable net income, which contains no such qualification:

> **§ 643(a)(3)** CAPITAL GAINS AND LOSSES. —Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year ...[117]

As between the Proposed Regulations and the Final Regulations, there was also a shift in the language of the second precondition applicable to discretionary powers:

> One commentator suggested that a discretionary power to allocate capital gains to income should not have to be exercised consistently. The exercise of the power generally affects the actual amount that may or must be distributed to the income beneficiaries and affects whether the trust or the beneficiary will be taxed on the capital gains. Thus, the IRS and the Treasury Department agree that the power does not have to be exercised consistently, as long as it is exercised reasonably and impartially. However, if the amount of income is determined by a unitrust amount, the exercise of this discretionary power has no effect on the amount of the distribution, but does affect whether the beneficiary or the trust is taxed on the capital gains. Under these circumstances, a discretionary power must be exercised consistently. One commentator suggested changing the phrase "if not inconsistent with local law" because powers to allocate capital gains to income will almost always be inconsistent with the default provisions of state law. Accordingly, the phrase has been changed to "if not prohibited by local law."[118]

Now this change the author thinks may cause some confusion. Literally, if capital gains are allocated to income, and income must be distributed, then of course the allocation has direct economic substance in that it goes to the income beneficiary, rather than staying in the trust. But changing the term to "impartially" sounds like the language was borrowed from Section 104 of the Uniform Act, which in fact says nothing at all about allocation of capital gains to income or principal. While the tax effects of an adjustment are to be taken into account, no state law version of the power to adjust speaks to whether capital gain is included in distributable net income, nor requires that an adjustment from principal to income come from either proceeds or capital gain!

Commentators requested examples of how the rule would work in the application of the power to adjust, but the request was not granted. Again the Summary provides some insight:

> Two commentators requested examples of the inclusion of capital gains in DNI when the trustee exercises a power to adjust between income and principal under applicable local law. The circumstances in which a power to adjust is exercisable may vary among states and may be determined by the powers of the trustee to make distributions of

[117] I.R.C. § 643(a)(3).
[118] *See* n. 98 *supra* at 14.

> income and principal under the terms of the governing instrument. For example, if a trust instrument does not permit the trustee to distribute any corpus and the power to adjust under local law may be exercised only with respect to receipts from the sale of trust assets, the amount allocated to income under the power to adjust may have to be from the realized appreciation in the value of the assets that were sold. On the other hand, if the trust instrument permits discretionary distributions of principal and the power to adjust under local law may be exercised only with respect to appreciation in the value of trust assets, the power to adjust may be similar to a unitrust amount that is payable irrespective of whether appreciated assets are sold during the year. Because of the potential variations in the circumstances and ramifications of exercising a power to adjust under applicable state statutes, additional examples would be unlikely to provide meaningful or complete guidance; thus, the final regulations contain no additional examples concerning inclusion of capital gains in DNI when the trustee exercises a power to adjust.[119]

What this author thinks all of that means is that where the power to adjust or a discretionary distribution power works like a unitrust, where the distribution is not contingent upon there being realized capital gain that is allocated to income and distributed, then a discretionary power is going to have to be exercised consistently, as is expressly required for a unitrust. If the exercise of discretion with regards to capital gain under the power to adjust and the governing instrument actually results in increasing the distribution to the beneficiary, then the exercise of discretion must be impartial, but not necessarily consistent year to year. This is the only way in which the foregoing makes sense within a tax perspective; that is, that where the inclusion in capital gains in income is merely a tax question of the composition of DNI, and does not affect what is distributed, it must be done on a consistent basis, because it is a tax accounting function, not an economic concept, and the Service is more sensitive to changes in accounting methods. But it seems to the author that the Service misapprehended the variety of power to adjust statutes out there. To the knowledge of the author, there is no state statute affecting private trusts that has varied the power to adjust so as to require that an adjustment of principal to income be from capital gain or appreciation, apart from the charitable endowment field, where the Uniform Management of Institutional Funds Act, a significant precursor to the total return trust movement, provides as follows in Section 2 of the Act:

> **SECTION 2. [Appropriation of Appreciation]** The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by Section 6. This Section does not limit the authority of the governing board to expend funds

[119] *Id*. at 16.

> as permitted under other law, the terms of the applicable gift instrument, or the charter of the institution.[120]

But the power to adjust has no such requirement, nor would such a requirement be wise, as it would cause problems for a trust portfolio that happens to start in a bear market, which would not allow the trustee to invest for total return until it had realized gains or at least experienced appreciation. So it is unhelpful that Treasury didn't give us guidance in this regard, and the summary leads one to think that the Regulation writers did not understand this important nuance of the Uniform Act. It is certainly possible that a trust document might contain such a provision, but it would be unusual.

What can we learn from the 14 examples provided by the Final Regulations? Example 1 reads as follows:

> Example 1. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.[121]

The first thing we notice is that these rules are far broader than just the changes in the definition of income with the unitrust and the power to adjust. *They apply to ordinary discretionary distributions of principal as well.* Since the distribution of principal was made as an exercise of discretion which did not depend upon whether capital gains are included in income, the decision to not include capital gains in the $12,000 distribution of principal must be made consistently. Note that the last sentence in example 1 was added in the Final Regulations, so that the failure to include the capital gains in DNI will require a consistent treatment in future, just as would a decision to include the capital gains in DNI, which is illustrated by Example 2.

> Example 2. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary

[120] UNIF. MANAGEMENT OF INSTITUTIONAL FUNDS ACT, 7A Part II U.L.A. 475 (1999).
[121] Treas. Reg. § 1.642(a)(3) ex. 1.

distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.[122]

Example 3 indicates that if a trustee "intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments,"[123] that would be considered to be a reasonable exercise of discretion as well. This raises the possibility that if there is a particular class of investment, for example real estate, a closely held business, or even a very large block of a company's stock, for which it is desirable to have the capital gains taxed in the trust or to the beneficiary, that would be possible, though this discretionary power is extremely unlikely to be found in a trust instrument or for that matter in state law either at this point. It is a point where additional guidance by the service will be needed.[124]

Example 4 is quite important, in that it may shed light on the "and" versus "or" question:

> Example 4. The facts are the same as in Example 1, except that pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.[125]

This example seems clear enough in providing that if the governing instrument requires that capital gains be allocated to income, as long as the provision to do so is not prohibited by applicable local law, then capital gain will be included in DNI. Commentators are not in agreement about what one takes from this Example. Some think that it is strong evidence that the governing instrument and applicable local law should be read together to determine whether the necessary requirement or authorization exists.[126] Others argue that the regulation does not specifically address the issue of what happens if the governing instrument, or applicable local law, but not both, direct that capital gain be part of income.[127] Still others would argue that "and" means "or" in this context.[128] This author believes that the determination would be made by examining local law and the governing document together and if the direction is in either, but not contradicted by the other, it should be followed and respected by the Service. This means that it would be respected if the document provided that distributions of principal would be deemed to include capital gain realized in the tax year, and

[122] *Id.* at ex. 2.
[123] *Id.* at ex. 3.
[124] *See* Sloan, *supra* n. 94, at 40.
[125] *See* n. 120, *supra* at ex. 4.
[126] *See* Sloan, *supra* n. 94, at 39.
[127] *See* Blattmachr and Gans, *supra* n. 94, at 901.
[128] *See* Blattmachr and Gans, *supra* n. 94, at 901, Professor Mark Ascher's view noted in fn. 29.

state law was silent about it (as essentially all state law is, at the moment). And if state law said that it would be deemed to include capital gains and the document was silent on the matter (as essentially all trusts are, at the moment), it would be respected also. If, however, state law prohibited such a characterization, regardless of the governing instrument, it would not be respected even if the governing instrument so provided. If the governing instrument prohibited it, and state law merely allowed it, it would not be respected. But none of the foregoing suggests real meaning for the "and" in the Regulation apart from a reading of both together. And that of course is what we do in the trust law all the time. We read the trust, and if it covers a matter and is not prohibited by state law, that is the law as applicable to the trust. And if it is silent, we look at the state law to fill in the gaps. Is there something more eloquent really intended? This author does not think so.

Examples 5 and 6 illustrate that if the trustee uses the amount of capital gain realized to determine the distribution to the beneficiary, then the capital gain should be included in DNI. Again this makes sense in the more traditional analysis that if the amount of the capital gain determines what is paid out, then the distribution includes the capital gain in it. That, after all, is true for an allocation to income as well, where the income is required to be paid out to the beneficiary.

Example 11 helps flesh out the rule in the context of the total return unitrust:

> 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.[129]

This example could reflect a statute such as the Pennsylvania statute, which has an ordering rule that directs that the unitrust payout is to be paid first from income defined as if the trust were not a unitrust (this would be very similar, though not identical with "ordinary and tax-exempt income"),[130] and then from short-term gains, long-term gains and then the principal of the

[129] Treas. Reg. § 1.642(a)(3), ex. 11.

[130] "Net income" would have the apportionment of trustee's fees applicable to it, whereas all of the trustees' fees would be deducted before determining the ordinary income and tax free income are part of DNI. Hence "net

trust.[131] From the example, the governing instrument does not have the ordering requirement expressly stated, and yet the example says that is all right. Since two of the specific examples do not comport with the most literal and strict (and perhaps impractical) interpretation of the Final Regulations that would require an ordering rule to be in *both* state law *and* in the governing instrument, the author thinks that in this instance the word "and" is used to mean that the state law and the document should be read together. If the state law said something opposite from the governing instrument, or vice versa, then there is a question as to whether the ordering rule would be respected. But with Examples 4 and 11 to support us, it is most likely that silence in the governing instrument or the applicable local law, but not both, will not preclude an ordering rule from being respected.

And sound tax policy stands firmly in back of such an interpretation. Why should an ordering rule, which is obviously much less subject to manipulation than a power, be placed at a disadvantage?

Examples 12 and 13 assume the same facts as in example 11 (that is a 4% unitrust statute) but posit that if neither applicable state statute nor the governing instrument has an ordering provision, but "leaves such a decision up to the Trustee" the trustee's decision will be respected, provided the power is exercised in a consistent fashion. That all sounds sensible, but what does it mean for the state statute and the governing instrument to "leave" such a decision up to the Trustee? Is silence sufficient to do so? The author would argue that it is; that the powers of a trustee are otherwise plenary in the context of dealing with trust assets and the making of tax elections, perhaps in a fashion similar to the application of the 9th Amendment to the U.S. Constitution,[132] which implies that whatever rights are not expressly given to government are retained by the people. Hence the trustee retains those powers which are otherwise not addressed, provided that they are not against fundamental trust principals. Nevertheless, the author suggests strongly that states address this power directly in their statutes, as has been done by the overwhelming majority of states that have adopted unitrust statutes.[133]

Example 14 provides helpful clarification in noting that a trustee administering a number of trusts need not exercise its discretion consistently on the matter of whether to include capital gains in distributable net income.[134]

But what about the inclusion of capital gains in DNI pursuant to the exercise of the power to adjust? To the best of the author's knowledge, there is no state statute that grants the power to

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income" is generally greater than DNI because the income beneficiary gets the benefit of the deduction for all of the trustees' fees even though the majority of the fees may have been paid by the trust, and not deducted from the income account.

[131] 20 PA.C.S. § 8105(f)(2).

[132] "The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people." U.S. Constitution, Amendment IX.

[133] Only four states with a unitrust statute Kentucky, New York, Missouri and Wisconsin, do not have either a tax ordering rule or a tax ordering power. Kentucky's statute is an unusual adaptation of the power to adjust which requires court approval for all adjustments, but expressly allows the power to be exercised in a unitrust manner. *See* the Table of Total Return Statutes set forth, *supra.*

[134] Treas. Reg. § 1.642(a)(3), ex. 14.

include capital gains in income as part of the power to adjust. And it is highly unlikely that the issue is addressed in the governing instrument in any appreciable number of cases. So unless the Service takes a liberal view of the state law requirement for this power or a very liberal view of tax apportionment language that might be found in documents, there will not be authority to use the power to consider capital gains as part of an adjustment of principal to income. This is unfortunate, in that including capital gains in DNI will allow a higher payout to be prudent, and may allow the beneficiary to offset trust gains against her personal capital losses. No doubt there will be exceptions, but it is almost always better to tax out the gains to the beneficiary. But the power to do that at the present time is highly uncertain.

If the power to adjust were to allow the trustee to include capital gains in DNI, must it do so consistently? Again we cannot be sure. As noted above, Treasury refused to provide any examples of the way the power to adjust might apply to allow the inclusion of capital gains in distributable net income, and commentators are split on the likely result.[135] The summary, it seems to this author, clearly indicates that the Regulation writers thought that the power to adjust could include this power, but the consistency requirement would depend upon the way the power to adjust statute was written and applied. If the allocation of capital gains did not affect the amount of the distribution, such as in a unitrust, then it is likely that the power to adjust would bring with it the same consistency requirement imposed upon the unitrust. So the overall rule would be that if the allocation of capital gains to income did not determine the amount that was paid out, then it was really just a tax accounting practice that must be applied consistently. If under the terms of the statute, the adjustment of principal to income were dependent upon the realization of capital gains during the tax year, then the power would only have to be exercised reasonably and impartially, not consistently.

The express change in the Regulation language eliminating the word "consistently" argues strongly that the power to adjust would allow one to change capital gain treatment in DNI from time to time. The reason for the change as expressed in the Summary, however, reflects a likely misunderstanding of the power to adjust and argues strongly that consistency should be required.

Since neither the Uniform Act nor any state statute adaptation of the power to adjust ties the adjustment to realized capital gains, the author concludes on the basis of tax policy that for a trustee to have the power to include capital gains in DNI as part of the power to adjust, the trustee would have to make that decision on a consistent basis. Further guidance is definitely needed.

So the existence of the power to consider capital gains as part of an adjustment from principal to income is quite uncertain, as is the consistency requirement if the power exists. This is more confusing than it is critical, since the adjustment can simply take into account the tax

[135] *See* Blattmachr and Gans, *supra* n. 94, at 905 and 906 advising that the result is uncertain, versus Professor Ascher at fn. 53 who apparently argues that capital gains would always be included in DNI in conjunction with an exercise of the power to adjust principal to income, and contrast with Sloan, *supra* n. 94, at 40 arguing that without some specific provision in the governing document, capital gain would not be part of DNI in connection with the power to adjust.

effects, as noted in the Uniform Act. If a trustee were to not include capital gains in DNI, then the trustee could have relative certainty, since if the trustee had the power to include the capital gains in income, then by filing without doing so, the trustee would have exercised that power, which it is likely (but not certain) to be required consistently in the future. If the trustee did not have that power, then capital gain should be taxed to the trust, as that is the default rule. It is difficult to see a scenario in which the trustee can include capital gain in DNI and have certainty, unless the governing document grants the trustee the express power to do so, which is unlikely at the present time, unless a general power to make tax elections were considered to be sufficient, which is subject to some considerable doubt if proof of that power is required to be quite specific.[136] If one looks at a trustee's power as residual in nature—that is, the trustee has all appropriate powers to deal with trust property except those which are denied to it, then a trustee's power to allocate capital gains to DNI will probably be present in the majority of trusts in the majority of states, since most state laws and most governing instruments are silent on the subject. This silence is unfortunate, since taxing out the capital gains to the beneficiary will generally be desirable, though improvement in regulatory guidance would be preferable to further importation of tax concepts into our principal and income laws.

Going forward, it is quite important to include such a power in our state statutes so that the issue is not left to doubt, and in our documents to the extent that it is not in our state statutes.

Further guidance by the Service as to whether a specific power must be included by state statute or by governing instrument, or whether in the absence of a prohibition the power will be presumed would be very helpful. Capital gain is, after all, a tax concept and has not typically been included as a concept in either trust law or trust instruments.

5. ***Generation-Skipping Transfer Tax***—the concerns of those fearing the loss of generation skipping transfer tax grandfathering were quelled by the Final Regulations:

> (D) * * *
> (2) * * * 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 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.
>
> Example 11. Conversion of income interest to unitrust interest under state statute. 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

[136] *See* Sloan, *supra* n. 94, at 39.

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 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.

Example 12. Equitable adjustments under state statute. 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 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.[137]

[137] Treas. Reg. § 26.2601-1(4)(i)(D)(2).

From these two new examples, we get even more than what we might have expected. Not only did Treasury bless the conversion to a unitrust and the use of the power to adjust under applicable local law as not causing a loss of grandfathering for GST purposes, but such a change in definition of income under state law is not a gift or a sale or exchange.

And even better, Examples 11 and 12 very clearly give Treasury's blessing to a change in situs from a state without total return legislation to one with total return legislation. In such case the conclusions would be the same as if the trust had stayed in a state where the law had changed. A change in situs will not automatically bring with it a change in state law concerning income and principal, as, for example, where the trust instrument contains a choice of law provision as to administration of the trust even if the situs has changed,[138] but in the absence of such a provision it is likely that the administration of the trust will be governed by the state of administration.[139] While the determination of governing law could otherwise be a bit thorny, it is likely that such changes in situs will occur primarily when there is consensus among all of the parties, which as a practical matter is likely to smooth the process, particularly if the Service does not have a bone to pick concerning the change of situs to obtain more favorable administrative provisions.

So a trust in Rhode Island or North Dakota, which do not have a favorable total return trust law as of yet, might be moved next door to South Dakota, which has unitrust legislation, or Connecticut, which has the power to adjust, or Delaware or Nebraska, which have both, and take advantage of those more modern laws. The laws and process of changing situs of a trust depend upon state law as well and, of course, the terms of the governing instrument, so every trust may not be able to do this successfully, but this should significantly increase the pressure on states which do not have total return legislation to put it on their agenda or suffer the financial consequences to their financial services and trust businesses.

6. Marital Deduction is Safe. The new definition of income under Section 643(b) is specifically incorporated into the power of appointment marital trust under 20.2056(b)-5.

> (f) * * * (1) * * * In addition, the surviving spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1 of this chapter.

And the QTIP trust provisions were amended under § 20.2056(b)-7:

> A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of § 1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

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[138] *See* Sloan *supra* n. 94, at 30.
[139] *See* Blattmachr and Gans, *supra* n. 94, at 914.

At first glance one might conclude that the power to convert to a unitrust would not be acceptable for a QTIP trust, since only the power to adjust is specifically mentioned in that section, but the preexisting Regulation § 20.2056(b)-7(d)(2) states that the principles of 20.2056(b)-5(f) relating to the spouse's income interest apply to a (b)-7 QTIP interest as well, thus incorporating the general power of appointment "fix" quoted above for the QTIP trust as well as to the definition of income. While the power to convert to a unitrust could have been included in the language of the (b)-7 regulation specifically, it was probably not thought to be necessary, once the change was made so that "income" was deemed equivalent for marital deduction purposes, particularly since with the unitrust, there is no continuing power other than the power to switch back and forth under applicable local law, and Treasury was comfortable with that.

7. Distribution in Kind to Satisfy New "Income".

Confirming the provisions in the Proposed Regulations, a distribution of an asset in kind in satisfaction of income under a unitrust statute or the power to adjust will be a realization event for a simple trust under Treas. Reg. § 1.651(a)-2(d) and for a complex trust under Treas. Reg. § 1.661(a)-2(f), and a distribution of more than the ordinary income in this context will not disqualify the trust as a simple trust. *See* Treas. Reg. § 1.651(a)-2(d).

8. Charitable Remainder Unitrusts-NICRUTs and NIMCRUTS.

In its plain vanilla format, the new definitions of "income" should have no effect on the charitable remainder unitrust, which already defines what is distributed based upon a unitrust payout. And both the Uniform Act and most state statutes exclude from the operation of the power to adjust or the power to convert to a unitrust a trust which describes what is payable to the beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.[140] But in a net income CRUT, the lesser of the net income or the unitrust amount is paid out, and in the net income with makeup CRUT, or NIMCRUT, if the income is greater than the unitrust amount, the income may be paid out until the amount paid in excess of the unitrust amount makes up for any previous shortfalls below the unitrust amount. In these two CRUT variations, then, the net income does matter, and the new state law income definitions and the Final Regulations fit together rather imperfectly. The Regulations do not allow income to be defined as a unitrust amount in the context of a NICRUT or a NIMCRUT, since to do so would basically allow a payout of less than 5%.[141]

The NICRUT or NIMCRUT trust provisions may direct that post contribution realized gain may be allocated to income if not prohibited by applicable local law, and a discretionary power to make this allocation can be given to the trustee, but only to the extent that the discretionary power is given to the trustee to treat the beneficiaries impartially.[142] It is possible that this will be a useful power, but because the power given in the Uniform Act does not limit

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[140] UNIF. PRINCIPAL AND INCOME ACT, *supra* n. 11, § 104(c)(3).
[141] Treas. Reg. § 1.664(3)(i)(a)(1)(b)(3). Just as an aside, this makes only marginal practical sense, since the deduction granted for the NICRUT assumes actuarially that the 5% is paid out. Why prohibit a taxpayer from paying herself less and thereby giving the charity more later?
[142] *Id.*

the adjustment to post contribution gains, it is not likely to be available unless amendments are made to fit within the Regulation. Indeed, the Uniform Act should preclude the exercise of the power to adjust because of the provision contained in Section 104(c)(4)that an adjustment must not be made

> (4) From any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside.[143]

Literally, the charitable remainder unitrust is a trust for which the portion not distributed is set aside for charitable purposes. The phrasing of the exclusion is identical to that used in Section 642(c), however, so that in states following the language in the Uniform Act, it may not be entirely clear that the power to adjust or a power to convert to a unitrust is entirely precluded for a NICRUT or NIMCRUT, if this limitation applies only to those trusts relying upon the Section 642(c) set aside deduction, since the NICRUT and NIMCRUT rely upon Section 664 for their exemption from tax, rather than the 642(c) deduction to escape taxation for capital gains incurred.[144] Unfortunately also, the Comments do not provide any helpful insight, as there is no comment concerning the (c)(4) exclusion, and a comment limiting the (c)(3) exemption (the power to adjust is not applicable to a trust that pays out an annuity or unitrust amount) could infer that it does apply:

> For example, if a beneficiary is to receive a fixed annuity or the trust's income, whichever is greater, subsection (c)(3) does not prevent a trustee from making an adjustment under Section 104(a) in determining the amount of the trust's income.

This is an argument outside the literal wording of the Uniform Act, and so in this author's opinion, the power to adjust should be precluded for a NICRUT or NIMCRUT. This is helpful, in that otherwise the Regulation could cause disqualification of the trust, clearly not an intended result. Some other states, such as Pennsylvania, added language to preclude the application of the power to adjust and the power to convert to a unitrust only where a gift or estate tax deduction has been taken.[145] Since a gift or estate tax deduction will always have been taken for a NICRUT or NIMCRUT (though not a deduction under Section 642(c)), this should be sufficient to preclude the application of the power to adjust or the power to convert to a unitrust.

Going forward, drafters should take this Regulation into account, and it may be helpful to add language to legislation applicable to the NICRUT and NIMCRUT that fits within the Regulation's requirements, clearly precluding a unitrust conversion in all cases and permitting adjustments only from post contribution gains, and then only as required to satisfy the duty of impartiality. In the meantime, it is unlikely that there will be any way to use the power to adjust or the power to convert to a unitrust with these trusts—the best result being simply that these powers are inapplicable. If there are concerns under applicable state law about whether the power to adjust or the power to convert to a unitrust might apply, a release of the power to

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[143] UNIF. PRINCIPAL AND INCOME ACT, *supra* n. 11, § 104(c)(4).
[144] *See* Blattmachr and Gans, *supra* n. 94, fn. 61.
[145] *See* 20 PA.C.S. §§ 8104(c)(4), 8105(i)(2).

adjust under Section 104(e) or a release of the power to convert might be advisable to insure that qualification under Section 664 is not threatened.

9. ***The Pooled Income Fund.***

The Final Regulations do allow for state law changes in conformance with 1.643(b)-1, so that a trust can still be considered to be a pooled income fund even if state law would give the trustee the power to convert to a unitrust, though for the power to adjust, the trustee may not allocate to income the portion of proceeds of an asset representing the value of the asset when contributed to the trust or when purchased in the trust.[146] However, for the same reason set forth with reference to the NICRUT and NIMCRUT, it seems that the Section 104(c)(4) should preclude the application of the power to adjust, since the income and principal are not both set aside for charitable purposes.

However, while the foregoing application of the definition of income as a unitrust amount and the limited use of the power to adjust do not disqualify the pooled income trust as a pooled income trust, the possibility of paying out a unitrust amount or the adjustment of principal to income which takes into account unrealized appreciation does disqualify the capital gains realized in the pooled income trust from the set aside deduction given by 642(c).[147] The income in a pooled income fund is not exempt from taxation, since it is distributed to the non-charitable beneficiary of the trust, but capital gains realized are held in the fund and not distributed, and hence enjoy the permanent set aside deduction, but if a unitrust definition of income is used, then obviously the realized capital gains may be used to satisfy a portion of the unitrust amount, and as such, the charitable set aside deduction is denied. So also with the power to adjust if it may take into account unrealized appreciation in the fund (which it may). This effect is prospective, however, and it could be avoided by reformation:

> In a state whose statute permits income to be determined by reference to a fixed percentage of, or the unrealized appreciation in, the value of the fund's assets, net long-term capital gain of a pooled income fund may be considered to be permanently set aside for charitable purposes if the fund's governing instrument is amended or reformed to eliminate the possibility of determining income in such a manner and if income has not been determined in this manner. For this purpose, a judicial proceeding to reform the fund's governing instrument must be commenced, or a non-judicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner.[148]

It is the author’s opinion that this reformation should have been needed in very few instances, because the language of the Uniform Act provides a savings provision that causes the power to adjust not to be applied to charitable split interest trusts. In addition, even if it were held to apply, the trustee could

[146] *See* Treas. Reg. § 1.642(c)(5).
[147] *See* Treas. Reg. § 1.642(c)(2).
[148] *See* Treas. Reg. § 1.642(c)(2)(e).

permanently release the power to adjust principal to income under Section 104(e). Whether this release would be considered a "non-judicial reformation" is not entirely clear, but it should be considered as sufficient.

At this time, such a reformation will only be an issue for new statutes, as otherwise the window of opportunity has closed. But even if that window is still open, it is submitted that the trustee should consider carefully whether the power to adjust or the power to convert to a unitrust should be eliminated, since without these powers, the trustee may well not be able to invest for total return, and the ability to invest for total return is likely more valuable than the charitable deduction on capital gains!

For example, the ability to invest for total return may allow the trustee to invest in 80% equities and 20% fixed income, while without such power the trustee might invest in 50% equities and 50% fixed income. Assume that the equities in both portfolios are highly appreciated (80% capital gain) and that the portfolio is actively managed with a 25% turnover ratio. Even in that situation, the average ending market value for a 4% unitrust payout over all of the rolling 20-year periods in history would be significantly greater than having the more conservative asset allocation and never paying out any principal or capital gains. In the foregoing example, the average ending market value for the 4% unitrust enabled to invest for total return is over 27% more than the average ending market value of the more conservatively invested and distributed trust.

In summary, judicial reformations are probably unneeded because of the protective language already in most state statutes, but if they were needed, they may well be inadvisable, as the reformation would be giving up something (the ability to invest for total return) which is clearly more valuable than what was gained-that is a 0% tax on capital gains inside the pooled income fund. For the foregoing calculations, it was assumed that the capital gains distributed to the taxable beneficiary can be taxed out to her as part of DNI, which should be possible if done on a consistent basis.

10. What Other Acronyms are Affected—QSSTs and QDOTS.

While not mentioned in the Final Regulations, the summary makes clear that the new regulations and the new state law definitions of income apply to Qualifying Subchapter S Trusts because the 643(b) definition of income is incorporated through Section 1361(d)(3). This may be particularly important with the power to adjust, which can flexibly respond to situations involving a closely held company held in a trust.

The QDOT regulation was changed to specifically allow the new state law definitions of income under 26.2056A-5(c)(2) which should be particularly helpful in the context of the Qualified Domestic Trust because of the imposition of the federal estate tax on the payment of any principal during the life of the surviving non-citizen spouse. Discretionary powers to distribute principal in such a trust could not sensibly be utilized, so that a unitrust definition of income or the power to adjust would be particularly helpful in this context, wherein there is no practical alternative to modernizing our notion of income.

D. DESIRABLE LEGISLATIVE RESPONSES TO THE REGULATIONS

1. Regulations Likely to Spark an Additional Round of Legislation.

What the Regulations make crystal clear is that those states without modern total return statutes are and will continue to be at a disadvantage compared to those states which have taken the plunge towards the future.

For existing trusts, trustees will continue to be trapped in many cases in an "income" regime that does not allow them to invest for total return and puts them in the middle as between the current income beneficiary and the remainder beneficiary. Without a unitrust conversion statute, even if the trustee could convince a local court that it had the power to reform the income trust into a unitrust, there would be all of the questions surrounding the conversion that practitioners were worried about before the Regulations were made final. While PLR 200448001 is encouraging, it seems quite clear that where there is such a conversion, the trustee and her attorney are not safe in assuming that the generation skipping transfer tax grandfathered status has been preserved, that the marital deduction is safe or even that the income interest may not have been "sold" in the process.[149] And if a conversion occurs in a state with neither a unitrust conversion statute nor the power to adjust, there is no safety at all from these tax issues.

For new trusts, the drafter in a non-unitrust state will continue to be required to draft their unitrusts which are intended to qualify for the marital deduction as requiring the unitrust amount or the net income, whichever is greater. And there may well come a time in the world of investments when very high interest rates make that a real problem. And a QDOT simply cannot be drafted as a unitrust without a unitrust statute. It simply cannot be done in a state without a unitrust definition of income. So Texas practitioners, despite the absence of a unitrust conversion statute, should be in good shape for drafting unitrusts for marital trusts and QDOTs, because it has adopted an alternative unitrust definition of income, while practitioners in the 20 states which have only the power to adjust probably cannot safely draft QDOTs as unitrusts, or for that matter, the even more frequently useful QTIP trust, without requiring that the net income be paid out if greater than the unitrust amount. Ohio's virtually airtight unitrust safe harbor might provide a strong argument that a trust drafted as a 4% unitrust is paying out all of the "income" under Ohio law, but a ruling of some sort would be needed to give any level of assurance.

[149] Even if court approval were obtained, a private letter ruling would be needed to see whether the "stealth" ruling discussed previously, is solid or an aberration. The fact that the underlying facts of that ruling was a conversion to a regime paying out the income or the unitrust interest, whichever is greater, makes the ruling weak authority on the marital deduction and GST grandfathering issue, which would have been satisfied under those facts prior to the Final Regulations.

Worse yet for those states which have not taken the plunge is the fact that Treasury has given a very clear green light to changing the situs of trusts from a state without total return legislation to one that has such legislation. That is very likely to produce significant competitive pressure on those without the necessary statutory support to add that support, and to add it soon, so as not to disadvantage its banks, trust companies and other trust professionals.

Just as the Proposed Regulations resulted in a spurt in legislation across the country, so the Final Regulations should also be a catalyst for change to motivate the states which have not been quick to act.

2. *States With Total Return Legislation Should Consider a Tax Regulation TRU-up!*

States which have enacted total return legislation should promptly consider whether additional changes or fine tuning are necessary in light of the issuance of the Final Regulations. Because of the variety of the legislation, it is difficult to generalize as to what might be needed, but several general points might be considered.

First, a number of states required that unitrust conversions of marital trusts and trusts which are grandfathered from generation-skipping transfer tax to include a pay out of the income or the unitrust amount, whichever is greater. This is no longer necessary, and is therefore an unfavorable provision to retain in the law, since it could force distributions to be too large and produce conflicts in making investment decisions in a future period of high interest rates.

Second, but probably more important, in the author's opinion, is that essentially none of the legislation deals adequately with the trust that is drafted as a unitrust. It is very important that states consider adding provisions aimed at this increasingly common situation. The Final Regulations give an imprimatur to methods of defining income which reasonably apportion the annual total return from a trust and which are "pursuant" to a state statute. The concern is that the drafting of a unitrust as a unitrust may be "consistent with," but not "pursuant to" a state statute. This may be an overly technical reading of the Final Regulations but the Regulations have taken pains in the definition of income 1.643(b)-1 to use the word "statute" rather than the prior reference to "applicable local law," the latter reference being the words used in Code Section 643(b) itself. While it is the author's opinion that the Service will, for example, accept a 4% unitrust for the marital deduction in a state with a unitrust conversion statute with a default rate of 4%, and a Treasury representative has orally indicated her agreement with this, it will be a great deal more comfortable to point to a state statute that discusses express unitrusts as such, so that there can be no doubt that the trust drafted as a unitrust is "pursuant" to a state statute. A second reason for revisiting these statutes is to consider whether the provisions that are appropriate for a trust which is converted are the same as the provisions which are appropriate for those trusts drafted as a unitrust. Quite a few states[150] have a default rate of 4% for their converted unitrusts with no reference to the 3-5% range allowed by the Final Regulations. These states may wish to add, where necessary, a statutory recognition of that range for trusts expressly

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[150] Alaska, Georgia, Maine, Maryland, New York, Oregon, Pennsylvania, and Washington. New Hampshire is similar but uses a 5% rate.

drafted as unitrusts, to eliminate any question about whether the applicable state law requirement is met for those trusts. In the meantime, for example, a marital trust drafted in Pennsylvania must have a payout rate of at least 4% to be a safe bet to qualify for the marital deduction, and this may not be desirable in quite a few cases, particularly if the marital trust may be exempt from GST taxes and be intended to go on for multiple generations. And even that may not be really safe because a 4% unitrust is parallel and consistent with the Pennsylvania unitrust statute. It is not "pursuant" to it.

Third, in order for trustees to have better assurance that they know what their options are with respect to including capital gains in DNI, state laws need to address that area for unitrusts and for the power to adjust at a minimum, and in the opinion of this author and other commentators, ought to insert additional language giving the trustee discretion over this capital gain issue wherever possible, such as for other discretionary distributions of "principal".

The issues to be addressed are governed by the present statutory framework on a state by state basis, but discussion based upon a general categorization will likely be helpful:

a. Power to Adjust Only States. For states with only the power to adjust and which have adopted the Uniform Act largely intact, there are a number of questions which might be considered.

Can the Tax Savings Provisions be Withdrawn? The Uniform Act has a number of exclusions under Section 104(c) that were aimed at tax concerns and uncertainties existing at the time it was drafted.

> (c) A trustee may not make an adjustment:
>
> (1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment;
>
> (2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;
>
> * * *
>
> (4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;
>
> (5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment;

(6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment;

(7) if the trustee is a beneficiary of the trust.[151]

Should any of these tax protective provisions be withdrawn or revised at this time in light of the Final Regulations? There is nothing in the Final Regulations whatever that requires the power to adjust in the context of a marital deduction trust to never adjust the income downward. Indeed, it makes no sense for the power to adjust only to be the power to adjust upward, since the duty of impartiality runs uphill and downhill, depending upon the market conditions, yields and circumstances. It was never intended to be a one way street, as is noted in Example 2 to Section 104, which suggests that income should be transferred to principal under certain conditions. So should that provision be removed at this point?

And what of the other protective provisions, such as prohibiting an adjustment that reduces the actuarial value of an income interest where the gift tax exclusion is desired? The New York legislative advisory committee has suggested that this provision be deleted entirely, for reasons that seem well grounded, at least to this author.[152] First, it is entirely unclear that making an adjustment up or down to an income interest from time to time would have any effect on the actuarial value of the income interest. How does one determine the "actuarial value"? Is it the present value of all of the future cash flows? If so, what is the payout method, and what discount rate is used to determine the value?

The tables used by the IRS for valuation of an income interest assume that the 7520 rate is both the rate of return and the discount rate and that all of that return is distributed to the income beneficiary. That of course does not square with the "facts on the ground." The 7520 rate applicable for May of 2007 is 5.6%, and it is safe to say that most trustees hope to earn better than 5.6% on a total return basis in the long run. It is also safe to say that an income beneficiary would generally be thrilled to hear that she was getting a 5.6% payout. Further, if the trustee were to distribute all of the return to the income beneficiary, he would be violating the very principle of impartiality that the power to adjust was meant to address! Interestingly also, 5.6% is beyond the "safe harbor" 3-5% that Treasury has signaled loudly is an appropriate range, and yet their method of computing the value of income interests may well assume a range substantially above it, such as the 8% rate of June of 2000. It is difficult, therefore, to see how the power to adjust should influence this misvaluation. One is led to the following query:

> How can Treasury require that state laws defining income provide "a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year" as described in Regulation 1.643(b)-1, and then value the "income" interest on the basis that the entire total return from the trust is distributed to the income beneficiary?

[151] UNIF. PRINCIPAL AND INCOME ACT, *supra* n. 11, § 104(c).
[152] S 4548-B: TECHNICAL CORRECTIONS TO CH. 243, LAWS OF 2001.

And perhaps of more practical importance is the fact that if the exercise of the power to adjust did somehow influence the actuarial value of the income interest, the provision to exclude trusts intended to take advantage of the annual exclusion seems very much overbroad, since it could potentially include the host of life insurance or other trusts which rely on "Crummey" withdrawal powers to qualify gifts into trust for the gift tax annual exclusion. Of course, while these extremely common trusts do not need the Uniform Act exclusion, it would be unfortunate if the exclusion would serve to disable the trustees of those trusts from using the power to adjust, potentially for generations. For new trusts, the relatively less common trusts relying on an "income" interest for their qualification for the annual exclusion are probably ones in which other methods of qualification such as the Crummey withdrawal power are available or could be inserted. And in case of trusts for which transfers were made in the past, the gift tax annual exclusion has already been obtained, and hence could hardly be lost by virtue of later legislation. As a result, the New York Committee proposed eliminating this exclusion altogether.[153] Frankly, their arguments make good sense to this author.

As for the remainder of the listed exclusions, one is tempted to give due regard to the judgment of James Gamble, Co-Reporter for the Uniform Act, and conclude that it may be premature to withdraw these protective provisions. At the moment, they probably do no harm, and it is likely that changes to them should await further guidance from the Service. When the Regulations were written, Treasury had these provisions before them, so it is not clear what effect their withdrawal might produce. The one really important exclusion in the foregoing that will cause trouble sometime in the future is the one seeking to preserve the marital deduction. Here, perhaps a ruling from the Service would be quite helpful in giving guidance as to whether this exclusion is necessary. If it is necessary, it is likely to be interpreted as prohibiting an income to principal adjustment for trusts even if that were necessary in order to preserve impartiality and allow the trustee to invest for total return in a high inflation, high interest rate period. This provision is also overly broad in the opinion of this author, since unlike the exclusion concerning the annual exclusion for gift tax, it speaks to a trust for which the marital deduction "would be allowed." What about a credit shelter trust that pays the income to the surviving spouse? Certainly we have lots of them around, and there is no reason to deny them the power to adjust, unless we needed to correct some problems in the planning wherein a QTIP election were needed for that trust. This is too important a question to leave on the table, and a ruling on whether this exclusion could be withdrawn would be very helpful.

One other provision that it seems best to change in light of the Final Regulations is the one discussed previously that seems to cause some confusion in light of the Final Regulations:

> (1) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

As discussed previously, this provision is likely, but not certain, to protect the NICRUT and the NIMCRUT from problems with the Final Regulations in light of the fact that the provision tracks

[153] Preliminary Draft Memorandum of the EPTL-SCPA Legislative Advisory Committee, a copy of which was kindly provided to the author.

the 642(c) language, which does not apply to the trusts under Section 664. In addition, while it should protect the Pooled Income Fund from loss of the charitable deduction for realized long-term capital gains, it may also go too far in that it is not conditioned upon application to trusts for which such charitable tax benefits have been taken or qualified. For example, a trust which has a partially charitable remainder might be excluded from the benefits of the power to adjust simply because a portion of the trust proceeds will eventually go to charity. For this reason, Pennsylvania and some other states phrased the exclusion differently:

> (4) The adjustment is from any amount which is permanently set aside for charitable purposes under the governing instrument and for which a Federal estate or gift tax deduction has been taken unless both income and principal are so set aside.[154]

Whether this is ideal or not, it at least makes it clear that if the trust is one receiving no special charitable tax benefits, that the exclusion should not apply. The word "charitable" should be inserted before the word "deduction" to eliminate the possibility that a marital trust might be excluded, and the words "trust funds" might be better than the words "any amount" because in a NICRUT or NIMCRUT context the difference between the net income and the unitrust amount is not deductible, and it is preferable that the wording be as clear as possible that the exclusion does apply to such trusts.

The other change which should perhaps be considered in <u>all states</u>, including those with just the power to adjust would be a clear statutory basis for a trustee to consider capital gains to be part of distributable net income.

> Power to Treat Gains as Part of a Distribution of Principal.
>
> Unless prohibited by the governing instrument, the trustee of a trust shall have the power to consider gains from the sale of capital assets in the trust to be part of a distribution of principal to a beneficiary, [**In power to adjust states:** or part of an adjustment from principal to income], and if such power is exercised, such gains shall be treated consistently by the trustee on the trust's books, records and tax returns as part of a distribution to a beneficiary. **[Note that if one takes the position that the power need not be exercised consistently, different phraseology should be employed].**

It is of course not surprising that most states lack the express power to "deem" realized capital gains to be a part of a distribution of principal, since before the Proposed and Final Regulations, they would not have thought it helpful, or perhaps even possible, to have done so.

The foregoing provision should give trustees the power to exercise the new flexibility afforded by the Final Regulations, but which may well require explicit state law authority.

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[154] 20 PA.C.S.§ 8104(c)(4).

b. Delaware Style Unitrust States. Just as Delaware was the first state to adopt a unitrust conversion statute, it was also the first state to make significant changes to its statute to take into account the provisions of the Final Regulations.[155]

The changes made by Delaware represent a very good attempt to fine tune its statute to the new environment illuminated by the Final Regulations. It provides a worthwhile template for other states which have patterned their unitrust statute in whole or in part upon Delaware's statute.[156] They eliminated the unnecessary provisions concerning distribution of the income if greater than the unitrust amount for marital trusts and GST exempt trusts; they patched a gap in their notice provisions that clarify the persons entitled to receive notice; they expressly provide for the conversion of a wholly charitable trust to be converted to a unitrust under the statute also, and they added the following section to deal expressly with the unitrust that is drafted, rather than converted:

§ 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.

[155] *See* n. 94, *supra.*

[156] These states might include Colorado, Indiana, North Carolina and Virginia. It could also provide guidance to those states more closely aligned with the wording of the Illinois statute, the key difference being that Illinois and others following Illinois have a default unitrust rate, with a range of 3-5% allowable with the consent of the trustee and the beneficiaries, while Delaware's statute gives the trustee the power to choose within that range with notice to but not consent of the beneficiaries required.

(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.

Note that in 2005 Delaware also adopted the power to adjust,[157] and in doing so adopted an ordering rule for adjustments from principal to income, making it the only state to have expressly dealt with this issue in the context of the power to adjust.

The foregoing amendments to Delaware's statutes make their total return statutes perhaps the most flexible available at the present time. Note that if one took the view that for an ordering rule to be respected, that it really must be in both the governing instrument and in an applicable state statute, then the default rule should be that the trustee should have discretion, rather than the ordering rule set forth above. The ordering rule has the advantage of making the process simpler for the trustee, unless the drafter has selected a trustee who desires to fine tune the planning to the maximum extent. For both the power to adjust and the power to convert to a unitrust, the most likely choice is going to be to treat the income as being distributed in the order set forth above.

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.[158] 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.

c. Pennsylvania Style Statutes. A total of seven state statutes have drawn significantly on the Pennsylvania model.[159] As discussed previously[160], the language governing notice to beneficiaries must be changed to include all parties in interest. The following, drawn from language in the Uniform Trust Act, is suggested:

> (2) The trustee gives written notice of the trustee's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including what initial decisions the trustee will make under this section, to all the *sui juris* beneficiaries who:
>
> (i) are currently eligible to receive income from the trust; [and]
>
> (ii) would be eligible to receive, if no powers of appointment were exercised, income from the trust if the interest of

[157] *See* 12 DEL. CODE § 6113(h). For quick reference, *See* http://www.delcode.state.de.us/title12/c061/index.htm#TopOfPage
[158] *See* Blattmachr and Gans, *supra* n. 94, at 915.
[159] Alaska, Maine, Maryland, New Hampshire, Oregon and Washington.
[160] *See* text discussion at n. 66.

all those eligible to receive income under subparagraph (i) were to terminate immediately prior to the giving of notice; and

(iii) would receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately prior to the giving of notice.

Only two of the three beneficiary classes should be required to contain a *sui juris* beneficiary:

There is at least one *sui juris* beneficiary under paragraph (2)(i) and at least one *sui juris* beneficiary under either paragraph (2)(ii) or (2)(iii).

A suggested form of revision for the Pennsylvania statute as it related to express total return unitrusts follows. While a proposal different from the following has been enacted in Pennsylvania as omnibus amendments attached to the Uniform Trust Act[161], the author continues to believe that the following represents a more explicit and clearer starting point for such a statute, which as one can see is very similar to what was adopted in Delaware.

<u>Express Total Return Unitrusts.</u> The following provisions shall apply to a trust which by its governing instrument requires the distribution at least annually of a unitrust amount equal to a fixed percentage of not less than three nor more than five percent per year of the net fair market value of the trust's assets, valued at least annually, such trust to be referred to as an "express total return unitrust":

(a) The unitrust amount may be determined by reference to the net fair market value of the trust's assets in one year or more than one year.

(b) Distribution of such a fixed percentage unitrust amount is considered a distribution of all of the income of an express total return unitrust and shall be considered to be an income interest

(c) Such a distribution of the fixed percentage of not less than three percent nor more than five percent is considered to be a reasonable apportionment of the total return of an express total return unitrust.

(d) An express total return unitrust which provides for a fixed percentage payout in excess of five percent per year shall be

[161] SB 660. 20 PA.C.S.§ 8107. For quick reference, *See* http://www2.legis.state.pa.us/WU01/LI/BI/BT/2005/0/SB0660P1969.pdf Note also that Section 8108 granting the trustee discretion to deem capital gains to be a part of a distribution of principal was not adopted either, requiring either further amendment or inclusion in out trust boilerplate of that power, if it is desired.

considered to have paid out all of the income of the express total return unitrust, and to have paid out principal of the said trust to the extent that the fixed percentage payout exceeds five percent per year.

(e) The governing 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 income determined as if the trust were not a unitrust, or it may specify the ordering of such classes of income.

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

(1) from net income determined as if the trust were not a unitrust;

(2) from ordinary income not allocable to net income;

(3) from net realized short-term capital gains;

(4) from net realized long-term capital gains; and

(5) from the principal of the trust estate.

(g) The trust document may provide that assets used by the 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. Such use may be considered equivalent to the "income" or unitrust amount.

§ 8108. Power to Treat Gains as Part of a Distribution of Principal. Unless prohibited by the governing instrument or specifically addressed by the provisions of Section 8105(f) or Section 8107, the trustee of a trust shall have the power to consider gains from the sale of capital assets in the trust to be part of a distribution of principal to a beneficiary, and if such power is exercised, such gains shall be treated consistently by the trustee on the trust's books, records and tax returns as part of a distribution to a beneficiary.

What the foregoing would do is to provide clear and specific statutory support for a drafter of a unitrust, and would provide significant freedoms to her:

1. It would expressly allow a distribution of 3% to 5% to be defined as income. This is appropriate without court approval

because it is the drafter and settlor who are making the rate decision.

2. It allows the freedom to use a 3 year smoothing rule, or a 5 year rule, or no rule at all. This sort of a technical difference is not fundamental to the concept, and thus it should be allowed, as it is in the Regulations.
3. A payout of more than 5% is categorized as a distribution of principal to the extent that it exceeds 5%, while the first 5% is considered to be a distribution of all of the income of the trust.
4. Freedom to give the trustee the discretion of including capital gains in the unitrust distribution or not is granted, but if it is not exercised, the ordering rule is imposed.
5. Note that "ordinary income" apart from accounting income is placed in the rule. This seems appropriate, and consistent with the law and practice prior to the "income" revolution. It may be helpful if IRD is paid into the trust to avoid unfortunate results because of telescoping of the income tax brackets.
6. "Use" property is expressly excluded from the unitrust computation if this is desired by the drafter, which often it is. The "use" should be the substitute for the unitrust amount for property such as the residence property which may be held within a marital trust for the spouse.

d. States with No Unitrust Conversion Statute. For states that have no unitrust conversion statute, but wish to give drafters and settlors as much freedom to craft trusts as they choose, they might want to follow the lead of Texas which adopted a unitrust definition of income in a way that is believed to be consistent with the Regulations without going so far as to provide a unitrust conversion statute. The following language might well address that intent:

> Total Return Unitrusts-Alternative Definition of Income—The following provisions shall apply to a trust which by its governing instrument requires the distribution at least annually of an amount equal to a fixed percentage of not less than three nor more than five percent per year of the net fair market value of the trust's assets (the "unitrust amount"), valued at least annually, such trust to be referred to as a "total return unitrust":
>
> 1. The unitrust amount may be determined by reference to the net fair market value of the trust's assets in one year or more than one year.
>
> 2. Distribution of such a fixed percentage unitrust amount is considered a distribution of all of the income of the total return unitrust and shall not be considered a fundamental departure from applicable state law.

3. Such a distribution of the fixed percentage of not less than three percent nor more than five percent is considered to be a reasonable apportionment of the total return of a total return unitrust.

4. A total return unitrust which provides for a fixed percentage payout in excess of five percent per year shall be considered to have paid out all of the income of the total return unitrust, and to have paid out principal of the said trust to the extent that the fixed percentage payout exceeds five percent per year.

5. The governing instrument may or may not 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 amount exceeds the net accounting income, or it may specify the ordering of such classes of income.

6. Unless the terms of the trust specifically provide otherwise, or grant discretion to the trustee as set forth above, a distribution of the unitrust amount shall be considered to have been made from the following sources in order of priority:

(a) from net income determined as if the trust were not a unitrust;

(b) from ordinary income not allocable to net income;

(c) from net realized short-term capital gains;

(d) from net realized long-term capital gains; and

(e) from the principal of the trust estate.

9. The trust document may provide that assets used by the 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. Such use may be considered equivalent to the "income" or unitrust amount.

e. Consider Clarifying the Rules Concerning Retirement Accounts. As discussed previously, the rules concerning retirement accounts should be addressed specifically, and in light of the Final Regulations, it would be well to consider some alterations of Section 409 of the Uniform Act or whatever version of those rules have been adopted in your state. Pennsylvania's provision might be a place to start. I have inserted additional changes to Pennsylvania's statute in bold underlining which have been proposed but not yet adopted in order to illustrate proposed best fit language in light of Rev. Rul. 2006-26:

§ 8149. Retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments.

(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.

(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)**]A (including the power to adjust and the power to convert to a unitrust)** through E (relating to allocation of disbursements during administration of trust) is readily ascertainable by the trustee, **such internal net income of the fund shall be considered to be the income earned by the fund,** 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.

(3) The power to convert to a unitrust under 8105, the power to adjust under 8104, and the provisions governing express unitrusts under 8107 shall apply to retirement benefits covered by this Section 8149 (c) which are payable to a trust. These powers may be exercised separately and independently by the payee trustee or in the governing instrument as between the retirement

benefits and the trust as if they were separate trusts subject to this chapter.

(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.--In this section, "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.

Pennsylvania Comment: Section 8149. Where the actual interest or its equivalent on the unpaid principal balance is specified or can be easily calculated it seems counterintuitive to resort to an arbitrary 10% rule, which in those cases severely distorts economic reality. Subsections (a) and (b) would provide such specific apportionment for notes or other installment contracts calling for level payments, a portion of which would be credited to interest on the then unpaid principal balance and the remaining portion to principal itself. A term certain annuity readily lends itself to the same amortization concept since the difference between the total expected return and the original acquisition value is substantially the equivalent of interest. Although an annuity conventionally does not specify an interest rate, both the effective interest rate and the resulting contract amortization schedule will be readily ascertained since in most cases it will be the same as the Applicable Federal Rate used in determining the acquisition value. Even in other cases, the unspecified interest rate can be readily ascertained from the acquisition value and the amount, frequency and duration of payment factors using one of many loan amortization programs commonly available in both financial software and on the Internet. Most trustees or custodians of Individual Retirement Accounts (IRAs) and segregated 401(k) or HR-10 accounts render periodic statements which clearly reflect the interest and dividend income earned by the fund. Apportionment based on a presumed "pass through" of this income comes far closer to economic reality than an arbitrary allocation of 10% of a distribution which can range more or less from 1.3% to 50% of the underlying fund assets. The presumption as to the source of a distribution should resolve the problem of undistributed income identification where the retirement plan keeps all assets in a single pot. It will also aid in identification of when and by whom an IRC 691(c) deduction may be claimed. Thus principal which bore the burden of the tax should enjoy the full benefit of the deduction therefor. <u>8149(c) specifically confirms the freedom of a trustee to exercise the power to adjust, the power to convert to a unitrust and the power to draft a trust as a unitrust independently with respect to retirement benefits and a trust to which they are payable, as allowed by federal tax law.</u>

The foregoing provisions should avoid the issue for IRA's discussed previously of trying to determine what the income is and is not required to be in order to satisfy the Final Regulations under Section 643 and the all-important marital deduction, and it fits neatly into Ruling 2006-26, for states with both the power to adjust and power to convert to a unitrust, the foregoing should give the trustee and the drafter all of the flexibility that the federal tax law allows, which is considerable in this instance.

In some instances, it may be best to leave the old conventional definition of income in place for an IRA payable to a unitrust so as not to cause an increase in the distributions from the IRA to the trust, increasing income tax to the trust and/or the trust beneficiary in the bargain. However, if under all of the circumstances it is determined that the old "income" rule might cause difficulty in investing the IRA appropriately, as, for example, in a high-interest rate period, or where the higher unitrust "income" is needed by the surviving spouse, then giving the trustee the option of converting to a unitrust both with regards to the trust and to the IRA "trust within a trust" may be helpful flexibility. Without this clarification, the treatment under many state statutes will be very uncertain. Revenue Ruling 2006-26 teaches us the importance of creating and preserving the marital deduction separately for the IRA and the marital trust into which it pours, so it is best if the applicability of the unitrust statute to the IRA and the trust is made as explicit as possible.

E. DOES IT ALL REALLY MATTER? IS TOTAL RETURN INVESTING AND DISTRIBUTING STILL RELEVANT?

But does all of this really matter anymore, now that we know that the investment total return trees do not grow to the sky and that a price/ earnings ratio of 40 to 1 for the S & P 500, as it was in the year 2000, is neither sensible nor sustainable? The dividend yield on the S & P 500 is still well under 2%, specifically 1.89% at the present time, and while interest rates have been rising and the 10 year treasury bond yield is up to 4.62%, a 50/50 mix of the two would yield 3.2% before trustee's fees and 2.7% to 3.0% after trustees' fees, depending upon the amount of trustee's fees and the allocation as between income and principal. This would leave one with a net income production of something like $28,500 on a million dollar trust given a 50/50 asset allocation, which, as was discussed at the beginning of this article, is an asset allocation that is virtually doomed to fail in the quest of preserving or building real value in the family trust.

One would think that the effects of JGTRRA, with its 15% tax rate for qualifying dividends, would be to increase the emphasis on dividends from stocks substantially, and there are those who are adherents to that quite logical point of view.[162] And indeed there has been strong growth in both earnings and dividends and a substantial growth in the number of S & P 500 stocks that pay dividends. At present, about 77% of all of the S & P 500 stocks pay a dividend, an increase from the year 2001, when only 70% paid a dividend, but comparing rather poorly with the 94% that paid dividends in 1980.

In terms of performance, there has been relatively little evidence favoring the dividend paying stocks in the S & P 500. The 12-month period ending in March 2007 is the first such 12-month period in which they have outperformed their non-dividend paying brethren:[163]

	Average S&P 500 Payers	Average S&P 500 Non-payers
Month-average change	.54%	1.19%
Year-to-date-average change	2.65%	2.98%
12-months	13.57%	7.11%
Issues	386	114

And while there is definitely a trend towards higher dividend payouts, the increase in the S & P 500 dividend payout over the 12-month period ending December 31, 2006, was 12% over the same calculation one year earlier, while reported operating earnings were up 14% for the same

[162] *See "The Dividend Revolution," PNC Advisor's Investment Outlook*(Spring 2005).
[163] Data taken from Standard & Poors' Website, www.standardandpoors.com.

comparable period. So while the dividend yield has clearly increased considerably since its low point in the year 2000, it is a very long way from its historical average of over 4% and seems unlikely to reach that level anytime soon. And share buybacks have been using up corporate cash at perhaps a higher rate than dividend increases. In 2004 a total of $197 billion was spent on share buybacks by companies in the S & P 500, while in the first half of 2005 alone there, was a total of $163 billion.[164] At the same time, it is interesting to note that the total dividend payout of the S & P 500 for the 12 months ending September 30, 2005, was $196.7 billion. So the large companies which were in the best position to pay substantial dividends were still using more cash buying back their own shares than paying out a healthier stream of dividends.

The trends that caused the "income" problem to begin with have diminished a bit, but are still very significant. But the need for a total return investment and distribution policy for trusts does not depend upon this "problem." At all times, and in all markets, it is critical that trustees be able to invest for total return without having to worry about whether the choice of investment favors the current beneficiary or favors the remainder beneficiary, because what the "income" beneficiary receives is defined by what satisfies the traditional definition of income. The issues of total return investing and distributing the family trust are very much still with us.

III. SOME NEW THOUGHTS ON DESIGN INVESTMENT AND DISTRIBUTION POLICIES

A. RISK IN THE CONTEXT OF A TRUST—WHAT IS IT REALLY?

In determining the appropriate asset allocation and investment portfolio for a trust, the "risk" of the investments, or more properly, the investment portfolio, must be carefully considered. But how do we determine "risk" in the context of a trust? And is it at all different from how we would look at risk in an individual's personal portfolio?

The first question one might address in this context is "risk to whom?" In the context of an individual investor's portfolio the risk must be considered as it relates to that investor, and that investor only. The typical trust, on the other hand, involves the division of the economic interests, often in a variety of ways. The legal title to the trust property is in the trustee, while the beneficial interest is in the beneficiaries. The interests of the beneficiaries may be separated in time, as between the current income beneficiary and the future or remainder beneficiaries, or as between the economic interest held by each; the "income" being owned by the current beneficiary and the "principal" being owned by the remainder beneficiaries. And of course this latter characterization coupled with a duty of impartiality has caused tremendous changes in our principal and income laws which are the primary focus of these materials.

Generally speaking the risk as it applies to each participant in the trust arrangement relates to the variability of what that participant may in fact receive. So if one were looking at a strict "income" interest, it would be the variability of the "income" that would be important, while if the beneficiary's interest was in the "principal," then it would be the variability of the principal or market value of the portfolio that would be important. On a theoretical total return

[164] *Intel Ups Dividend Plans $25B Buyback*, Associated Press November 10, 2005, as published by America On Line.

basis, it would be the variability of "return" that would be measured, but in the real world, the real variability of "return" that matters is the downside. Nobody, really, nobody is offended by the ride up. It is the ride down that gets you! The various measures of volatility, most commonly "beta," treat the bull volatility and the bear volatility the same, but in the real world, it is the downside, the peak to trough decline in value or "income" that causes distress and difficulty with our beneficiaries.

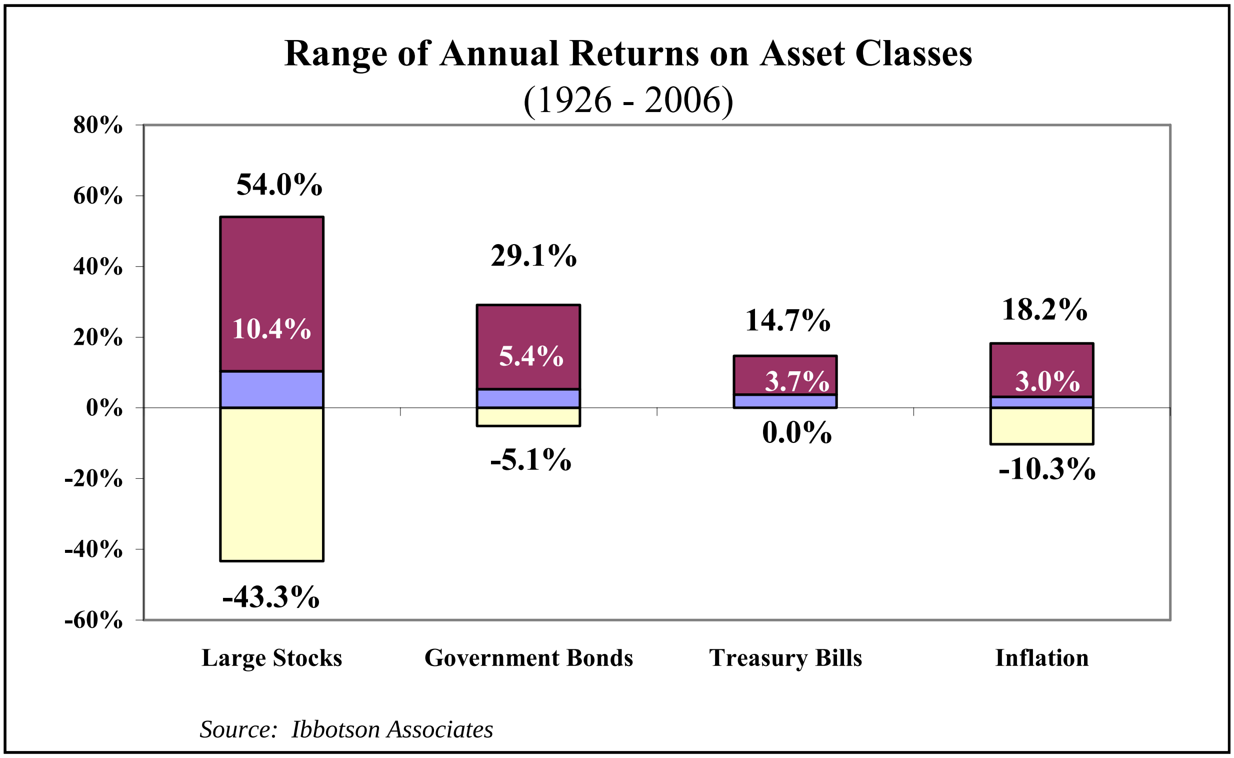
This is important in this context because if the income beneficiary requires a steady flow of "income" which is her primary or only source of support, then it is the volatility of that income stream that is the volatility that matters to her.

The remainder beneficiary is concerned only with the value of his remainder interest in the trust. And the remainder beneficiary most typically receives his interest in the trust at one particular point in time—when the trust terminates; while the income beneficiary receives her interest spread over time. So the risk to each is both defined differently and felt differently. Consequently, if we are able to control the risk as felt by the beneficiary, and particularly the income beneficiary, it is more important than controlling the technical up and down motions of the portfolio itself.

One of the key considerations, the investment "horizon," is critically impacted by this distinction, in that the "duration" of the interest is markedly different for the income beneficiary, than it is for the remainder beneficiary. *If the income interest were a fixed amount, such as in a bond, the duration of the income interest would be half as long as the remainder beneficiary's interest*.

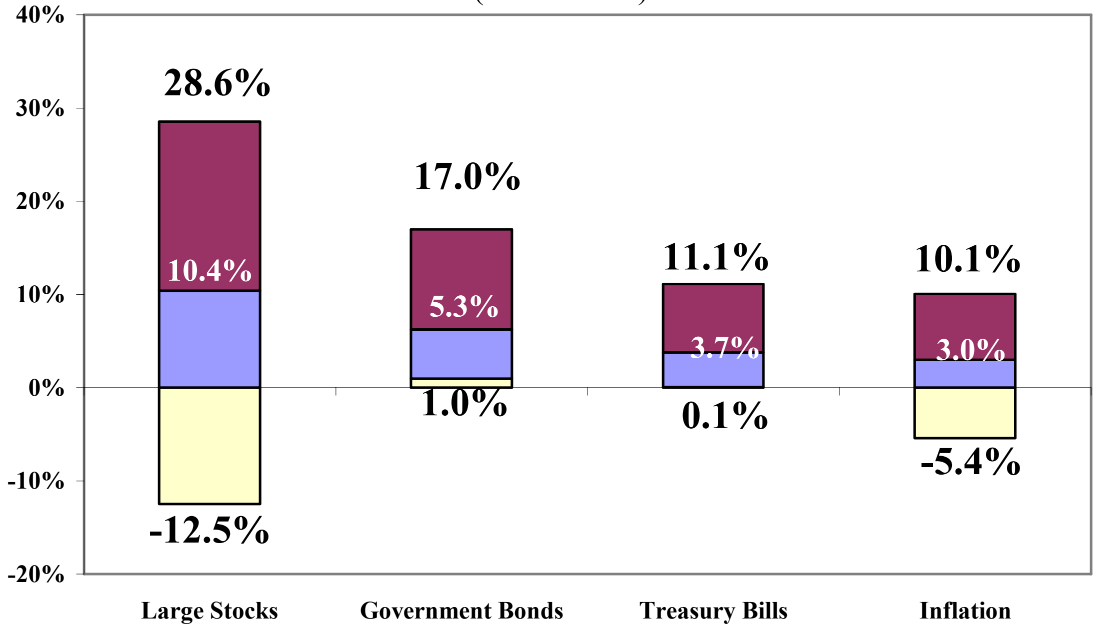
Because the dispersions of returns for stocks and other equity securities on a historical and on a problematic basis become smaller over time, it is clear that the longer the investment period which is measured, the more short term volatility can be endured. While risk and return are imperfectly correlated, it is very helpful to have a longer time horizon and risk tolerance if the goal is to produce the highest possible return.

The short term variability of returns over one year periods is tremendous for equities as the following chart displays:



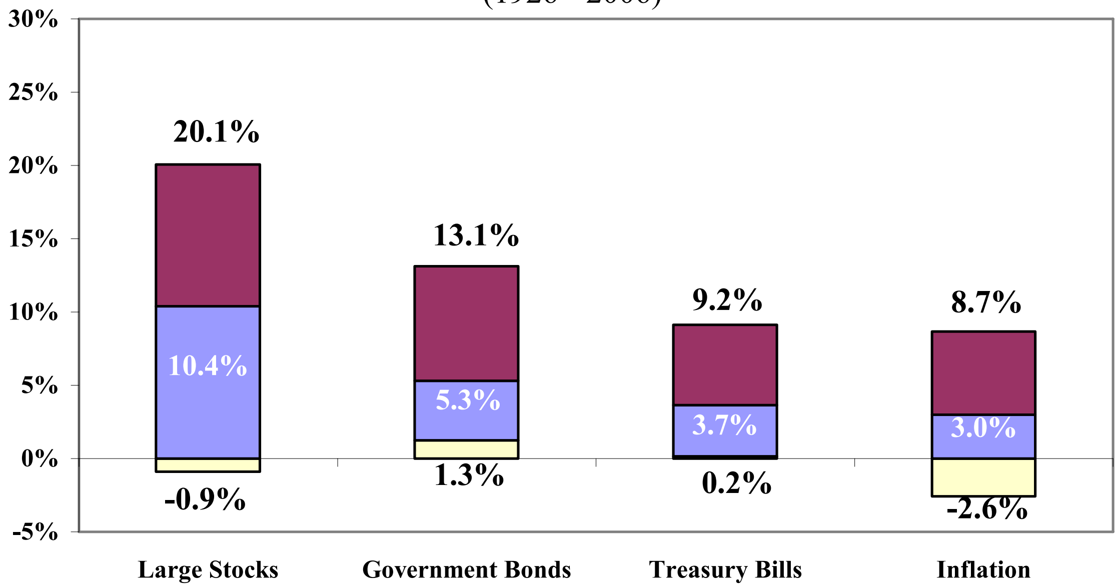
But as we examine the returns for 5, 10 and 20 year periods, the variability of return on an historic basis shrinks dramatically, particularly for the large capitalization stocks.

Range of 5-Year Returns on Asset Classes
(1926 - 2006)

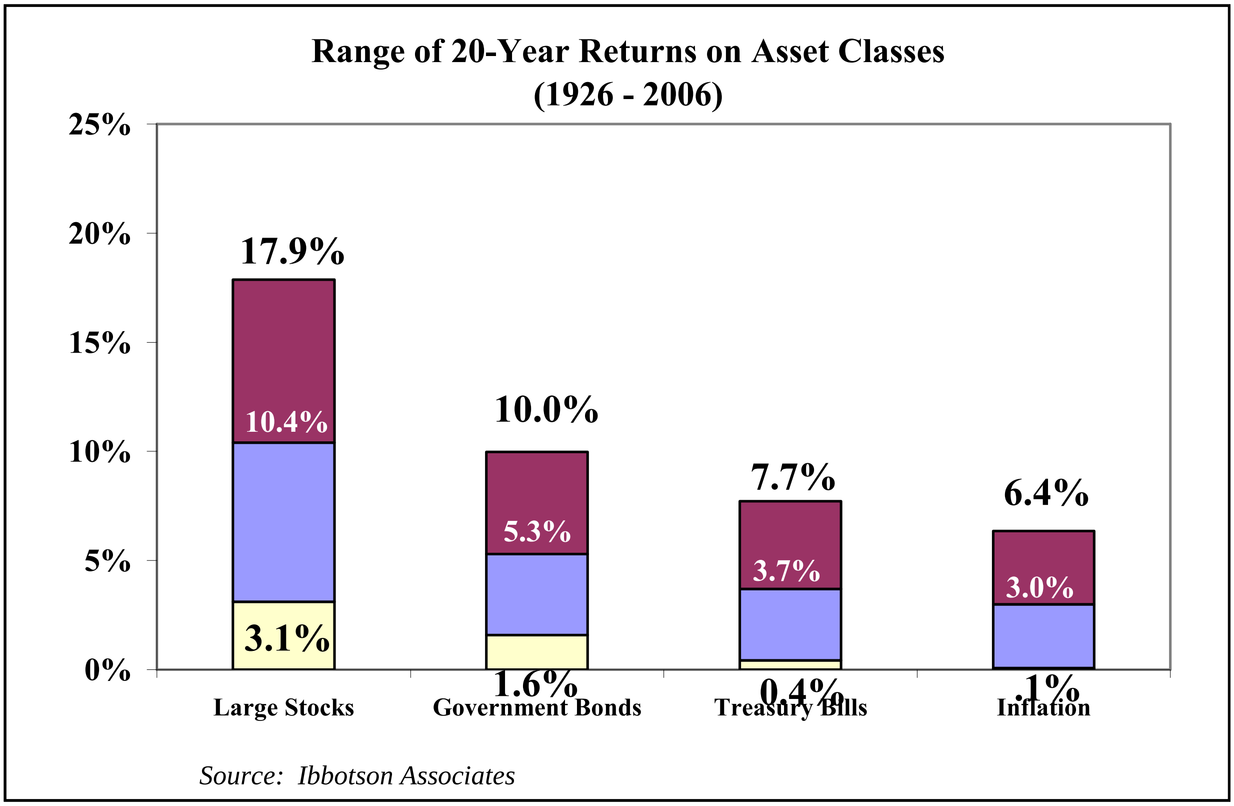


Source: Ibbotson Associates

Range of 10-Year Returns on Asset Classes
(1926 - 2006)



Source: Ibbotson Associates



For 20 year periods, stocks have always (up to the present time) had a positive return and always outperformed bonds. But these are the geometric total returns as measured at the end of the periods. The "ride", as we will discuss, is another matter.

So in considering the time horizon in which the "risk" is being considered, it is important to note that the investment horizon of the income beneficiary and the remainder beneficiary are not the same, nor are they affected in the same way by the "path of return." And the "path of return" matters a great deal to the trust beneficiaries, as discussed in subsection C in these materials.

If we are able to control the risk as it affects the income beneficiary, we can free ourselves to undertake a higher level of risk in the trust portfolio as a whole. Naturally, we should not do so unless we believe that the risk is appropriately compensated by a higher level of return. If we are of the view that additional risk is uncompensated by an appropriate return expectation, then obviously we should not intentionally take on that risk; but if we can take on more variability of return on a year to year basis, it is likely to be very helpful in achieving good long term results.

The foregoing discussion leaves out the many wrinkles and variables that make our lives interesting as trust and estate professionals including the fact that the duration of the trust as a whole typically depends upon the life of the income beneficiary, and while we may know the life expectancy of that individual, we do not know when the trust will actually end. And we must also take into account the possibility or probability that substantial additional funds apart from the "income" may be required to be distributed. In such case, the investment horizon shrinks to the same degree, because the "duration" of the trust cash flows theoretically decreases as well.

On the other hand, it is not axiomatic that the remainder beneficiary will automatically liquidate the trust portfolio when it comes into his or her hands. If the beneficiary may well keep the portfolio invested going forward, the investment horizon will expand. Do we ask at the beginning of a trust administration whether the remainder beneficiary will liquidate the equity portfolio whenever they received it? I would bet that very few trustees do so, but particularly in the context of a trust that extends only for the life of an older life beneficiary, it seems like an important question in the evaluation of "risk tolerance."

If the trust is one on which federal estate tax will be paid at the death of the life tenant, such as in a marital QTIP trust, I have heard trust professionals argue that the potential for that tax liability requires a more conservative asset allocation. I am unpersuaded by this point of view, since the federal estate tax is based upon the value of the taxable trust, whether it is up or down, so rather than hoping for a high market at the time of death in a taxable trust, one ought to look for a low market at that time, unless you are cashing out and exiting the market, since the federal capital gains tax rate of 15% compares very favorably to the federal estate tax rate of 45%.

The determination of the duration of the trust portfolio is a critical determinant in deciding upon an appropriate level of risk tolerance. But the risk tolerance of the income beneficiary should be examined separately and should take into account at least the following factors:

1. What portion of the income beneficiary's disposable income comes from the trust?

2. What other assets does the income beneficiary have which might serve as a "buffer" in the event of a downturn in the income stream?

3. Are the income beneficiary's assets increasing overall or decreasing? Is the beneficiary a net saver, or a net spender?

4. Given the beneficiary's expenses and lifestyle, what is the likely financial effect of a downturn in the income stream?

5. What is the personality of the income beneficiary and her attitude towards risk and uncertainty?

6. What is the character of the income beneficiary's other sources of income or savings? Is the other income fixed or variable? Is it guaranteed or is it subject to the same sort of risks as the income stream from the trust? If it is investment income, how is it invested?

7. Are there other financial risks in the income beneficiary's family that may stress her financial situation, such as children or other close family members with significant health or financial issues?

Clearly the risk to the income beneficiary is likely to be very important in most of the trust situations we encounter, so that if we are able to lower that risk, *as it is experienced by the current income beneficiary*, without decreasing our return characteristics from the underlying trust portfolio, it may be a very important step.

B. RETHINKING OUR SMOOTHING RULE—IS LONGER BETTER?

1. The Need For a Smoothing Rule

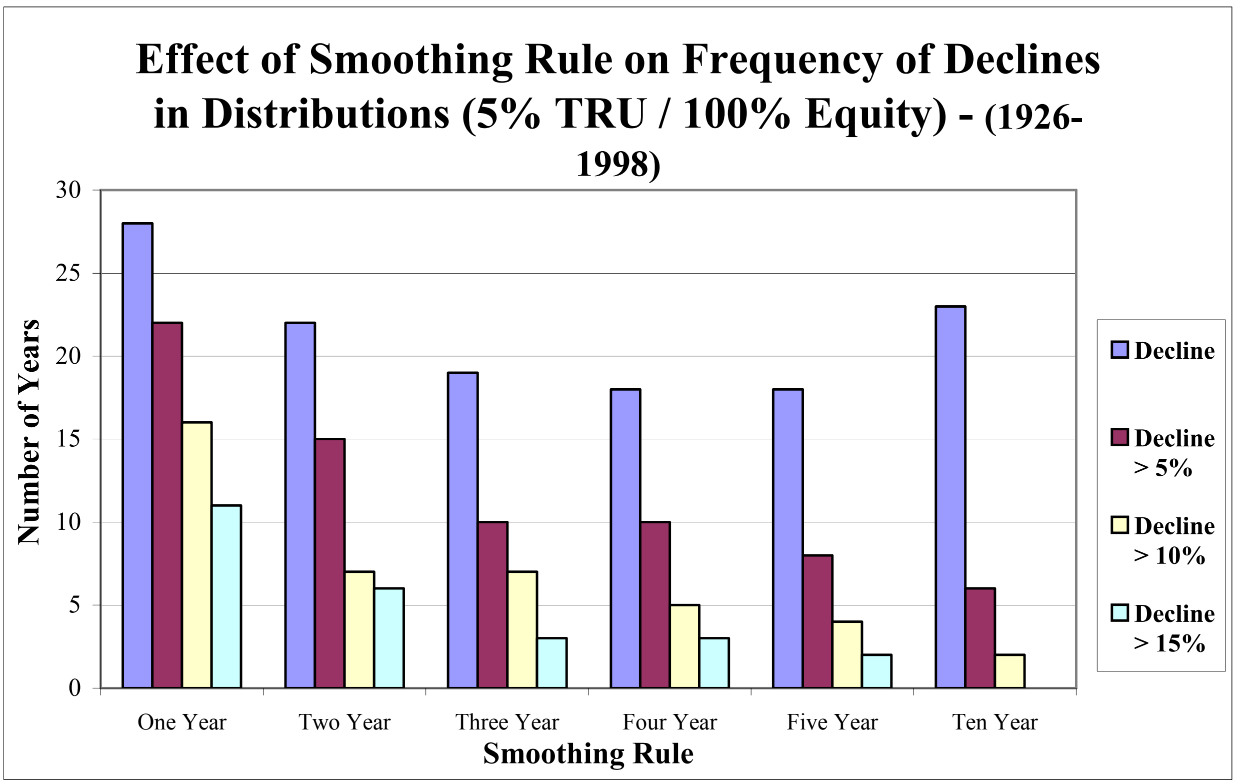
A total return unitrust payout method would clearly have allowed the preservation of the real value of a trust over very long historical periods, provided the payout rate was not too high and the trust was invested primarily in equities, regardless of whether the unitrust payout was or was not subject to the three-year smoothing rule that has been incorporated into most of the state unitrust statutes. A 4% unitrust with an 80%/20% portfolio from 1926 through 2006 would have gained 83% in inflation-adjusted value. A 5% unitrust with the same portfolio and same historical period would have lost 8% in real value. Not too bad, all things considered, over such a long period, even without any smoothing rule. But that is examining our results by looking only at the ending destination, rather than considering the quality of the "ride" for the income beneficiary. And clearly the "ride" would be pretty rocky for the income beneficiary. A 4% unitrust with no smoothing rule would have produced a distribution decline in 29 years, and 18 years when the decline exceeded 10%.

The returns from the Depression era provide a real perspective on just how badly the stock market performed beginning in 1929. During that period, a 5% payout (and the market value) would have decreased by 73% for 1929 to 1933. Interestingly, the dividend income on the Standard & Poor's 500 decreased almost as much, down 56% from 1930 to 1934.

2. The original research. The author's original research on the smoothing rule used an all-equity portfolio with a 5% payout rate. The all equity and relatively high payout were used to "stress" the volatility of the trust portfolio, since this would better test the effects of a smoothing rule. The period used was from 1926 through 1998. Throughout this 73-year period of the hypothetical trust from 1926 through 1998, with no smoothing rule, there were 28 years in which there was a reduction in the distribution, 16 years in which the reduction was more than 10% and 11 years in which the reduction exceeded 15%. The most recent major decline of the market prior to 1998 was in 1974 and 1975 and would have resulted in a 46% reduction in the distribution. At the same time, this 73-year record of distributions on a Standard & Poor's 500 portfolio with a 5% unitrust payout is still quite impressive, with a beginning market value of

$100,000 growing to an end market value as of December 31, 1998 of $2,439,053. Despite the impressive overall performance, however, the volatility of distributions for a unitrust without a smoothing rule seems too great for most private trusts. A smoother stream of distributions would be more desirable for the welfare of the life beneficiary, usually the spouse or other dependent of the testator or settlor.

By using a three-year rolling average of market values to determine the annual payout, the trust can provide much smoother streams of distributions. Note that the market value at the end of the 1926-1998 period with the three-year smoothing rule is $2,549,665, a 2450% increase.[165] With the three-year smoothing rule, instead of 28 negative years, there are only 19 negative years and only seven with a decline of greater than 10% and only two with a decline of greater than 15%. We tested out other potential smoothing rules rather thoroughly with the following results:



Based upon the foregoing, the three-year rule appears to get most of the smoothing that the longer rules provide, particularly in the number of "down" years overall and the number of years in which there was a decline of 5% or more. A 10-year rule would actually increase the number of down years by extending the effects of a bear market for a much longer period, while at the same time eliminating all of the declines over 15%.

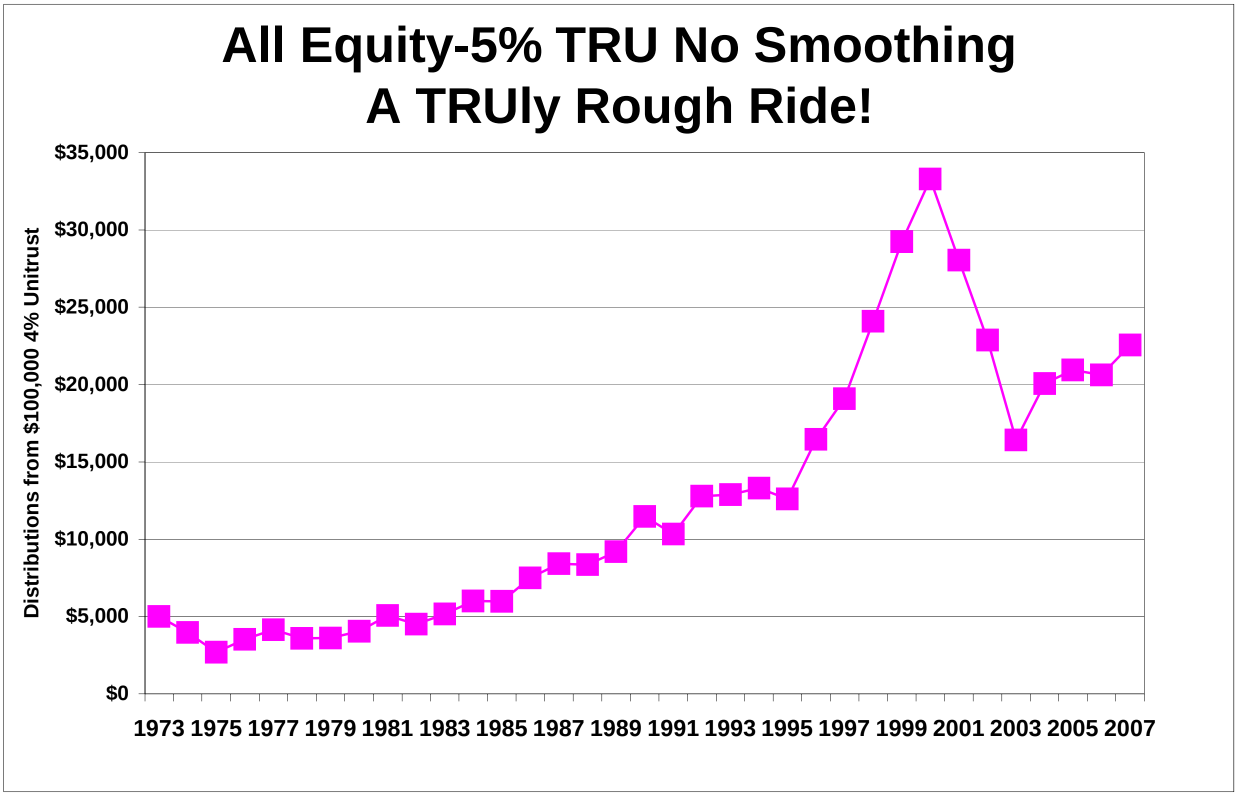
[165] This increase constitutes a real (after inflation) increase of 178%. The cumulative inflation rate was 914% from 1926-1998. IBBOTSON ASSOCIATES, *supra* note 4, at Table A-15 at 252-53.

But a second important consideration in selecting a smoothing rule is to try to preserve the important partnership between the current and remainder beneficiaries and the trustee. The longer smoothing periods allow the distribution to continue to go up and down long after the market is pointing the other way. If we go too far in this direction, we will destroy one of the really key benefits of the unitrust: the fact that the current and remainder beneficiaries and the trustee all profit from a higher value of the trust and suffer from a lower value. A really long smoothing rule would also reduce dollar averaging benefits available for the TRU when more is sold at higher market levels and bought (or not sold) at lower market levels.

Because of these results generally favoring the selection of the three-year smoothing rule, it has been used in our model documents up to the present time. The three-year smoothing rule appeared to represent the best compromise between the need for smoothness in the distributions and the need to increase or decrease distributions along with market performance quickly enough to preserve the trustee-life beneficiary-remainder beneficiary partnership. When drafting a trust for a 75-year-old beneficiary, it can be argued that a five- or ten-year smoothing rule may simply be too long to adequately produce the identity of interest that is at the heart of the TRU.

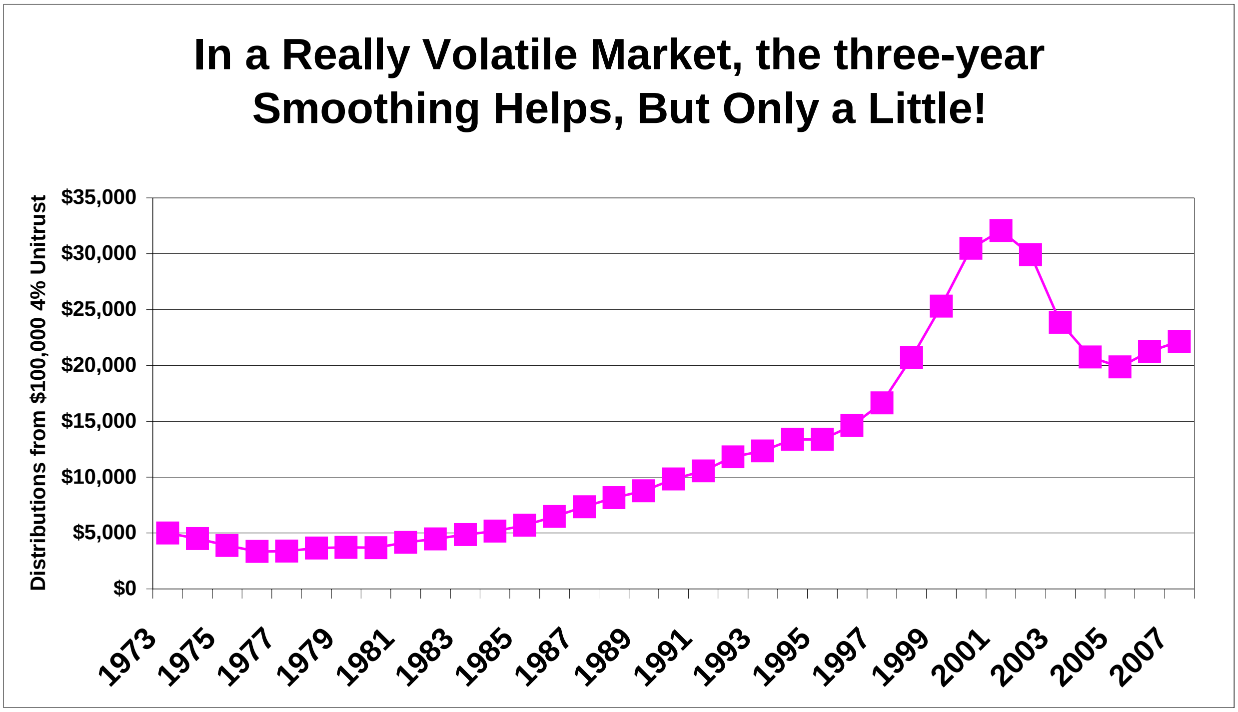
3. And Then Along Came the Greatest Bull/Bear since the Depression

There is little question that in most cases a three-year smoothing rule is preferable to no smoothing rule from the point of view of the income beneficiary. The following graph of a TRU with no smoothing rule shows how in a severe bear market, the volatility is undeniably too great on a year to year basis for the comfort of most current beneficiaries. While the volatility of the bear market of 1973-1975 cannot be seen clearly because of the scale of the graph, there would have been a 46% decline in the distribution during that period, and in the most recent bear market of 2000-2002, the decline was even greater: 48.6%! Predictably, the distribution for 2004 increases by 22.2%, based as it is on the year-end 2003 value, which included a gain in market value for the S & P 500 of 26.38%, which after expenses and pruning to provide cash for the 5% distribution, allowed an increase in a corresponding amount in the trust market value.



Without a smoothing rule, the distributions look pretty good after 2003, based upon the year end market value of December 31, 2003, as the returns were modest for 2004 and 2005, and were good for 2006, but there is no getting away from the tremendous volatility from 1995 to 2003! Clearly the destination is fine, but the ride is too rough.

Let us examine graphically the effects of the three-year smoothing rule through 2007 (based on year-end 2006 data) so that we may examine the smoothing rule when a super strong bull market from 1995-1999 turns into a super strong bear market of 2000-2002 and then rallies in 2003 and 2004 treads water in 2005 with a total return of 4.91% and returns to a strong gain of 15.8% in 2006. The three-year smoothing rule rounds the edges and smoothes the results, but the market value of an all equity trust is a real roller coaster during a time of unprecedented volatility:



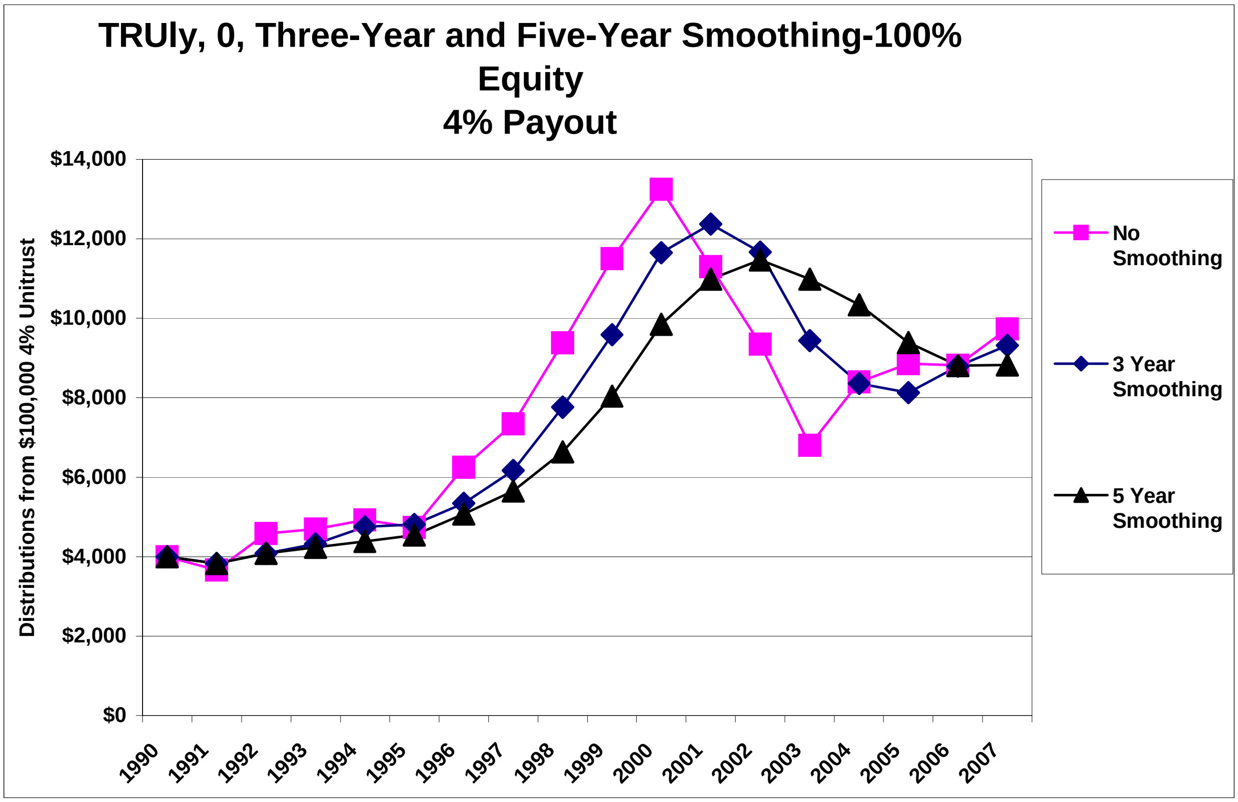
Clearly the three-year smoothing rule makes the ride a lot easier on the current beneficiary most of the time, but when the most productive five-year period in history from 1995-1999 turns into the second worst bear market in history from 2000 through 2002, the all-equity portfolio with a high payout is extremely volatile. And it is this combination of the extremely strong bull market followed by an extremely strong bear market that makes this so. The effects of the bear market of 2000 and 2001 are only first apparent in the distribution *in 2002*. The momentum of the extreme bull market of 1997-1999 is so strong that the distribution in 2001 actually increases over the 2000 distribution because the year-end value of 2000 is still higher than the year eliminated in 1997. This actually hurts total return, because the distribution continues to rise, while the market is going down. The helpful aspect of this characteristic is that it takes the short-term pressure off of the trustee in the event of a bad market because the three-year averaging dampens the effects on the current beneficiary's cash flow stream. This is probably the most important effect for any smoothing rule because it allows the trustee to think about the trust's asset allocation in the longer, rather than shorter, term. And generally speaking, longer term decision-making in setting and adjusting your asset allocation is more productive and safer for long term trusts. Designing a trust the distributions from which would be extremely sensitive to the changes in total return would be unwise because of the likelihood that it will encourage costly short-term management moves that in the longer term will work against the best interests of the trust and its beneficiaries.

Note also that the distribution in this trust declines modestly in 2005, and only turned upward again in 2006, despite the fact that the bear market ended in 2002, because the market value at the end of 2004 was still considerably lower than it was at the end of 2001. These are the consequences in an extremely volatile market of being 100% invested in equities with a high 5%

payout. The three-year smoothing rule even in this period changes a three-year decline of over 50% into a four-year decline of "only" 38%.

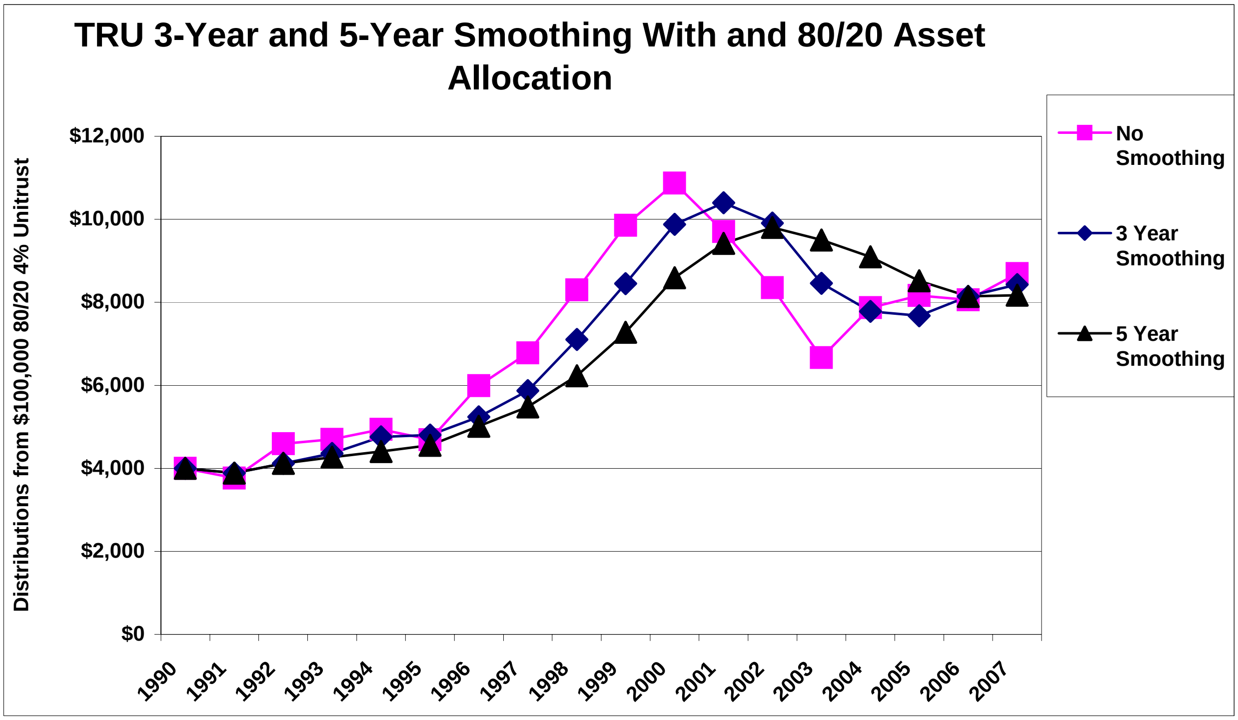
4. Let's Test Out a Five Year Smoothing Rule

To test out our alternatives more rigorously in this most difficult period in almost a century, we will model a 4% payout TRU with 100% equities for the period from 1990 to 2006 with no smoothing rule, a three-year rule and a five-year rule to see how they compare in this very difficult test track.



Quite a difference! With no smoothing rule, the distribution looks like the Swiss Alps, the three-year smoothing rule rounds off the mountain peaks, but not enough, while the five-year rule really makes a difference. The decline in the peak to trough with no smoothing rule and all equity is 48.6%, the three-year rule declines to 34.3% and the five-year rule is "only" 23.2%, a very considerable difference—almost acceptable under the circumstances. And one should note that despite the volatility of all of the income streams, all three trusts are distributing well above the level of income the income beneficiary enjoyed in 1997, and close to 40% more the beginning payout of 1990 after adjusting for inflation.

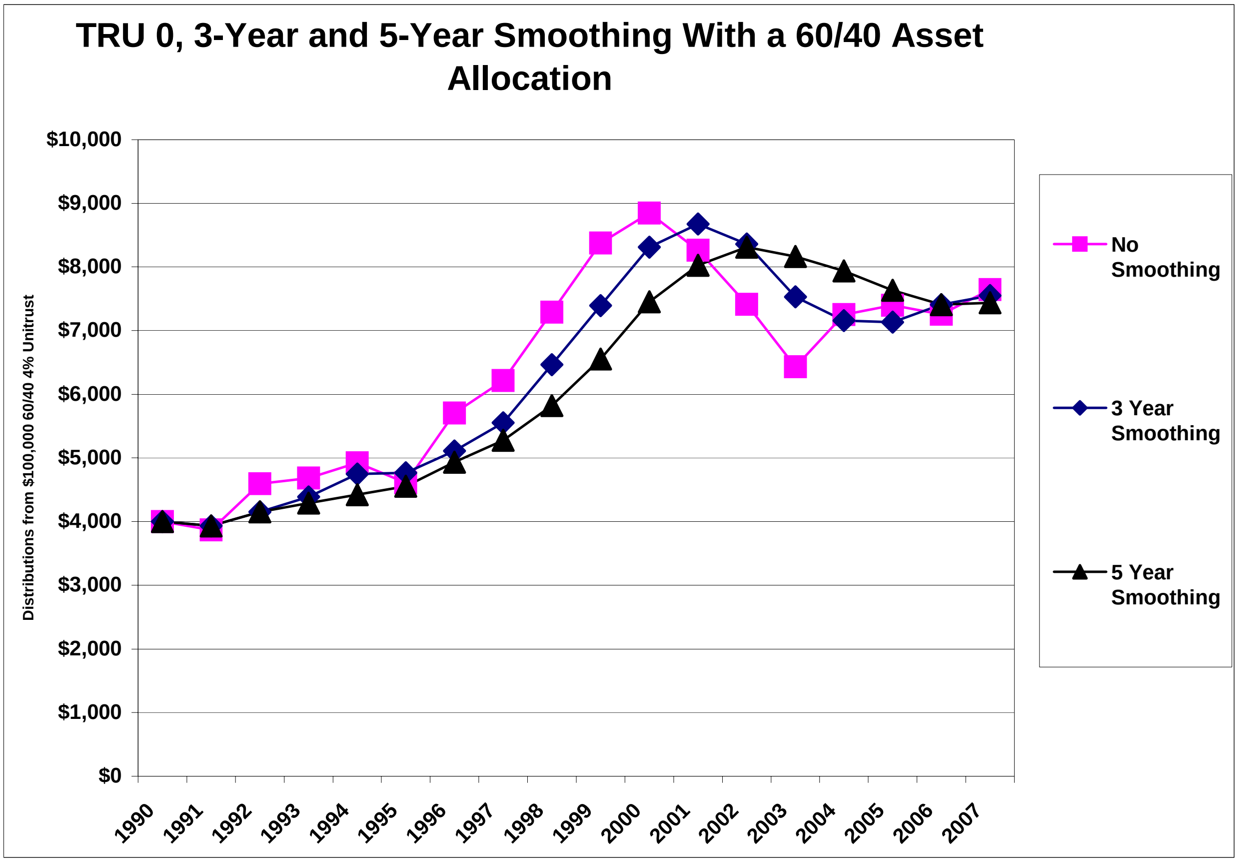
If one were to moderate the asset allocation, even to an 80/20 equity/fixed income mix, the ride smoothes out significantly. And this is perhaps a more common prudent but still growth-oriented portfolio, with at least some fixed income to temper the ups and downs of the equity markets.



With this asset allocation, the decline is reduced from 39% with no smoothing rule to 26% for the three-year rule and 17% for the five-year rule. Fairly reasonable, all in all, considering the volatility of the period, which was the worst since 1926-1933. In this extraordinary period, the five-year rule cut the volatility essentially in half, partly by not following the roller coaster quite so high, and then by not following it as far down either.

So there is a clear trade off with the longer smoothing rule. In exchange for the extra smooth ride, we may see a bear market affect the distributions a year or two longer than with the three-year rule.

And predictably, if we changed the allocation to 60/40, the result would be significantly smoother yet.



And with this more conservative asset allocation, the decline in the distribution goes from 27% with no smoothing rule to an 11% decline with the five-year smoothing rule. Quite a difference!

The foregoing results are achieved with only the two very simple asset classes represented by the S & P 500 and Intermediate Government Bonds. Clearly if international investing, investing across size and style classes, and other asset classes such as real estate and other largely non-correlated asset classes are added, the “ride” can be considerably smoothed out while preserving or even increasing return. The additional asset classes generally employed in stochastic modeling have not been incorporated into the author’s model for examining long term historical trends because the majority of the additional asset classes do not have the requisite data for long enough periods to allow the same level of reliable long term examination.

The other more technical disadvantage of a smoothing rule is the fact that it decreases or eliminates any dollar-averaging effect of a unitrust without the smoothing rule. A strict unitrust distributes less when the value of the trust assets is lower and more when the value of the trust assets is higher. Because generally the cash flow in the form of dividend and interest income from the portfolio does not typically go up and down with the market value, there may be a form of dollar averaging that occurs with a unitrust distribution as income may be reinvested in periods of higher interest rates and principal is consumed in periods of lower rates, which often correspond to periods of bear and bull markets. This is frequently, though not always the case, as is well illustrated by the bear market from 2000 to 2002 which had higher interest rates in 2000 and declining economic activity, followed by lower interest rates in 2001 and 2002, as the Federal Reserve lowered rates in order to stimulate economic activity.

With a smoothing rule, and particularly with a longer smoothing rule, as in a five-year smoothing rule, the change in the distribution will clearly be substantially damped in its reaction to the market value so that the trust will continue to distribute more in a down market and less in an up market for several years prior to any apparent reaction. This is unhelpful and will reduce total return to some degree because of its influence on the timing of buying and selling of investments in the portfolio necessary to pay the unitrust amount.

But does this potential decline in the dollar-averaging effect result in smaller ending market values after long periods such as 20 or 30 years? Intuitively one might think so, and indeed if a total return calculation were done taking into account the present values of all cash flows, some decrease in total return might well be measured, but as we shall see, it does not evidence itself in a loss of ending market values.

The chart of ending market values which follows for a 4% unitrust invested 80% in the S & P 500 Index and 20% in the Intermediate Government Index shows that in the overwhelming number of 20-year periods in history, the five-year smoothing rule produces the highest ending market value. Only in the Depression era did the “no smoothing” produce better results. In every 20-year period starting from 1931 on, the five-year smoothing rule produced the best results, always superior to the three-year smoothing rule! And the “worst case” period was better for the five-year rule than either the no smoothing or three-year smoothing. Surprisingly, the worst case for all three is the period 1962-1981, on an inflation-adjusted basis, substantially worse than the periods starting around the stock market crash of 1929 and the Great Depression.

Ending Market Values

Adjusted for Inflation

No Smoothing			**3-Year Smoothing**		**5-Year Smoothing**	
80/20 4% TRU			80/20 4% TRU		80/20 4% TRU	
20 Year Period Results			20 Year Period Results		20 Year Period Results	
AVERAGE	134,133		AVERAGE	137,931	AVERAGE	141,288
BEST	311,775		BEST	327,682	BEST	339,652
WORST	40,990		WORST	41,281	WORST	41,567
PRESERVED	60.00%		PRESERVED	61.67%	PRESERVED	61.67%
	* Best			* Best		* Best
5 Wins	Result		**No Wins**	Result	**57 Wins**	Result
20 Year Data			20 Year Data		20 Year Data	
1926-1945	135,912	*	1926-1945	133,059	1926-1945	130,133
1927-1946	96,261	*	1927-1946	94,784	1927-1946	92,720
1928-1947	69,532	*	1928-1947	68,057	1928-1947	66,235
1929-1948	51,953	*	1929-1948	50,378	1929-1948	49,076

1930-1949	64,700	*	1930-1949	63,426	1930-1949	62,841	
1931-1950	88,690		1931-1950	89,183	1931-1950	89,820	*
1932-1951	132,395		1932-1951	135,248	1932-1951	137,109	*
1933-1952	140,672		1933-1952	144,161	1933-1952	146,366	*
1934-1953	99,846		1934-1953	101,853	1934-1953	103,206	*
1935-1954	144,605		1935-1954	147,270	1935-1954	148,875	*
1936-1955	136,117		1936-1955	138,665	1936-1955	139,901	*
1937-1956	111,150		1937-1956	113,394	1937-1956	114,866	*
1938-1957	136,836		1938-1957	141,033	1938-1957	144,344	*
1939-1958	141,560		1939-1958	145,045	1939-1958	148,807	*
1940-1959	150,756		1940-1959	155,350	1940-1959	159,954	*
1941-1960	162,802		1941-1960	168,786	1941-1960	174,198	*
1942-1961	234,628		1942-1961	243,664	1942-1961	252,084	*
1943-1962	205,138		1943-1962	213,334	1943-1962	220,596	*
1944-1963	205,260		1944-1963	212,367	1944-1963	218,860	*
1945-1964	204,981		1945-1964	211,717	1945-1964	217,897	*
1946-1965	176,829		1946-1965	182,148	1946-1965	187,349	*
1947-1966	196,065		1947-1966	203,100	1947-1966	209,563	*
1948-1967	236,519		1948-1967	244,254	1948-1967	252,312	*
1949-1968	242,284		1949-1968	250,570	1949-1968	258,610	*
1950-1969	181,300		1950-1969	187,658	1950-1969	193,175	*
1951-1970	157,090		1951-1970	161,512	1951-1970	165,981	*
1952-1971	155,108		1952-1971	158,869	1952-1971	163,026	*
1953-1972	154,739		1953-1972	158,544	1953-1972	162,137	*
1954-1973	125,995		1954-1973	129,545	1954-1973	132,112	*
1955-1974	63,779		1955-1974	64,820	1955-1974	65,918	*
1956-1975	64,301		1956-1975	64,359	1956-1975	65,279	*
1957-1976	73,227		1957-1976	73,650	1957-1976	74,423	*
1958-1977	70,408		1958-1977	71,406	1958-1977	71,908	*
1959-1978	52,838		1959-1978	53,133	1959-1978	53,514	*
1960-1979	50,017		1960-1979	50,181	1960-1979	50,581	*
1961-1980	55,536		1961-1980	55,834	1961-1980	56,179	*
1962-1981	40,990		1962-1981	41,281	1962-1981	41,567	*
1963-1982	51,247		1963-1982	51,611	1963-1982	52,004	*
1964-1983	50,692		1964-1983	51,028	1964-1983	51,375	*
1965-1984	46,307		1965-1984	46,726	1965-1984	47,018	*
1966-1985	53,391		1966-1985	53,834	1966-1985	54,230	*
1967-1986	68,770		1967-1986	69,731	1967-1986	70,429	*
1968-1987	59,660		1968-1987	60,594	1968-1987	61,200	*
1969-1988	62,628		1969-1988	63,609	1969-1988	64,456	*
1970-1989	86,651		1970-1989	88,462	1970-1989	89,884	*
1971-1990	79,800		1971-1990	81,904	1971-1990	83,184	*
1972-1991	90,391		1972-1991	92,498	1972-1991	93,990	*
1973-1992	84,426		1973-1992	86,482	1973-1992	88,321	*
1974-1993	108,439		1974-1993	112,327	1974-1993	115,388	*
1975-1994	143,996		1975-1994	149,836	1975-1994	154,399	*
1976-1995	156,228		1976-1995	161,683	1976-1995	166,385	*
1977-1996	156,432		1977-1996	162,137	1977-1996	166,929	*
1978-1997	220,814		1978-1997	230,350	1978-1997	237,673	*
1979-1998	279,081		1979-1998	292,429	1979-1998	302,365	*

1980-1999	311,775	1980-1999	327,682	1980-1999	339,652	*
1981-2000	256,286	1981-2000	269,720	1981-2000	280,574	*
1982-2001	253,665	1982-2001	266,554	1982-2001	278,439	*
1983-2002	179,424	1983-2002	186,507	1983-2002	194,663	*
1984-2003	192,302	1984-2003	197,736	1984-2003	205,121	*
1985-2004	197,088	1985-2004	202,808	1985-2004	208,887	*
1986-2005	161,381	1986-2005	165,658	1986-2005	169,743	*
1987-2006	154,405	1987-2006	158,038	1987-2006	161,849	*

If the same trust portfolio is modeled over all of the 30-year periods, one finds that the results here are remarkably consistent, with the five-year smoothing rule producing the best results, based upon the percentage of periods in which real value is preserved, average ending inflation adjusted value and worst case 30-year period. Interestingly again the worst 30-year period for maintaining real value was 1955-1984. Not many would have guessed that one!

ENDING MARKET VALUES ADJUSTED FOR INFLATION

No Smoothing			**3-Year Smoothing**			**5-Year Smoothing**		
80/20 4% TRU			80/20 4% TRU			80/20 4% TRU		
30 Year Period Results			30 Year Period Results			30 Year Period Results		
AVERAGE	124,955		AVERAGE	129,232		AVERAGE	133,251	
BEST	242,220		BEST	252,643		BEST	262,004	
WORST	64,969		WORST	66,564		WORST	67,889	
PRESERVED	61.54%		PRESERVED	61.54%		PRESERVED	63.46%	
1 Win	* Best		**3 Wins**	* Best		**48 Wins**	* Best	
30 Year Data	Result		30 Year Data	Result		30 Year Data	Result	
1926-1955	193,625		1926-1955	193,720	*	1926-1955	193,621	
1927-1956	175,669		1927-1956	177,119	*	1927-1956	176,752	
1928-1957	120,345		1928-1957	120,814	*	1928-1957	120,196	
1929-1958	119,537	*	1929-1958	118,891		1929-1958	118,396	
1930-1959	134,998		1930-1959	135,949		1930-1959	137,729	*
1931-1960	150,997		1931-1960	155,947		1931-1960	160,647	*
1932-1961	242,220		1932-1961	252,643		1932-1961	262,004	*
1933-1962	209,514		1933-1962	219,429		1933-1962	227,958	*
1934-1963	176,774		1934-1963	183,657		1934-1963	189,884	*
1935-1964	200,948		1935-1964	209,042		1935-1964	215,689	*
1936-1965	163,955		1936-1965	170,207		1936-1965	175,202	*
1937-1966	117,905		1937-1966	121,994		1937-1966	125,981	*
1938-1967	188,122		1938-1967	195,684		1938-1967	203,361	*
1939-1968	154,172		1939-1968	160,260		1939-1968	166,554	*
1940-1969	132,381		1940-1969	138,167		1940-1969	143,960	*
1941-1970	143,397		1941-1970	149,497		1941-1970	156,132	*
1942-1971	187,026		1942-1971	195,214		1942-1971	203,909	*
1943-1972	200,178		1943-1972	208,888		1943-1972	217,245	*
1944-1973	139,769		1944-1973	145,911		1944-1973	151,244	*
1945-1974	87,078		1945-1974	90,141		1945-1974	93,378	*
1946-1975	86,619		1946-1975	88,258		1946-1975	91,224	*
1947-1976	125,457		1947-1976	128,858		1947-1976	132,888	*

1948-1977	114,442	1948-1977	118,315	1948-1977	121,677	*
1949-1978	108,512	1949-1978	111,815	1949-1978	115,196	*
1950-1979	95,295	1950-1979	97,897	1950-1979	100,804	*
1951-1980	92,407	1951-1980	94,870	1951-1980	97,355	*
1952-1981	73,798	1952-1981	75,958	1952-1981	77,904	*
1953-1982	76,178	1953-1982	78,109	1953-1982	80,100	*
1954-1983	87,548	1954-1983	89,910	1954-1983	92,058	*
1955-1984	64,969	1955-1984	66,564	1955-1984	67,889	*
1956-1985	65,958	1956-1985	67,169	1956-1985	68,491	*
1957-1986	74,926	1957-1986	76,673	1957-1986	78,334	*
1958-1987	81,944	1958-1987	84,400	1958-1987	86,302	*
1959-1988	69,735	1959-1988	71,485	1959-1988	73,082	*
1960-1989	79,278	1960-1989	81,272	1960-1989	83,114	*
1961-1990	72,547	1961-1990	74,782	1961-1990	76,534	*
1962-1991	74,662	1962-1991	76,701	1962-1991	78,620	*
1963-1992	83,075	1963-1992	85,844	1963-1992	88,149	*
1964-1993	76,599	1964-1993	79,132	1964-1993	81,220	*
1965-1994	65,996	1965-1994	68,166	1965-1994	70,052	*
1966-1995	79,908	1966-1995	82,405	1966-1995	84,766	*
1967-1996	101,613	1967-1996	105,449	1967-1996	108,643	*
1968-1997	111,226	1968-1997	115,581	1968-1997	119,047	*
1969-1998	130,568	1969-1998	136,259	1969-1998	140,921	*
1970-1999	166,287	1970-1999	175,128	1970-1999	182,150	*
1971-2000	149,905	1971-2000	158,509	1971-2000	165,409	*
1972-2001	122,528	1972-2001	128,851	1972-2001	134,937	*
1973-2002	90,200	1973-2002	93,858	1973-2002	98,601	*
1974-2003	132,173	1974-2003	137,587	1974-2003	144,495	*
1975-2004	191,190	1975-2004	200,080	1975-2004	209,164	*
1976-2005	159,373	1976-2005	166,512	1976-2005	173,139	*
1977-2006	153,974	1977-2006	160,339	1977-2006	166,779	*

Why is this so? It would seem that a rule that would keep a higher payout going into a bear market would cause a decline in ending market values because high payouts in low markets are very damaging. And that is certainly the case, but it is also true that when the value of the trust portfolio is rising, the longer the smoothing period, the more the increase in the distribution will be retarded, and this will build market value in the trust because of the reinvestment return on that growth in value. *And that is the secret: a longer smoothing rule will increase the ending market values on average as long as there are more years in which the portfolio is growing than years in which it is shrinking.* Hence, if the payout plus expenses and taxes is on average more than the total return, then a shorter smoothing rule will better protect the remainder beneficiaries. If the trust payout is significantly smaller than the total return from the trust portfolio on average, as it should be if the trustee expects any prospect of preserving real value against the ravages of inflation, a longer smoothing rule will protect the remainder beneficiaries more frequently.

This conclusion was reached only after reexamining the issue of smoothing rules in light of the extraordinary period from 1995 through 2006. And during this period, there would have been a total return "cost" to the longer smoothing rule. If one models an 80/20 trust portfolio with a 4% TRU payout from 1990 through 2006 and then present values the after-tax income streams to determine total net after-tax return, the portfolios stack up as follows:

Smoothing Rule	Net Total After Tax Return 1990-2006
None	7.64%
Three-Year	7.59%
Five-Year	7.57%

So there is a "cost" to the longer smoothing rule period, but it is only two basis points as compared to the three-year rule and seven basis points as compared with no smoothing rule at all—clearly not enough to offset the advantages of the much smoother distribution payout. And this is the "cost" of the longer smoothing rule in a period of extraordinary volatility. A more ordinary period might well decrease or perhaps eliminate the net "cost" of smoothing the income stream substantially.

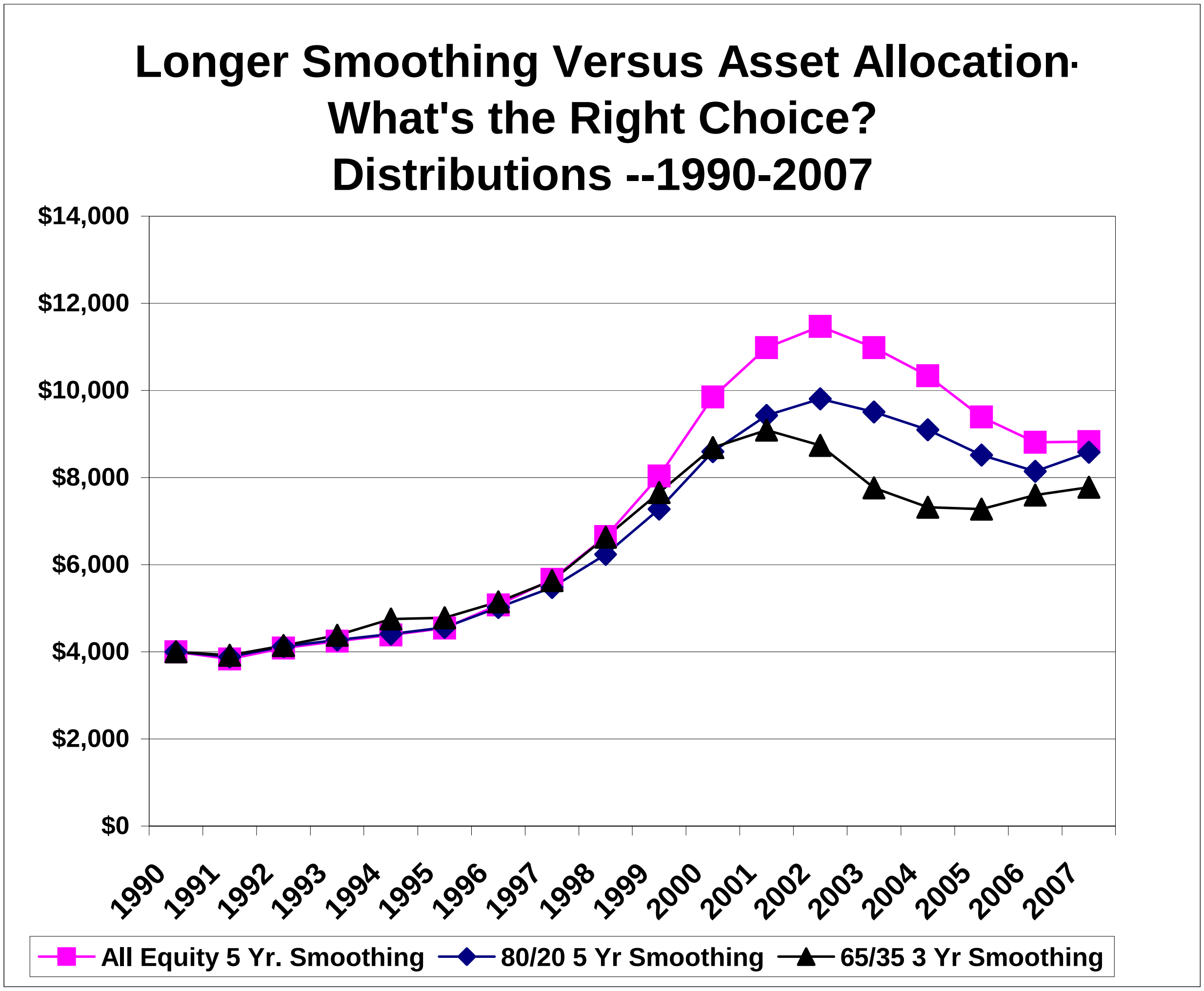
Bill Hoisington suggested almost 10 years ago that a five-year smoothing rule was better than the three-year rule, and in light of the subsequent volatility in the meantime and the further studies detailed above, he was probably correct in reaching that conclusion. The primary downside to a five-year rule is not the loss of total return, which is clearly miniscule, but simply the fact that the five-year rule "unlinks" the interests of the current beneficiary and the remainder beneficiary to some degree, certainly much more than the three-year rule. As noted previously, the five-year smoothing rule causes a modest 4% decrease in the distribution for 2007 for a 4% TRU with an 80/20 portfolio, despite four years having passed since the low point of the bear market in 2002. Nevertheless, the additional smoothness is probably worth the unlinking in very volatile markets. Further, the volatility of the TRU distribution is the most critical disadvantage of the TRU overall, so the issue is well worth addressing. That volatility is the primary impetus behind the Bernstein Collar, which is discussed in the next section of this article.

A cautionary note should be added at this juncture. A drafter needs to consider whether his or her state statute would define a unitrust with a five-year smoothing rule as "income" for purposes of the marital deduction. In many of the statutes, a three-year rule is specifically mentioned, which is why in the "tax fix-up" portion of this article I suggest a distribution based upon "one or more" years, as allowed by the Final Regulations and as has been incorporated into the Delaware statute and others.

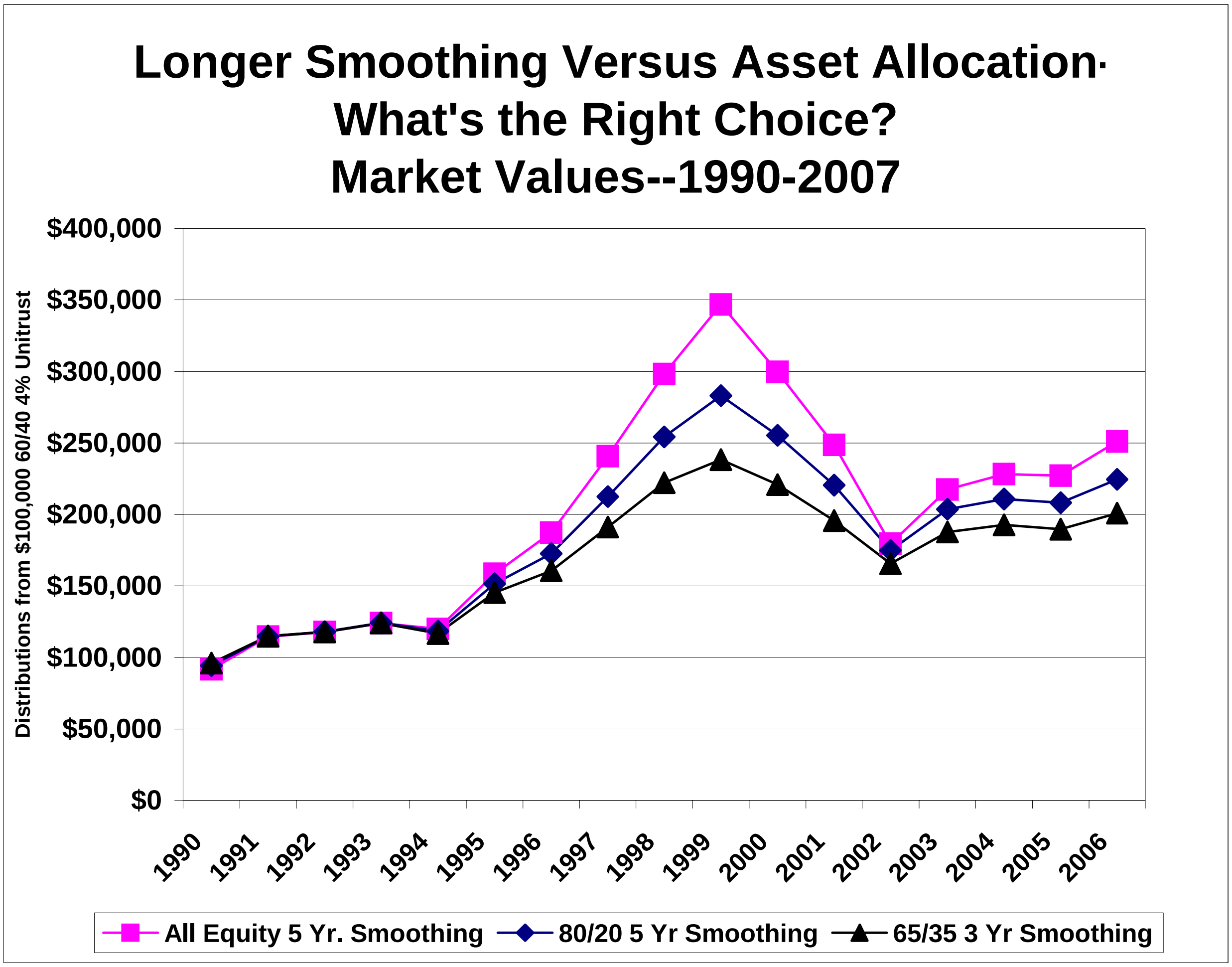
5. Strong Versus Smooth – Asset Allocation Versus Smoothing

Asset allocation is often critically determined by the tolerance of a trust and its beneficiaries to withstand the ups and downs of the capital markets. If the duration of the trust is relatively short, and if at the end of that period the investment portfolio will be sold and the proceeds distributed in cash, then the investment time horizon is short and the need to control the market value volatility is very real. As an example, a charitable remainder unitrust whose life tenant is 90 years of age would have a real concern that an aggressive portfolio might have to be liquidated in order to distribute the proceeds to the charitable remainder beneficiaries. In such a situation, the fluctuation of the market value could have more than a psychological effect on the trust beneficiaries. Similarly, if there is significant possibility that the trust portfolio may require heavy principal distributions to satisfy the needs of a beneficiary, the volatility of the market value of the trust in the short run could also make a real difference. Both of these situations would require the trustee to consider carefully choosing an asset allocation and an investment portfolio that would temper the volatility of the trust market value.

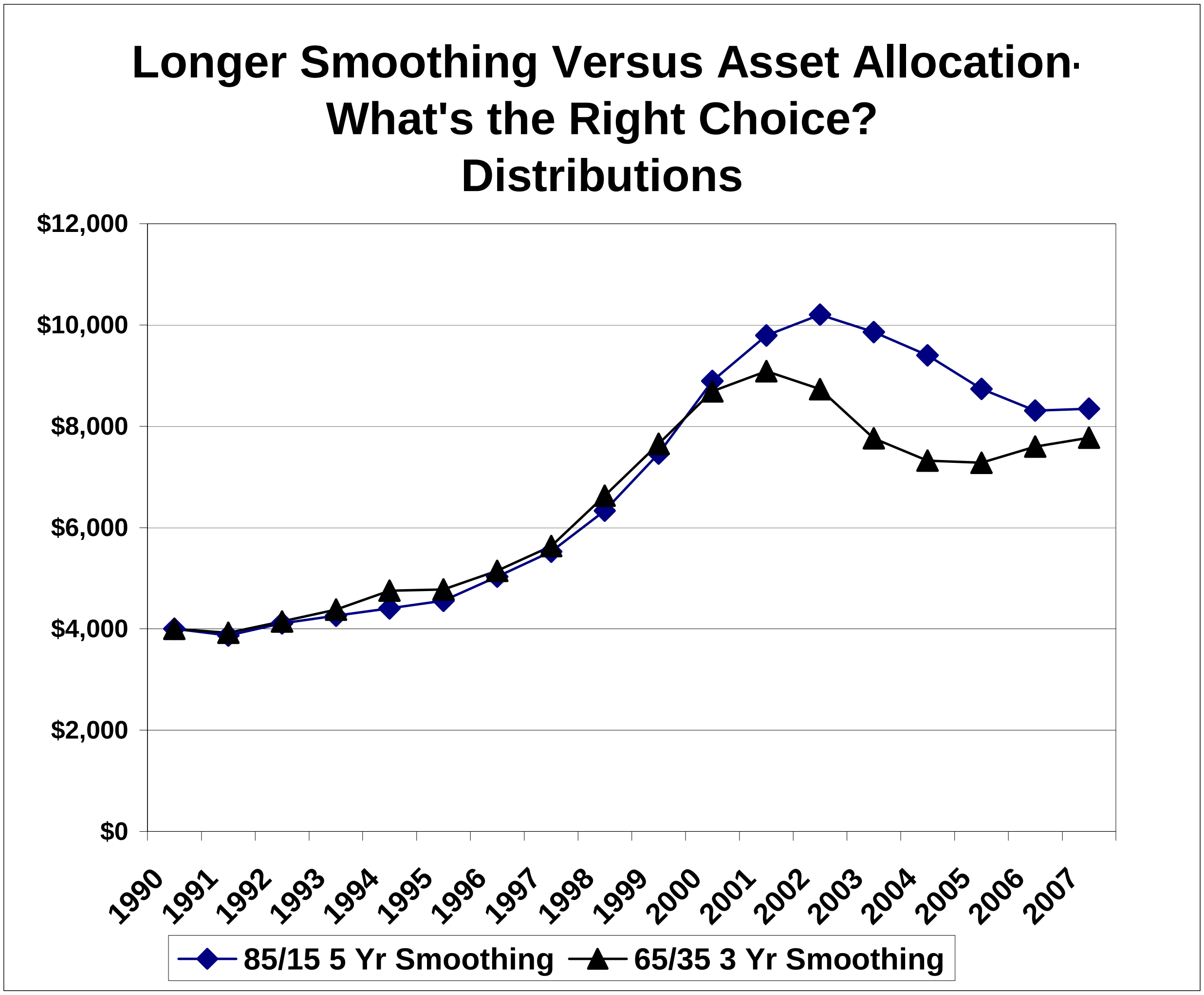
For trusts that are long term, however, where the normal "income" distribution and the long term results are the primary drivers, the volatility that matters the most may be the volatility of the distributions from the trust, rather than the volatility of the trust portfolio itself. As a result, one should consider carefully in these instances whether a better smoothing rule will likely give us a much better result all around than a more conservative asset allocation. In this connection, let us look at our hyper-volatile period from 1990 through 2007 again on the assumption that the trustee, wishing to avoid the volatility, chooses a 65/35 asset allocation but stays with a 3-year smoothing rule versus a more aggressive 80/20 or even all equity growth portfolio with a 5-year rule.



The surprising thing about this graph is that the 5 year smoothing rule makes more difference than putting in another 15% bonds in the portfolio!. The peak to trough decline in the 80/20 portfolio with the five-year rule was 16.99%, while the peak to trough decline in the 65/35 portfolio with the three-year rule is 19.9%. So the five year rule allows the more aggressive portfolio to generate a smoother ride for the beneficiary. The all equity portfolio, even with the five-year averaging, generates a peak to trough decline of 23.1%, and that is not so surprising. Let's take a look at the market values to compare the volatility of the underlying portfolios to the distributions.

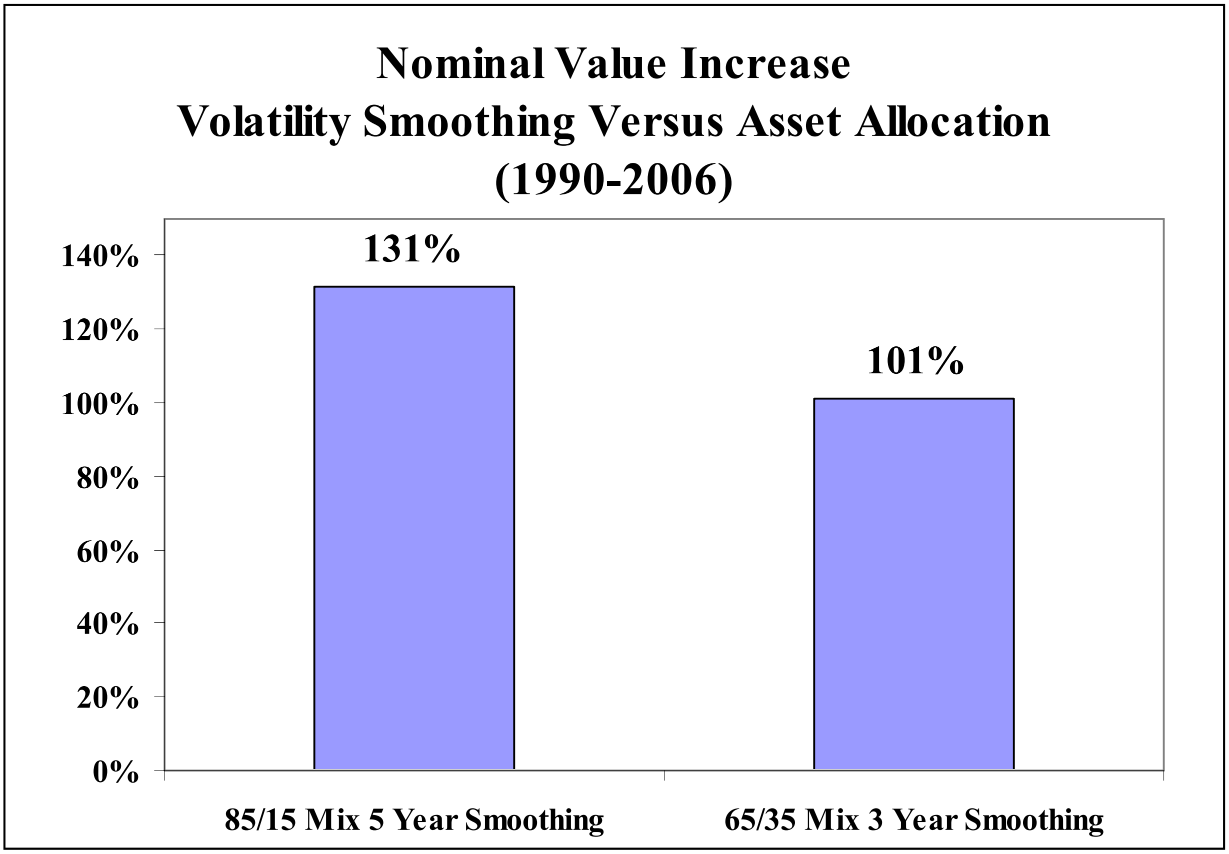


Clearly the portfolio volatility is there, but the smoothing rule does its work to protect the trust beneficiary from feeling the full effects of the roller coaster. Let's try to equalize the distribution volatility by varying the asset allocation and see how much we can add to our equity portfolio and still stay under the volatility of a conservative 65/35 asset allocation.

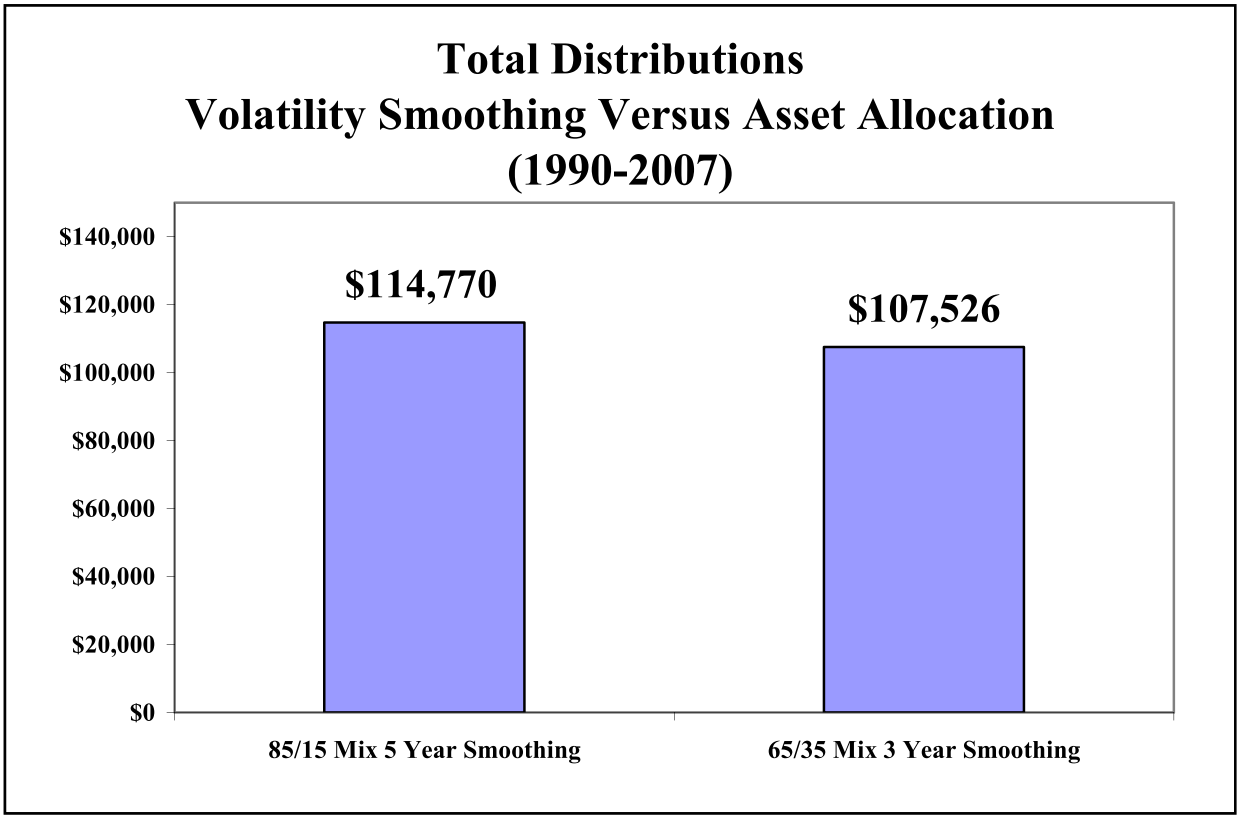


It appears that the extra two years of smoothing is just about a trade off for a 20% higher equity asset allocation as the above graph suggests. The peak to trough decline on the 85/15 portfolio with the five-year smoothing rule is 18.6%, 1.3% less than the 65/35 portfolio with the three year rule, leading us to the conclusion that a 20% differential looks about right. Of course the volatility of the 85/15 portfolio is occurring at a much higher level than the more conservative portfolio.

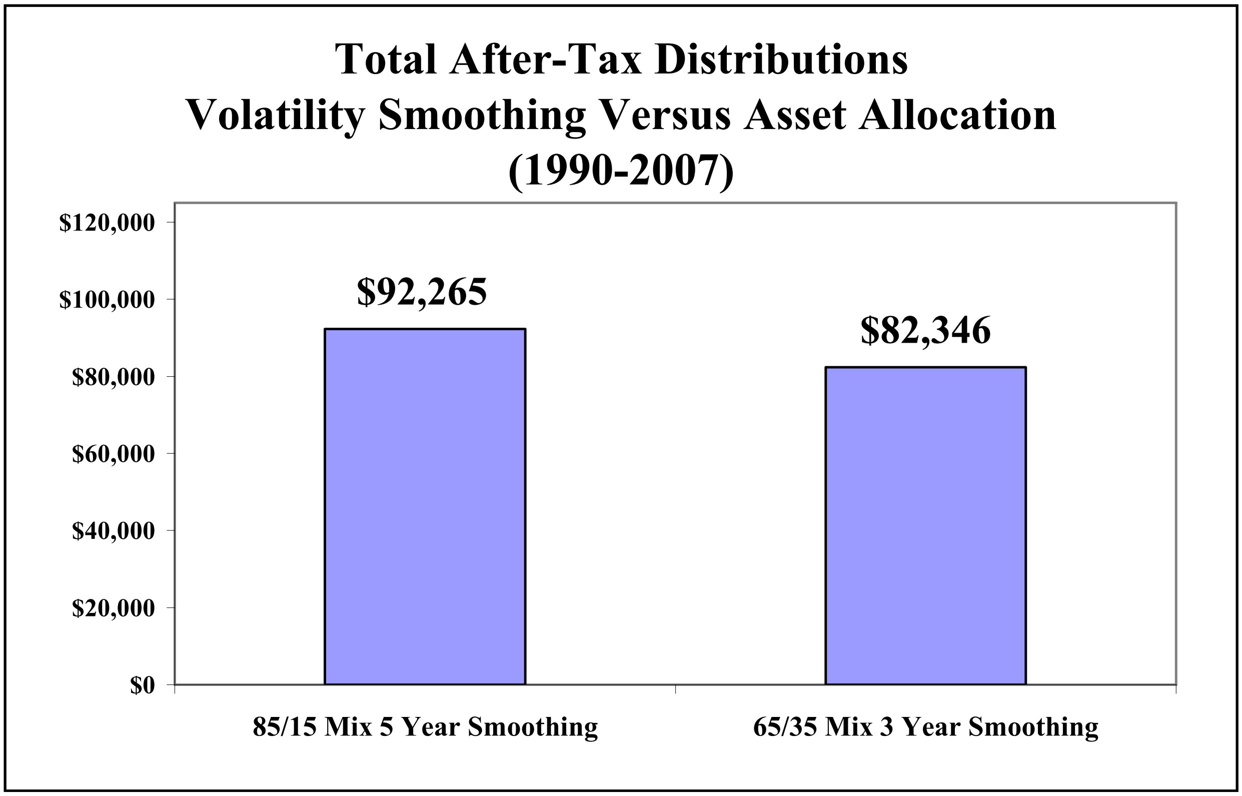
The difference in the growth in value of the two portfolios is real enough, as the following graph illustrates.



At the end of the day, the remaindermen are much better off with the higher equity portfolio, and the income beneficiary gets about the same ride because of the longer smoothing rule, but what about the total of the income beneficiary's distributions?



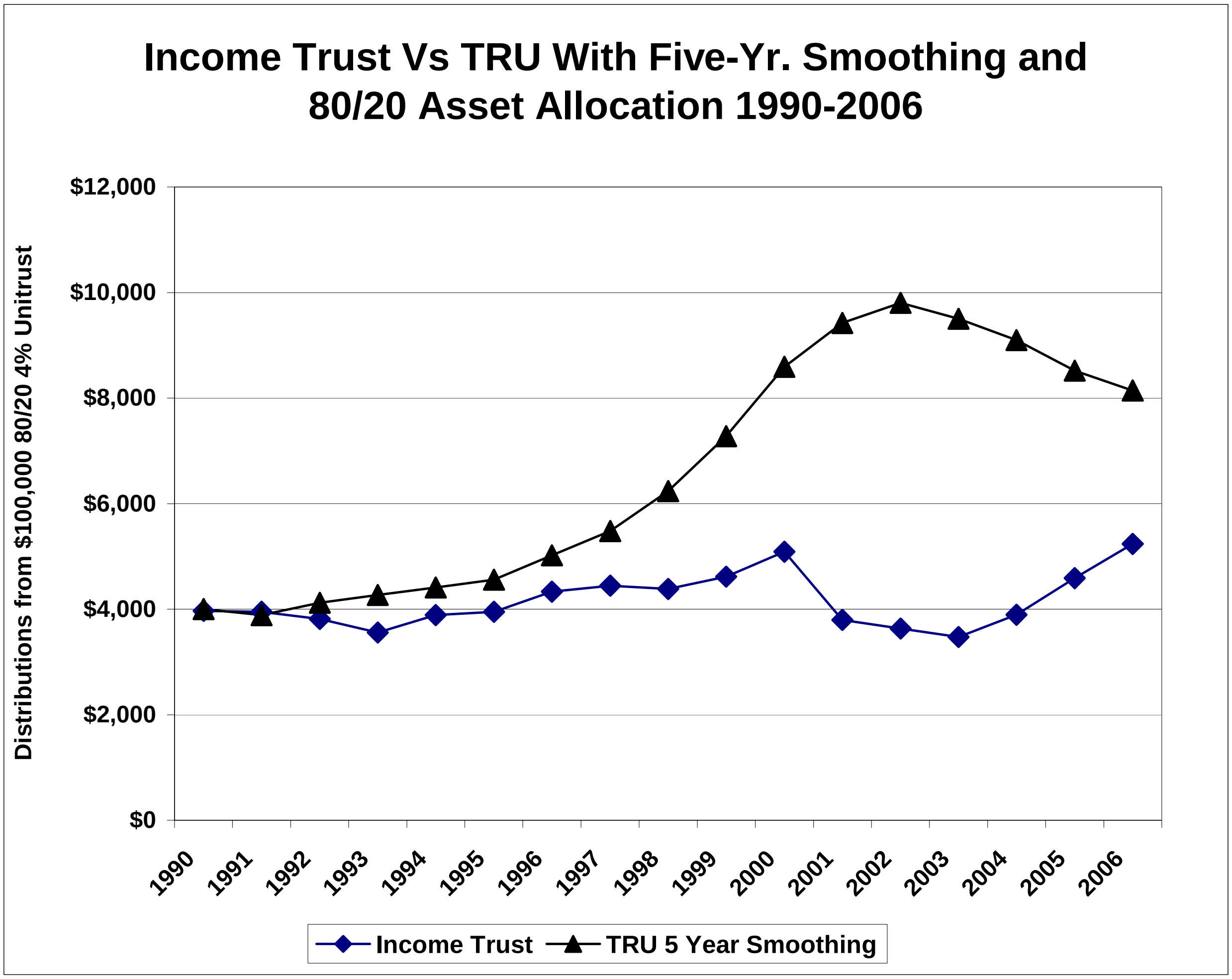
So the 85/15 mix with the five year smoothing wins for ending market value, for smoothness of distributions and for total distributions. How about after-tax?



And as we might suspect, the after tax difference is greater than the before tax difference, with 12% more total distributions after tax than the more conservative asset allocation using the currently low rate of taxation on long term capital gains and qualifying dividends. The difference will likely increase over time as well, as the differences in the total return from the two portfolios compound over time in most markets.

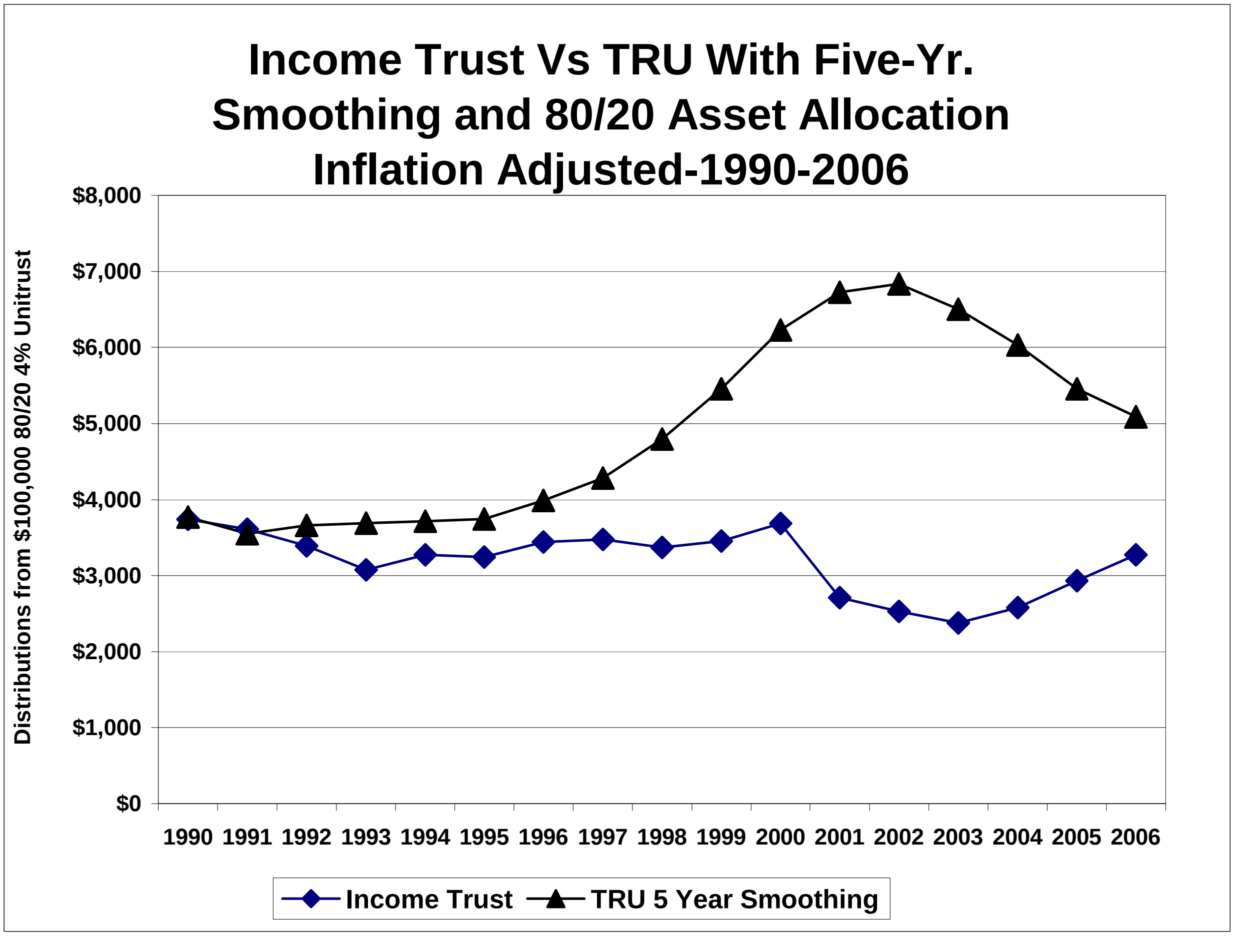
6. The Way Forward is not Backwards

Just in case you are discouraged by the volatility of the unitrust distribution during these volatile times and are tempted to move backward to the income trust, rather than forward into new forms of trust design, let us look back on the distributions from a traditional income trust with an 80/20 asset allocation to see what the distributions from the traditional trust would have looked like during the same period.



Clearly the income trust avoids the upward volatility of the TRU during the bull market of the 1990s, but a careful inspection of the distributions show that the downside of the income trust from 2000 to 2003 was a peak to trough decline of 32%, while the TRU decline through 2006 was only 17%. Volatility is not easily avoided, and it cannot be avoided by traveling backward in time to find shelter in traditional "income."

And the volatility of the income trust during this period was not the worst of its sins against the income beneficiary. Let's take a look at the same graph adjusted for inflation.



The income trust during that period delivered an 18% decline in spending power to the income beneficiary while the TRU with the five-year smoothing even after its decline delivered an over 27% increase in spending power during the same period with the same asset allocation. The reason for this is simple enough. The yield payout on the income trust was 2.1% in 2006 versus 3.82% for the TRU as a function of the year-end 2005 values of the trusts. Because of this income diet over 15 years, the income trust would have an ending value of about 18% more than the TRU assuming the asset allocation was maintained over that period. The more likely result, however, is that the income beneficiary's complaints to the trustee would have caused a change in the asset allocation to one more income-oriented, which in the end would have caused even greater downside volatility during the declining interest rate period of the early 2000s. The greatest likelihood is a lose-lose situation for the income beneficiary and the remainder beneficiary due to a very substantial loss of total return during the great bull market of 1995-1999.

Rest in peace, income trust!

C. SOME NEW THOUGHTS ON DESIGN AND DISTRIBUTION POLICY— THE BERNSTEIN COLLAR

1. The Theory and General Comments. Until quite recently, estate planners, investment advisors and trustees did not give a sufficient amount of thought and technical expertise to the matter of trust design, distribution policy and the matching of objectives and goals of a trust with its investment and distribution policy. This trend has reversed itself with more and more consideration being given to choosing the best method for determining distributions from a trust for a given set of goals, conditions and people, and an appropriate payout rate for those methods.

One of the most interesting new ideas on distribution methodology is the result of the work of Paul S. Lee of Bernstein & Company Investment Research and Management, who acknowledges the benefits of a unitrust methodology but notes its limitations, particularly in the situation in which the current income beneficiary is very dependent upon a reliable income stream and cannot afford substantial risk to that income stream.[166]

The present value of a unitrust distribution varies only with the time period and the payout rate, where the assumed rate of return and the discount rate used in the calculation are the same. In other words the present values of the interests of the current and remainder beneficiary are agnostic to the rate of return, which is unlike any other method of distribution, which are generally quite sensitive to the rate of return.[167] But while a unitrust methodology produces highly predictable and consistent fairness as measured by the present value of the income and remainder interests, in reality the "path of return" matters a great deal to the beneficiaries.[168] Return periods with the same total return which boast the highest return at the beginning of the period increase the real wealth enjoyed by the unitrust beneficiary, while having the highest return at the end of the study period benefits the remainder beneficiary. If the bull market occurs at the end of the period and the bear market at the beginning, the current unitrust beneficiary does not do well because she only participates for a short time in the higher distributions, whereas if the bull market is at the beginning, the present value of the actual unitrust distributions will be larger because those larger distributions are at the beginning. A 4% unitrust will only reflect 4% of the market value for each year in which the value is up. The remainder beneficiary will benefit based upon the remaining value all at once, depending upon when the trust terminates, whereas the unitrust value is one received *over time.*

Clearly where an inflation adjusted annuity is paid out to the beneficiary, the distribution methodology has allocated all of the risk of volatility in the portfolio to the remainder beneficiary, unless of course the trust is completely depleted, in which case the annuity recipient shares in the risk, though not equally, by any means. In most circumstances an annuity payout shifts the risk entirely to the remainder beneficiary.[169]

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[166] Paul S. Lee, *Implementing Total Return Trusts*, American College of Trust and Estates Counsel, 2004 Fall Meeting Materials, at 30-37- PSL (2004).
[167] The reason for this is that a unitrust adjusts to excess returns by increasing the unitrust distribution, or decreasing it if the rate falls.
[168] Paul S. Lee, *supra* n. 166 at 21.
[169] *Id.* at 29.

An inflation-indexed annuity payout will work well enough if the initial payout is a small enough percentage, such as 3% or less, but if it is 4% or 5%, there is a very considerable risk of depletion of the trust. As demonstrated in my previously-published articles, a 5% inflation adjusted payout starting in 1973 would not last to the present time regardless of asset allocation, as least as between large capitalization U.S. stocks and intermediate government bonds, but would instead be depleted by 1992.[170] And this period is not unique. Using my trust computer modeling program, 37% of all of the rolling 30-year periods in history would have completely depleted a 5% indexed annuity trust with an 80/20 portfolio, the most recent of which was 1973-2002. And with a 60/40 portfolio, the result is even worse, with depletion in 46% of the periods. Clearly, that is an unacceptable result.

At a 4% payout level, 8% of the 30-year periods would have completely depleted the trust with a 60/40 mix or a 80/20 mix and 12% of the periods with a 100% equity portfolio. This is still likely to be too high a failure rate for the trust, especially considering the fact that many believe that future returns may be lower than the past. So the use of a strict index payout trust produces too many instances of complete depletion of the trust and too much risk to the remainder beneficiary whether modeled on an historic or a stochastic or probabilistic basis.[171]

Where a unitrust distribution method is chosen, there is relatively good predictability of the ability to maintain the remainder value against inflation over relatively long time periods. [172] But at the same time there is a considerable risk to the current unitrust beneficiary that the distribution may go down and stay down, even go down a lot, and stay down a long time. And the peak to trough volatility is considerable, if adjusted for inflation, with almost a 40% chance of experiencing a 40% decline with a 100% equity portfolio, according to Lee's modeling.[173] Note that the risk in the markets is always quite considerable, and the ability to preserve value over time with any degree of certainty is a daunting task, as noted very early on in this article, so the fact there might be a 40% decline adjusted for inflation over a 30-year period is not as shocking as it might seem. Indeed an income beneficiary of a 60/40 "income" only trust starting in 1977 would have begun that period with an income distribution of $4,832 on a $100,000 trust, and would have enjoyed an inflation-adjusted income distribution of $2,648 in 2005, a decline of 45% from beginning to end. The impoverishment of the income beneficiary in that case would have generally been quite gradual, the result of the erosive effect of inflation and the long term decline in interest rates, but the cumulative effect is dramatic. The decline in "income" for a 50/50 income trust from 2000 to 2006 is 26% on an inflation-adjusted basis, so the real disfunctionality of the former "income" regime should be kept in mind when judging all of our new solutions to the problem. With more attention and sophistication being given to the distribution and investment process, we have raised the bar a great deal, and appropriately so, but there is no going back.

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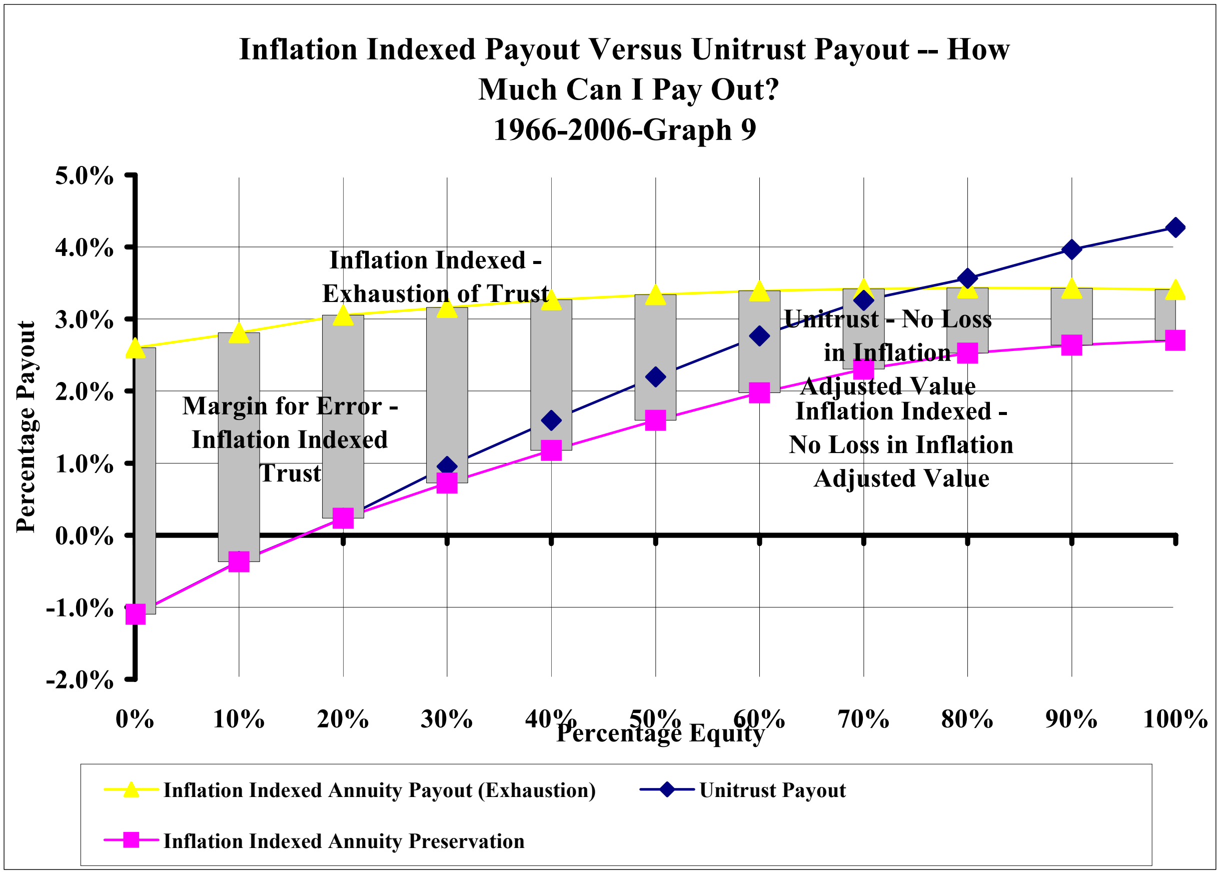
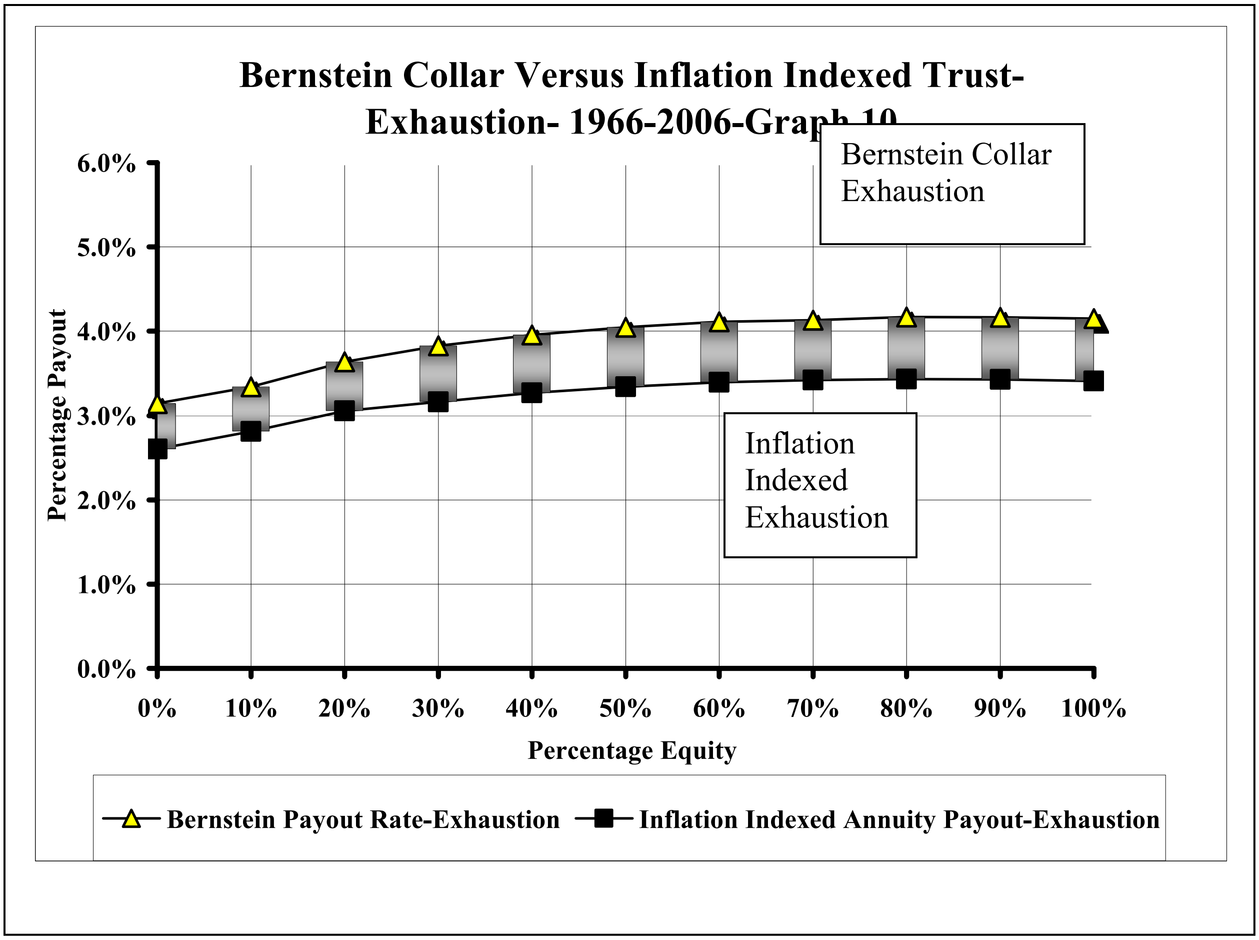
[170] *See* Robert B. Wolf, *Estate Planning with Total Return Trusts, 36* REAL PROP. PROB. & TR. J. 169, 216-217 (2001); Robert B. Wolf, *Total Return Trusts—Meeting Human Needs and Investment Goals Through Modern Trust Design,* Fall Meeting of the American College of Trust and Estates Counsel, SI-216-219 RBW (2004).
[171] Paul S. Lee, *supra* n. 166, at 24-29.
[172] *Id.* at 33.
[173] *Id.* at 34.

Lee posits that by putting an inflation indexed “collar” on the unitrust distribution variations, we can improve the lot of the current beneficiary without exposing the remainder beneficiary to excessive risk of depletion. He uses two models for this purpose. The first is a unitrust, but has a “floor” of 70% of the *inflation adjusted* starting distribution, and a “ceiling” of 120% of the *inflation adjusted* starting distribution. The second model has an 80% floor and a 130% ceiling. From my point of view, the higher limits would be the most helpful, since the collar is likely to be used whenever there is substantial sensitivity or dependence on the income stream, in which case a 30% decline in real value of the distribution is likely to be unacceptable, at least in my opinion, despite the fact that many trust beneficiaries have experienced worse than that as illustrated in the prior paragraph. As a result, the 130/80 model is the one we will examine closely. ("Bernstein Collar")

The Bernstein Collar is a hybrid—part unitrust and part inflation-indexed trust. It becomes an inflation-indexed trust whenever the unitrust distribution amount would go above the ceiling or below the floor that is set. What this does is to guard against variations in return and the path of the return. So if a strong bear market is what is first encountered, it will pay out based upon the floor indexed annuity. If a strong bull market is what is first encountered, it will pay out based upon the ceiling indexed annuity. Even though there appears to be a 50% “window” or “wall” between the ceiling and the floor, the variability of return is such that in most markets the Bernstein Collar will become an indexed-payout trust on the high end or the low end. The first major market to be encountered will likely determine which indexed payout it will be. In other words, as Lee correctly and importantly emphasizes, the path of return matters a great deal.

2. The Risk of Exhaustion. Because the trust is likely to become an indexed-payout trust, we should seriously consider the chances of exhausting the entire market value of the trust. How does it stack up against the inflation-indexed payout? In fact, the relationship between the two is fairly clear, inasmuch as a 5% Bernstein Collar has a floor that is a 4% inflation-indexed trust. And a 5% Bernstein Collar is likely too high a payout to satisfy the exhaustion risk acceptable in most situations. An 80/20 portfolio with a 5% Bernstein Collar payout would have exhausted the trust in 10% of the 30-year periods in history using my historical modeling program—too high for most if not all long-term trust situations. A 4% payout, on the other hand, generates no instances of exhaustion in any thirty-year period in history, a good sign, to be sure. If we were to test the methodology over the period from 1966 through 2006, that would be a good and difficult test period, and the following graphs show how much one could have paid out on this basis and have preserved the real inflation adjusted value and how much to have avoided exhaustion of the trust, as compared to a unitrust and as compared to an inflation-adjusted annuity trust. We have incorporated a five-year smoothing period into the Bernstein Collar analysis as we have in the unitrust, since we have concluded that it is, on balance, better.


Inflation Indexed Payout Versus Unitrust Payout -- How Much Can I Pay Out?
1966-2006-Graph 9
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%
-2.0%
Percentage Payout
0%
10%
20%
30%
40%
50%
60%
70%
80%
90%
100%
Percentage Equity
Inflation Indexed - Exhaustion of Trust
Margin for Error - Inflation Indexed Trust
Unitrust - No Loss in Inflation Adjusted Value
Inflation Indexed - No Loss in Inflation Adjusted Value
Inflation Indexed Annuity Payout (Exhaustion)
Unitrust Payout
Inflation Indexed Annuity Preservation

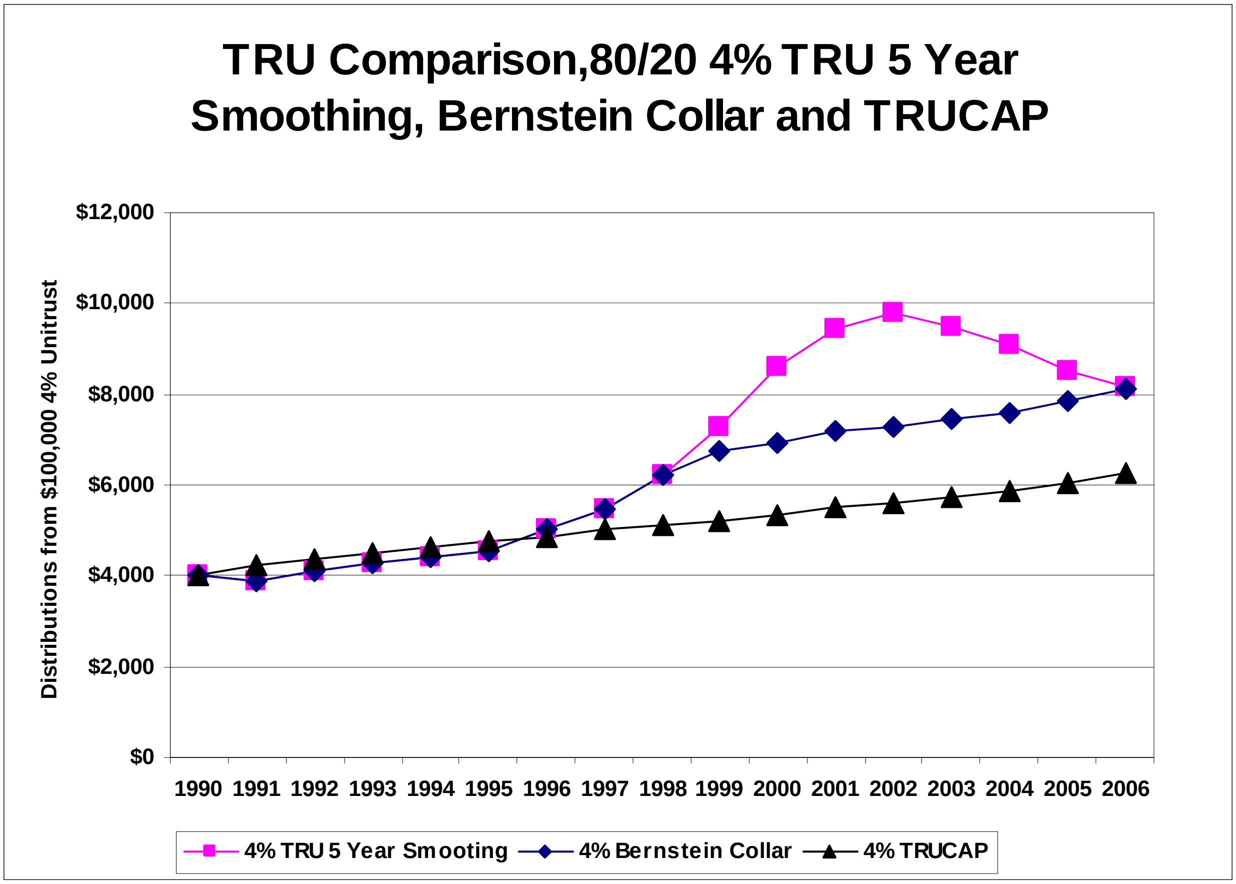


What can one glean from Graphs 9 and 10? First, insofar as the goal is to preserve real inflation-adjusted value for the trust, the Bernstein Collar is not all that different from the unitrust where the percentage of equities is low, but the gap widens as the percentage increases. This is sensible in that the unitrust will be more protective of a volatile portfolio than the Bernstein Collar, which will not allow the distribution to go down too much in a bear market, particularly one accompanied by high inflation, illustrated in the first 15 years in the period examined in the above graph from 1966 to 1980. At 100% equities, the unitrust with a five-year smoothing rule can pay out 1.04% more than the Bernstein Collar and still preserve the real value of the trust for the remainderman.

On the exhaustion side, the Bernstein Collar is very similar to a lower rate inflation-indexed trust. And this is not surprising, since it has a "floor" at 80% of the initial payout indexed for inflation. And the difference for most of the likely portfolios is very close to 20% of the difference—about 75-77 basis points, taking into account the fact that the Bernstein Collar does not instantly turn into an inflation-indexed distribution at 80% of the initial payout, but it does so within the first five years of the trust, in this case in 1971. One can conclude that for the Bernstein Collar to work sensibly and safely for a longer term trust, it must have a payout of 4% or less, and that may be safe only if the future real returns are not too much less than past returns.

3. What About the "Ride"? But the main point of the Bernstein Collar is to dampen the bumpy ride that the income beneficiary may get with a unitrust. How does it do on that score, and how might it compare to a unitrust with a five-year smoothing rule and to a

TRUCAP unitrust suggested as an alternative by me in my previous publications.[174] A TRUCAP unitrust is an inflation-indexed payout with a "cap" at a percentage of the net market value of the trust. Generally the "cap" should be no more than 10% and the point of that is to avoid complete exhaustion of the trust in difficult markets. Let us compare these three alternative trust designs in a couple of different periods, starting with 1990 to 2006.



The lowest and smoothest of the lines in the graph above is the 4% TRUCAP, which is basically just a 4% indexed-payout trust for this period. It is therefore extremely smooth in distributing just the inflation-adjusted value of the initial payout based upon the initial fair market value of the trust. The Bernstein Collar distribution increases during the middle of the period until it gets to be 30% larger than the inflation-indexed initial distribution, and then it becomes an indexed payout trust essentially at 5.2% of the initial distribution, and the lines are parallel with the TRUCAP unitrust, which during this period, never becomes a unitrust because it becomes a unitrust only when it has to do so to protect the trust from exhaustion, when the distribution is greater than 10% of the net fair market value of the trust, again averaged over a five-year period. And of course the market values of the three trusts will be a mirror image of their distributions assuming the same asset allocation.

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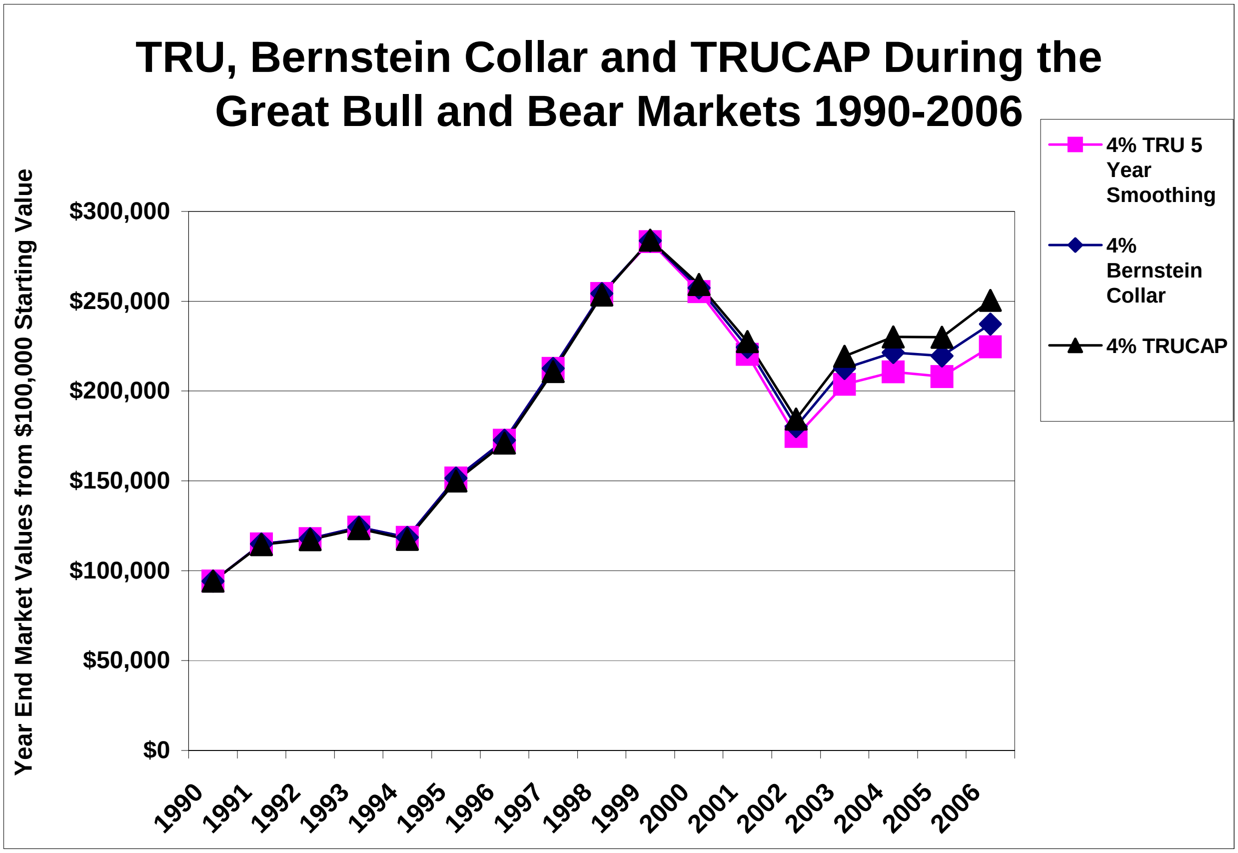
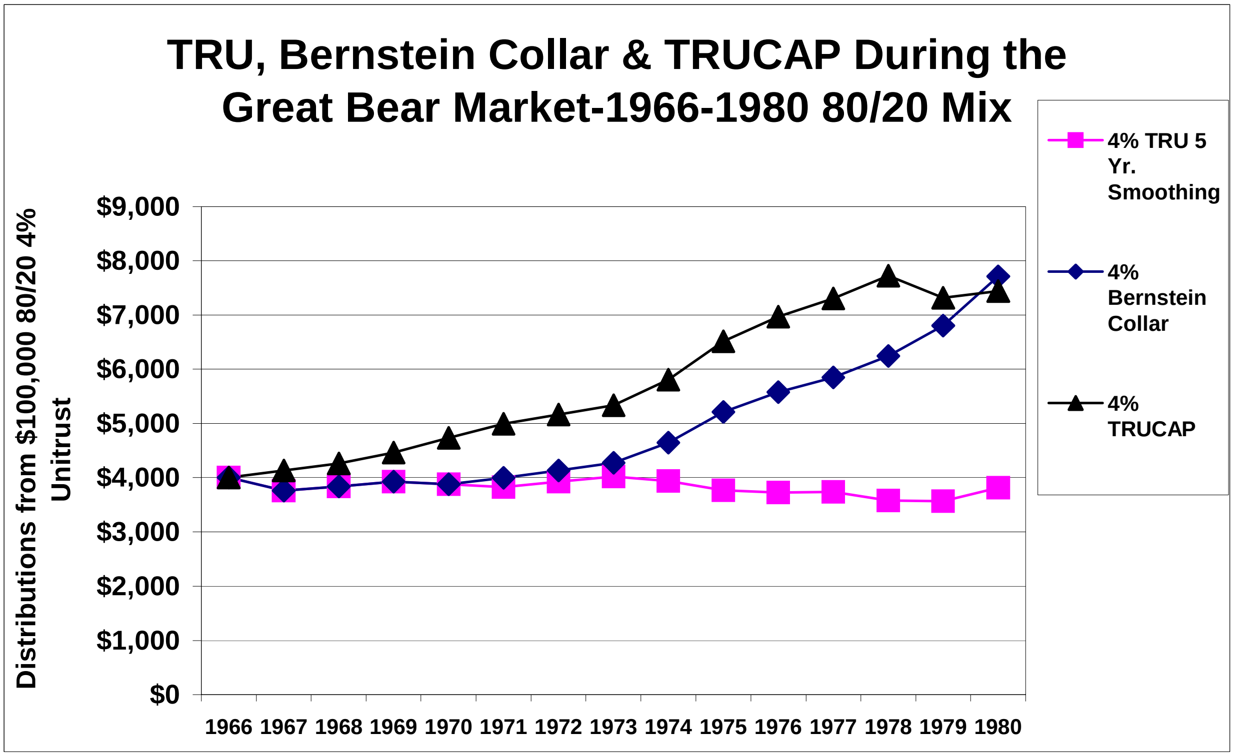
[174] *See* Robert B. Wolf, *Estate Planning with Total Return Trusts, 36* REAL PROP. PROB. & TR. J. 169, 222-230 (2001).



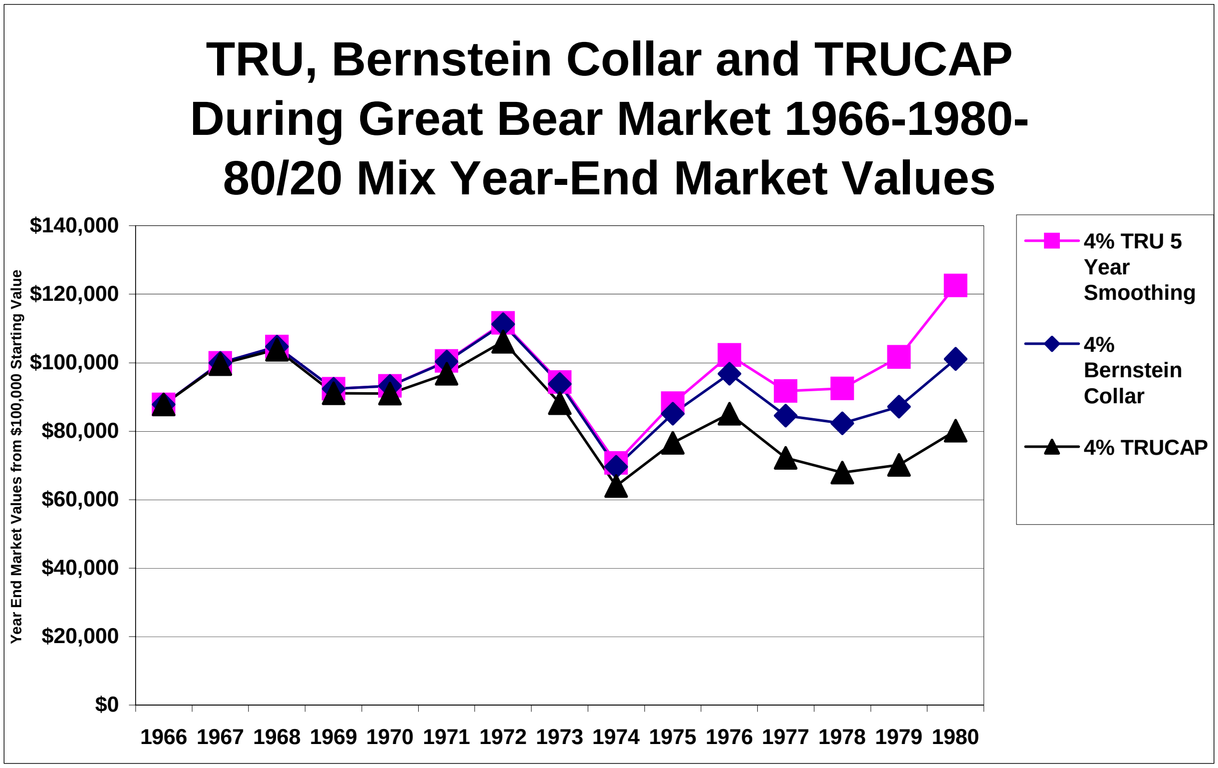
But another point becomes very clear in examining the graphs for this period. The distribution method and rate do not generally make much difference to the market value of the trust portfolio over "short" periods of time. That is, the distribution rate and distribution method will likely make a much greater difference to the income beneficiary than to the remainder beneficiary over relatively short periods of time, such as the 16-year period illustrated above. And indeed, the difference between the ending market value of the TRUCAP (the highest one) and the Unitrust (the lowest one) is only 10%. Not a lot of difference because not a lot of time has passed!

And what if we selected a very different period—one where there was a bear market at the beginning, rather than a bull market at the beginning? The market starting in 1966 was just such a market. So let us take the worst and longest bear market in the last 70 years to test it out and examine the difference that the distribution methodologies might make to the current and the remainder beneficiaries.



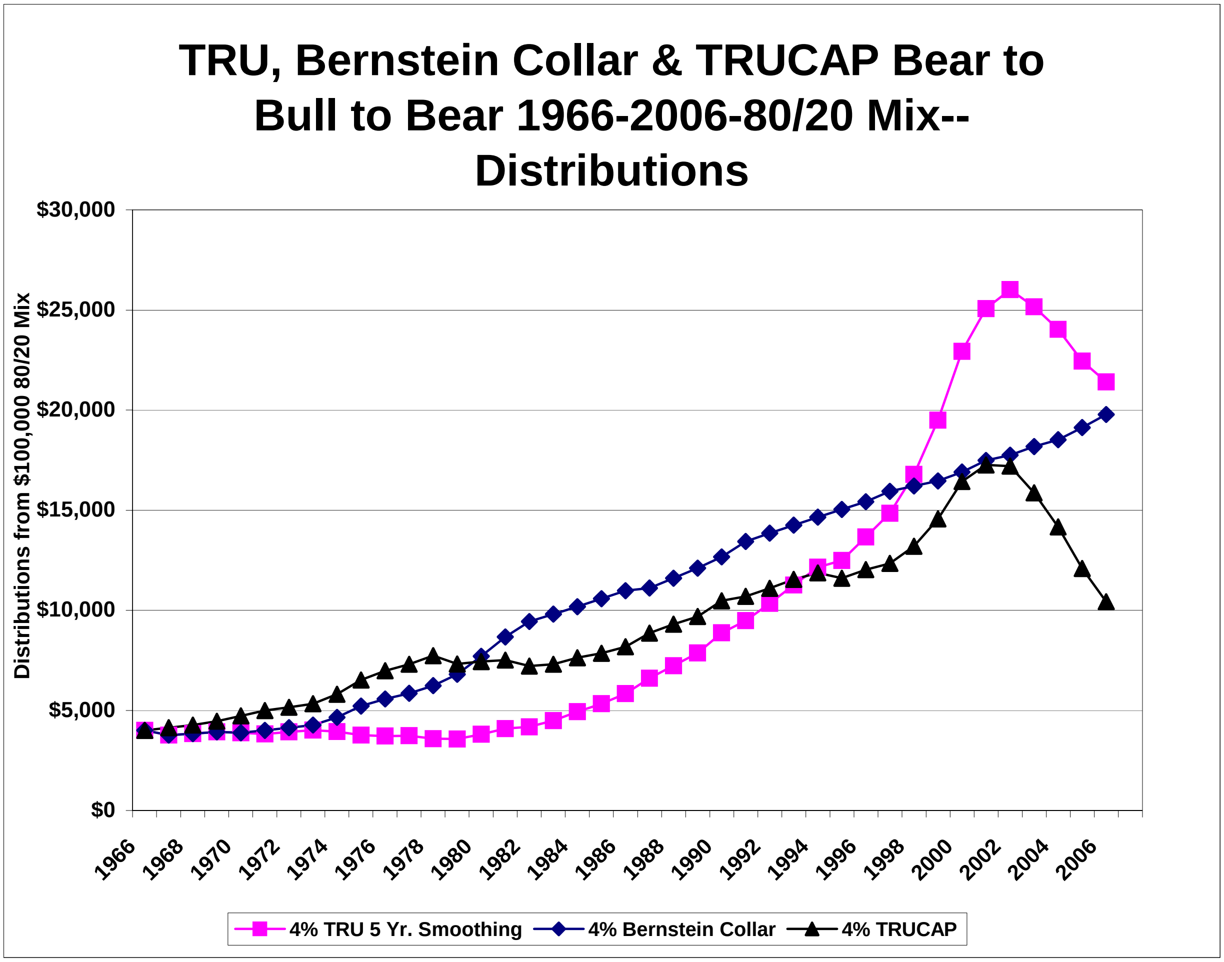
Here we see a real divergence in the methodologies, with the TRUCAP staying up with inflation from the beginning and the Bernstein Collar hanging back until the "floor" comes up to meet the ceiling (perhaps an apt metaphor for what the income beneficiary might be feeling during this very difficult period of declining markets and high inflation). And the unitrust does not even try to respond to the rampant inflation combined with the stagnant and declining bear market. And is that unreasonable and unfair? Let us consider the question. The total net return from the trust portfolio, when inflation-adjusted, was substantially negative during that period. If we had paid out nothing at all from a trust invested in an identical manner the portfolio would have lost over 30% of its real value after inflation. In such a period, what is a "fair" distribution to the current beneficiary? The unitrust distribution is quite probably the most fair under all of the circumstances, but it might well not be what the settlor of the trust wanted, and it certainly is not what the income beneficiary would want at the time, even though if he or she lived long enough, it may well have been in the income beneficiary's best interest.

Because of the substantial differences in the distributions, we show that even over a relatively short period of time, such as 15 years, the market values of the respective trusts reflect significant differences.

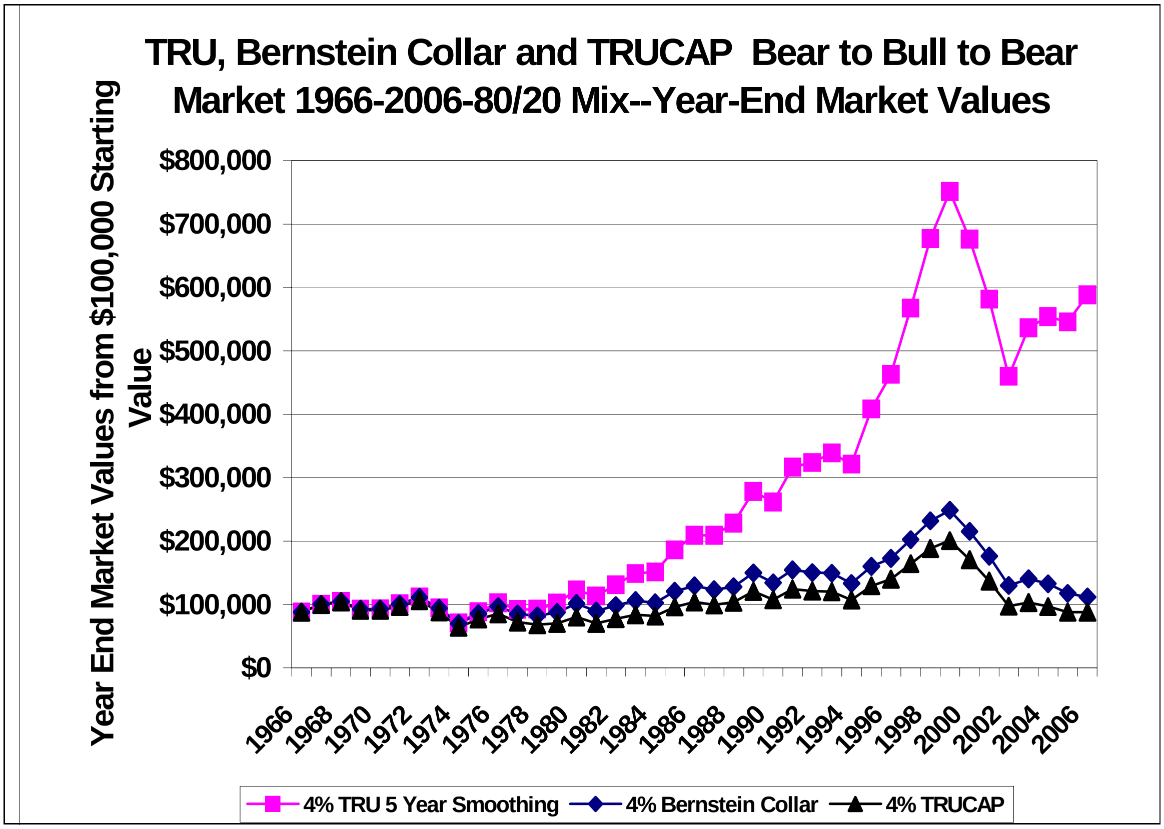


During this period the unitrust would end with 52% more value than the TRUCAP and 21% more than the Bernstein Collar.

What would happen if we extend this difficult period up to 2005 for a really long-term trust? How would these differences play out if a really long-term trust were drafted in one of these three ways, or the power to adjust or discretionary distribution powers were exercised consistently using these methodologies?



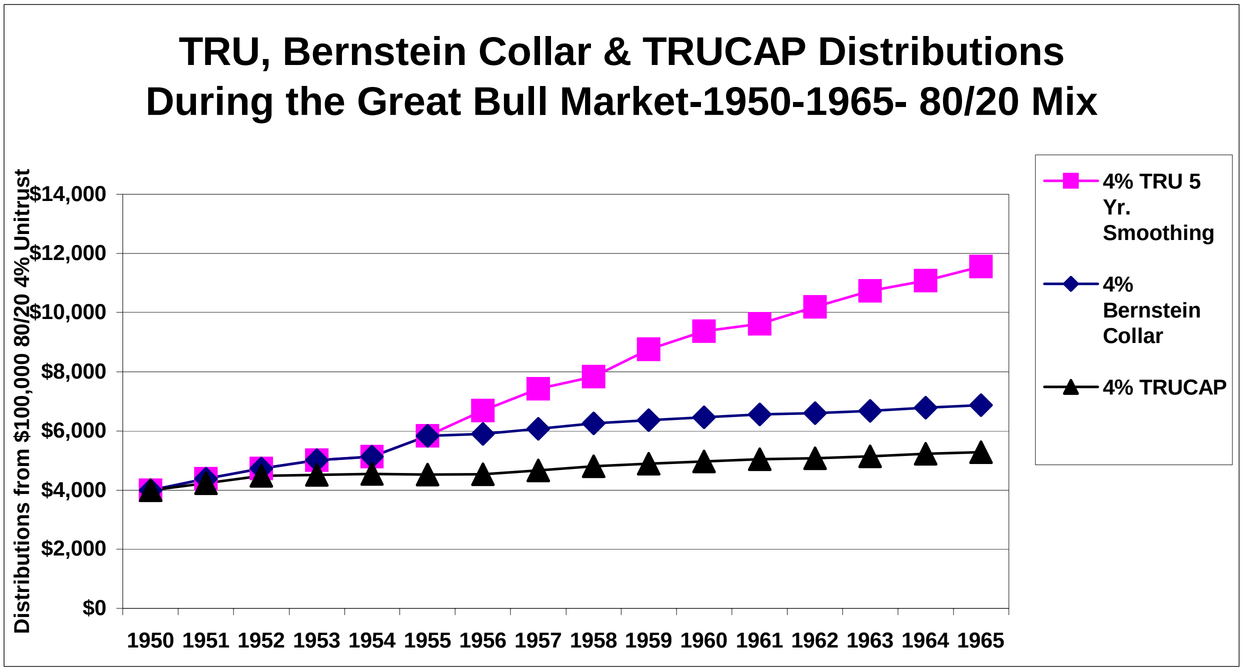
Here some general observations relative to the above graph may be helpful. The Bernstein Collar has the smoothest set of distributions taken as a whole, while the TRUCAP, because it tries to protect the income beneficiary by indexing the payout from the very first year, eventually becomes a 10% unitrust in 1979. And once it has become a 10% unitrust, it will not be able to morph back into an index-payout trust because the 10% payout is too high to let it happen. The Bernstein Collar becomes an index-payout trust very quickly, in 1971. Like the TRUCAP, the Bernstein Collar can never go back, as the inflation-indexed payout pressures the trust portfolio so that it cannot grow over time, even when the bull market eventually comes back in 1982. Let us take a look at the market values of the three trust models and see how these differences have affected them over a long period of time.



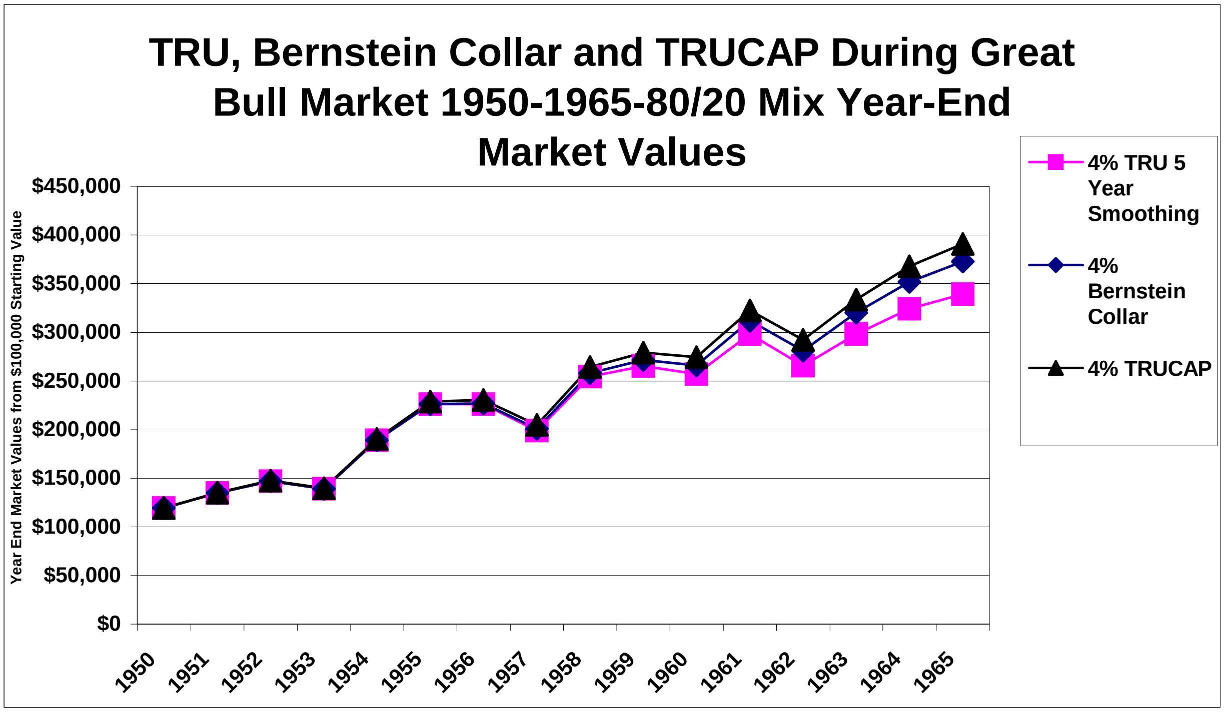
Time and spending method can really make a difference! The remainder beneficiaries would receive over four times as much money with the TRU than with the Bernstein Collar and over five times as much money as with the TRUCAP! One would be tempted to think a complaining remainder beneficiary to be a bit greedy. After all, most of the original dollars are still there, aren't they? Well, in a way, they are, but they are not the same dollars. The unitrust actually would have lost 7% of its real value after inflation, while the Bernstein Collar would have lost 82% of its real value and the TRUCAP 86% of its value.

So spending method makes a little difference over a little time and a lot of difference over a long period of time. And once the trust portfolios have been "stressed" so that the Bernstein Collar and the TRUCAP change to their alter-ego forms to protect the income beneficiary, in the case of the Bernstein Collar, and the portfolio from exhaustion. in the case of the TRUCAP, there seems to be no going back, or at least it is very unlikely that the triggers will ever reverse themselves. Note however, that with the TRUCAP, the CAP rate is adjustable, depending upon the priorities for planning purposes. The CAP rate that is illustrated in this article is a 10% payout, so it is intended to stay as an indexed payout unless or until it really has to convert to a unitrust payout to avoid potential exhaustion. With a 10% CAP it is unlikely to morph back into an indexed-payout, but if a more conservative rate is chosen, such as 6%, the chance of the trust being able to change back and forth will be greatly enhanced. The lower the CAP rate, the more frequently the trust will act like a unitrust.

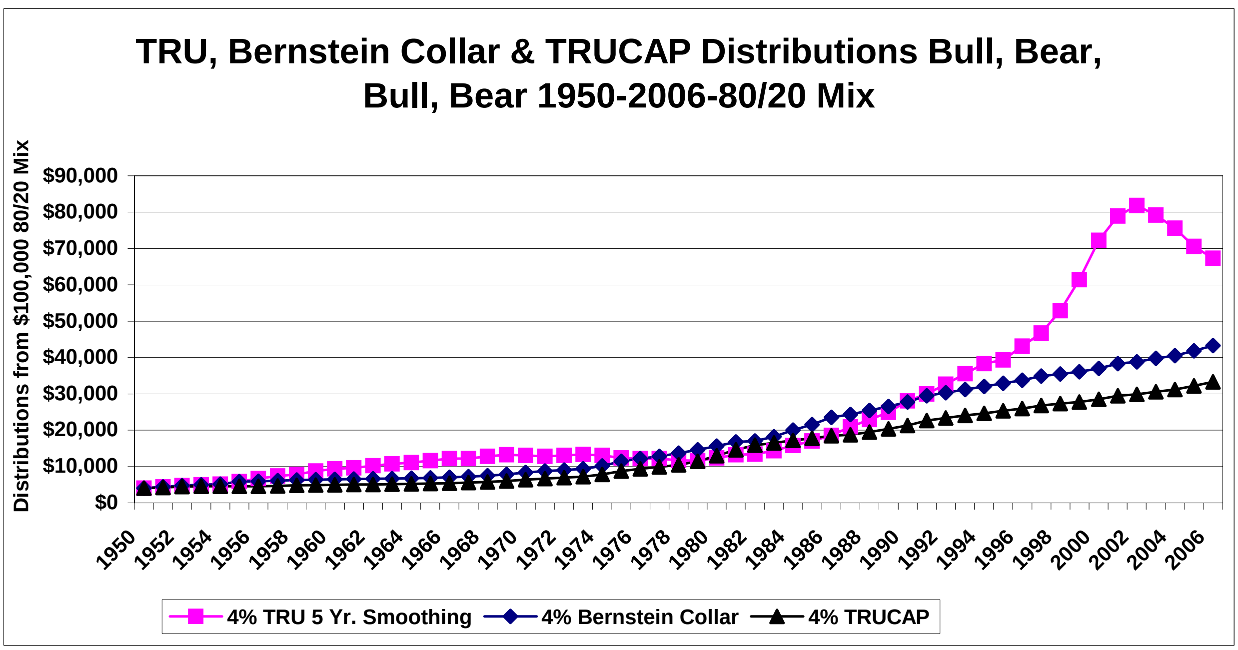
But what if we started in a great bull market with low inflation, such as that of the 1950s?



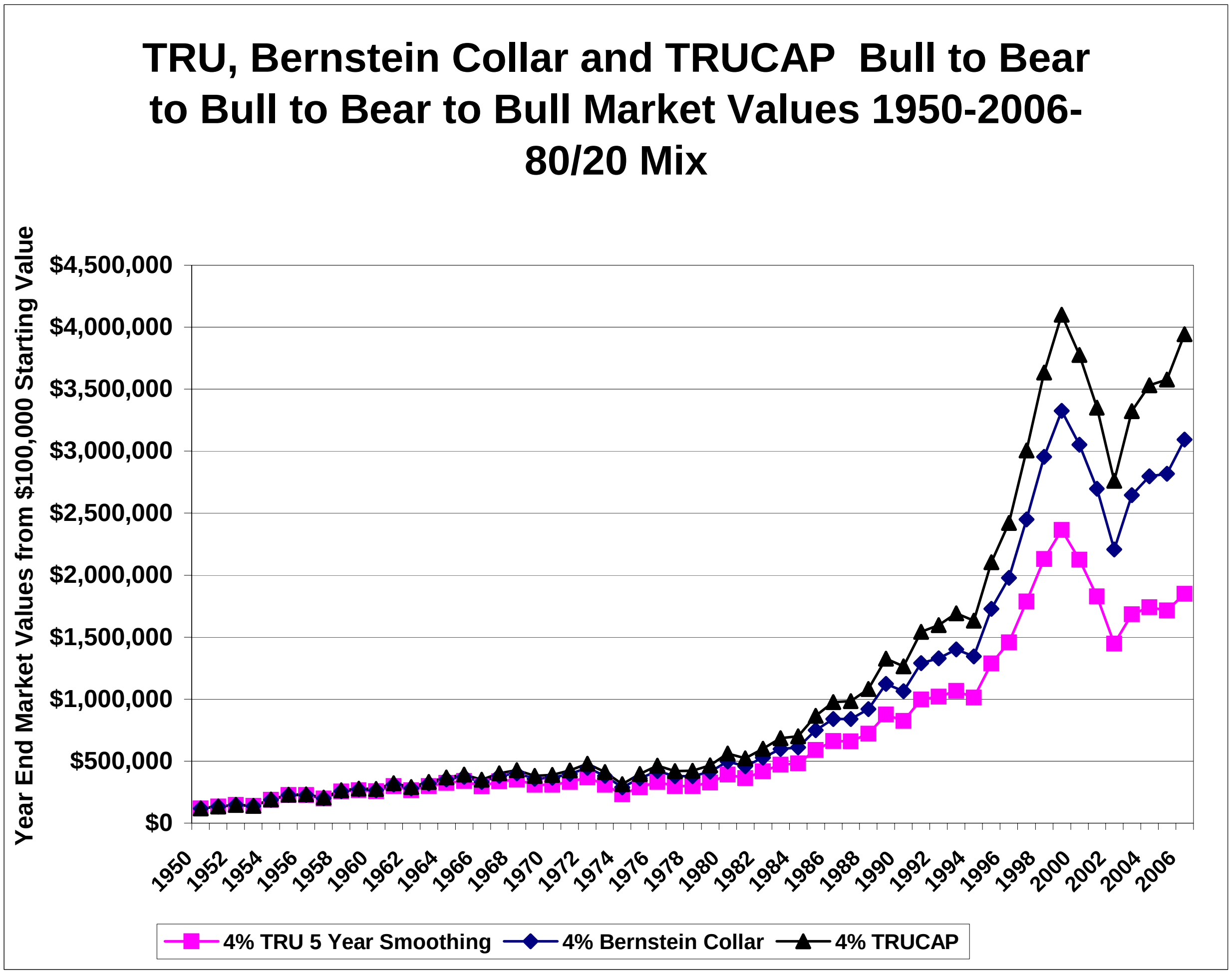
Here, inflation was so low and returns so high that the split in the methodologies is also most vivid. By the end of that bull market, at the end of 1965, the unitrust is paying out 138% more than the inflation-adjusted value of the initial unitrust payout, and 68% more than the Bernstein Collar, which allows the initial payout to increase 30% on an inflation adjusted basis before the ceiling imposes itself. Now of course, the ending market values are a different story.



Because the time horizon has not been too long, and particularly because the returns were so bountiful during that period, the difference to the remainder beneficiary, though significant, is not that significant, with the difference between the highest (the TRUCAP) and the lowest (the unitrust) being only 15.24%. But what if we really extend our study period from 1950 to 2006? How much will time change the effects of alternative spending methodologies?



Here the great rising and falling of investment returns over long periods of time shows that the volatility of the unitrust cannot be fully controlled by any sensible smoothing rule apart from some kind of collar like the Bernstein Collar or the TRUCAP. Let us turn to the market values of these trusts.



Here the TRUCAP finishes with well over twice the market value of the unitrust and the Bernstein Collar with about 66% more value for the remainder beneficiaries than the unitrust. Note that the volatility of the market values looks about the same in the extremely volatile markets of the late 1990s and early 2000s. And of course that is so, because they illustrate identical investment portfolios. Better spending rules may facilitate better investing that will allow the dampening of these great swells in the markets, but only proper diversification and work on reducing the risk inherent in the portfolio will make a difference here! But have the remainder beneficiaries and the current beneficiaries been treated fairly and impartially by these methods of distributions? It would seem so, and all three of the portfolios would have preserved real value for the remaindermen, with the unitrust having the smallest real gain with a gain of 116%, while the Bernstein Collar showed a gain of 263% and the TRUCAP with a gain of 362%! That certainly sounds terrific enough, but note that only the unitrust is paying out a sensible portion of the current trust portfolio at this point, with 4% of the five-year average, while the Bernstein Collar is paying out only 1.51% of the average market value and the TRUCAP only .92%. While the income beneficiary was treated fairly in all three methodologies, only the unitrust insures that a sensible proportion of the present portfolio continues to be distributed after a long period of time. Investment performance stress is *shared better* by the unitrust than by any other method of distribution.

Over long periods of time, all methodologies that use an indexed payout are very likely to become out of sync with the market value of the trust. While the income beneficiary received the bargained-for result with the Bernstein Collar, 130% of the initial inflation adjusted income stream, the income beneficiary may well resent the 263% inflation adjusted gain enjoyed by the trust portfolio, and implicitly the remainder beneficiaries.

This brings up an important planning point. For any of these alternative distribution methods apart from the unitrust to qualify for the marital deduction, the traditional accounting income must be distributed if it is greater than the distribution amount calculated. And the point is not entirely academic, as the foregoing case illustrates.

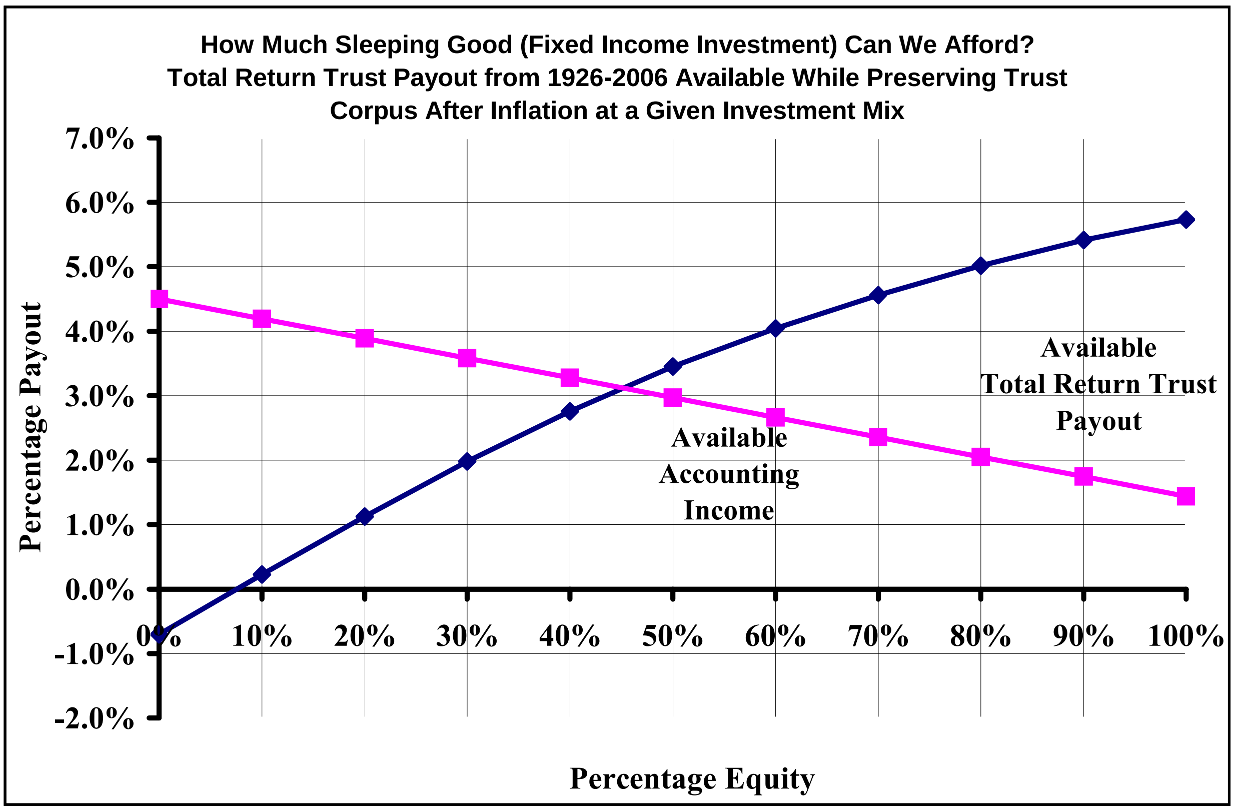
What does one conclude from all of this? First, in this author's judgment the Bernstein Collar is the best new alternative design for implementing a total return strategy since the unitrust, and is a viable approach to exercising the power to adjust in instances in which a unitrust approach may allow too much volatility for the current beneficiary. The Bernstein Collar tends to test out better than the TRUCAP primarily because the Bernstein Collar does not try to do as much as the TRUCAP. If we allow for a 20% real decline in distributions, it is safer for the portfolio than if we start with an indexed payout trust at the initial payout level. But it is still quite possible to completely deplete the trust with the Bernstein Collar, so one would do well to stay to the south of a 4% payout rate to minimize this risk unless the payout period is likely to be relatively short. If a trust is being designed for an 80-year old beneficiary only, one can be more aggressive with the payout method and rate and still be fairly confident that the trust will not deplete itself. On the other hand, a long term trust for multiple generations should have a great deal of thought put into its spending methodology if the distribution rule, rather than discretion, is the only or primary method of adjusting to changing times and markets.

However, when drafting a trust for a real, rather than hypothetical, family, a unitrust with a payout in the range of 3-4% depending upon the duration of the trust and the needs of the beneficiary, with a discretionary power to distribute additional principal if needed for the beneficiary's health, maintenance and support (or broader powers if the trustee is independent), may yet be the most frequently useful model that allows the trustee to invest for total return and distribute fairly to the current beneficiary.

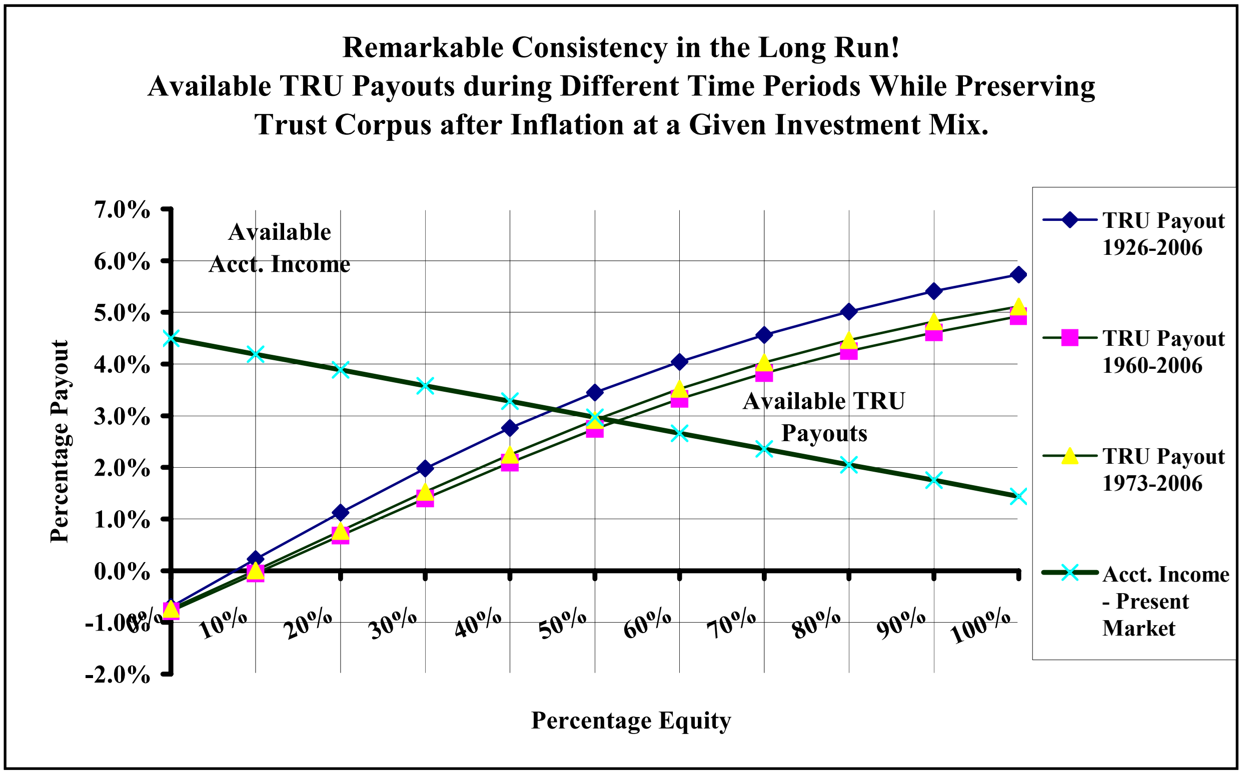
Where the trust faces the really tough challenges in rough financial markets, such as during the period from 1966 to 1980, granting the trustee a discretionary power in addition to a distribution formula and having that trustee weigh the difficult financial markets versus actual human need may be better than any "set it and forget it" formula. Now that may sound strange coming from someone suggesting a unitrust distribution method, which is just such a "set it and forget it" method. But the greatest disadvantage of the unitrust is no doubt the potential for significant volatility to the income beneficiary's interest, and that can be addressed by the addition and exercise of trustee discretion, while the unitrust distribution, likely to be fair and impartial in almost all markets, is still probably the most benign of the alternatives to the traditional income regime.

D. SPENDING RATE FOR THE CHARITABLE TRUST—HOW MUCH DIFFERENCE DOES A TAX FREE TRUST MAKE?

A charitable trust can afford to be more generous to its charitable beneficiaries than a taxable trust can be to its taxable beneficiaries because the charitable trust does not have the "drag" of the taxes that are paid inside the taxable trust. But how much difference does it make really over long periods of time? We might start by looking at the long term results for a taxable trust, with a graph of the amount that could be paid out over a very long-term period of time, 1926-2006, as a function of asset allocation and still have the same value at the end of the period as we did at the beginning after taxes, expenses and inflation. Using the same standard assumptions of 5% turnover and 1% expenses and assuming that capital gains can be distributed to the unitrust beneficiary to the extent that their distribution is more than the traditional DNI, we can produce the following graph of those long term data points:

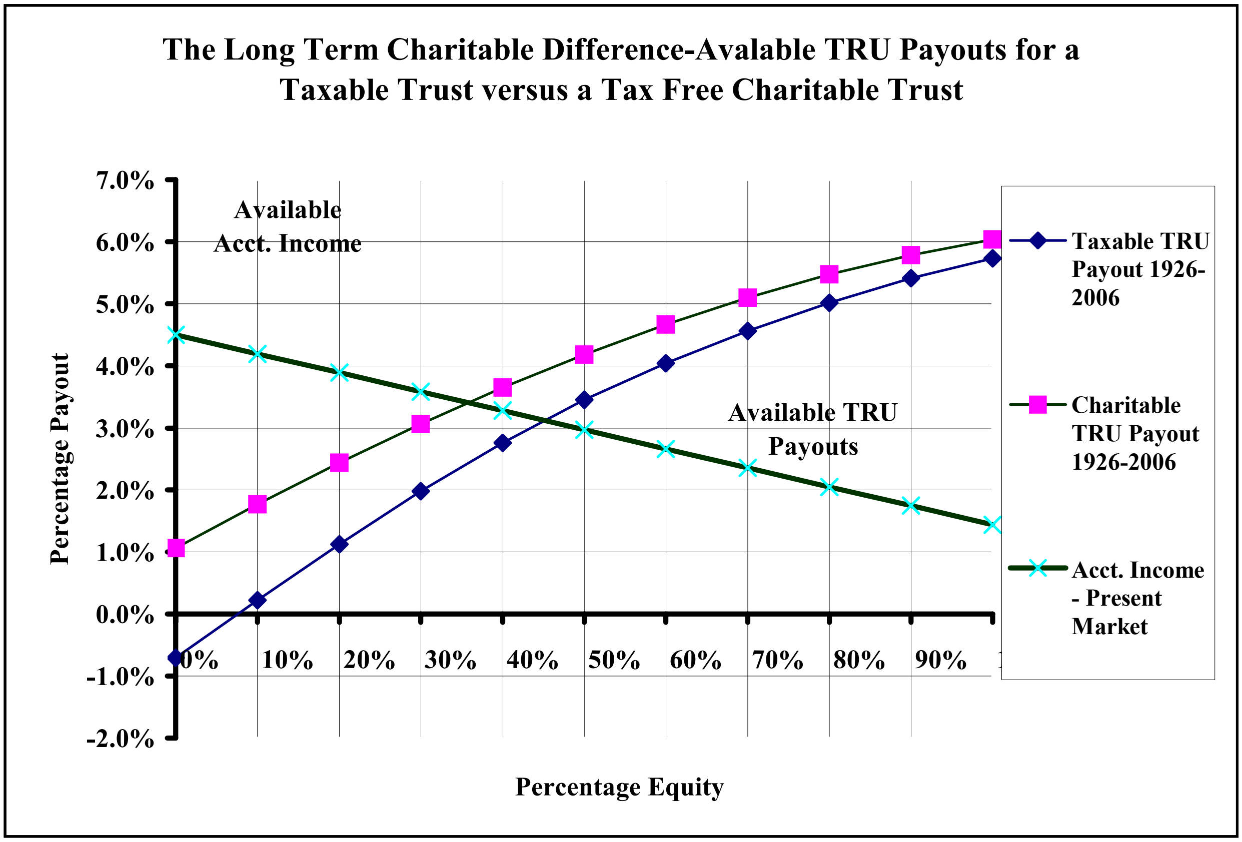


It is immediately striking that the available accounting income and the available total return trust payout are entirely opposite one another. The higher the income payout, the lower the total return payout from a portfolio, and sensibly so, because the high equity portfolios have the lowest yield but the highest total return. And while the foregoing is only one "path" of return, plotting the more recent long-term periods of 1960-2006 and 1973-2006 (See graph on next page) produces a remarkably consistent picture of return and potential payout. The maximum spread is about 8/10ths of 1% difference at 100% equity portfolio. The other thing that is quite notable about the more recent periods of time is that the net available return is lower than for the long-term period, which means that the combination of return and inflation was actually more propitious in the period 1926-1959 than thereafter. This is largely because of the deleterious effect of inflation.

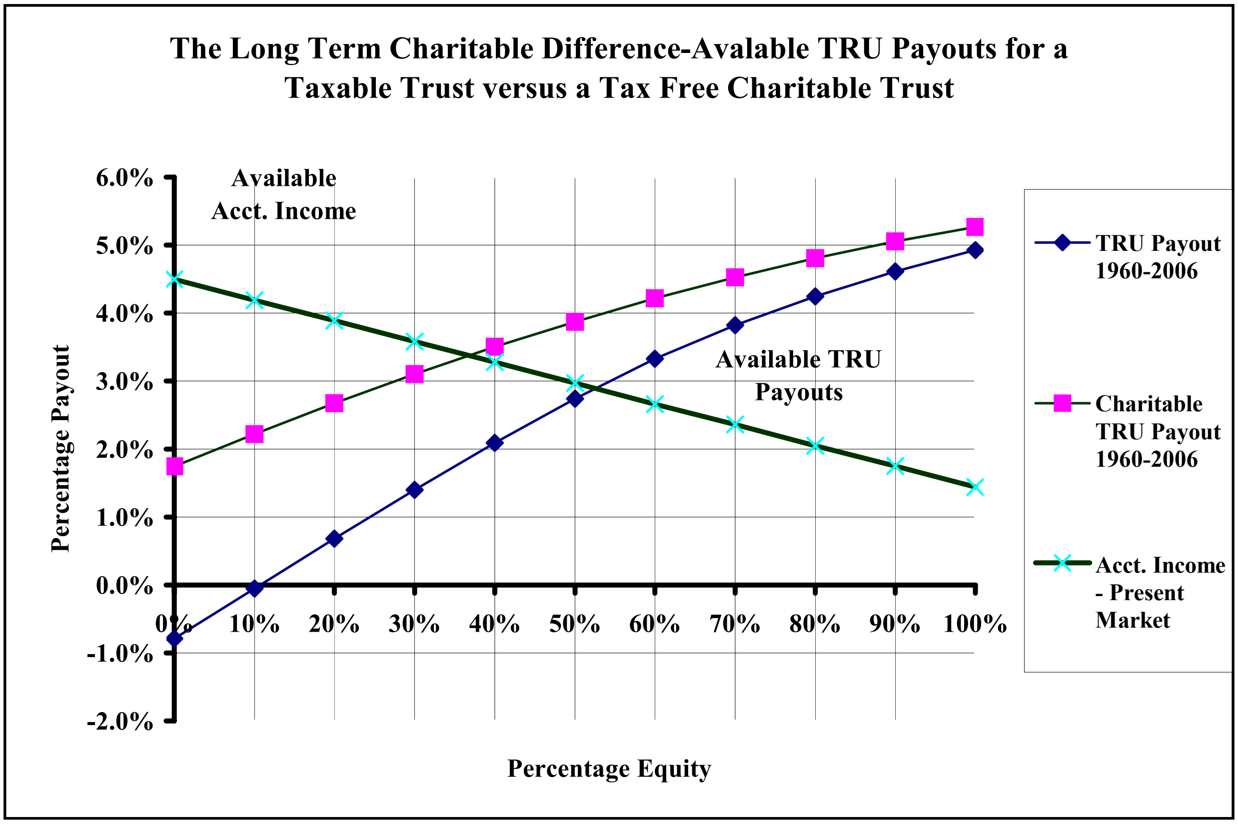


The lesson from all of that, which is generally reinforced by a more extensive review of all of the rolling periods in history, is that with an 80/20 portfolio, one might be able to afford to pay out 4% and have a reasonable prospect of preserving the real value of the trust and the long term payout. It is also a fair conclusion that with a 50/50 portfolio, 3% or less is the reasonable limit to the payout to have a reasonable probability of preserving the real long term value of the trust. While this can be examined in a number of ways and by a number of methodologies, the conclusion that a 3-4% payout is sensible for most portfolios and that 5% is a reasonable limit on the payout is reasonably well accepted and has formed the basis for many of the new state laws and the Final Regulations defining income for tax purposes. It is also absolutely clear that the more fixed income you add to the portfolio, the less you can afford to pay out.

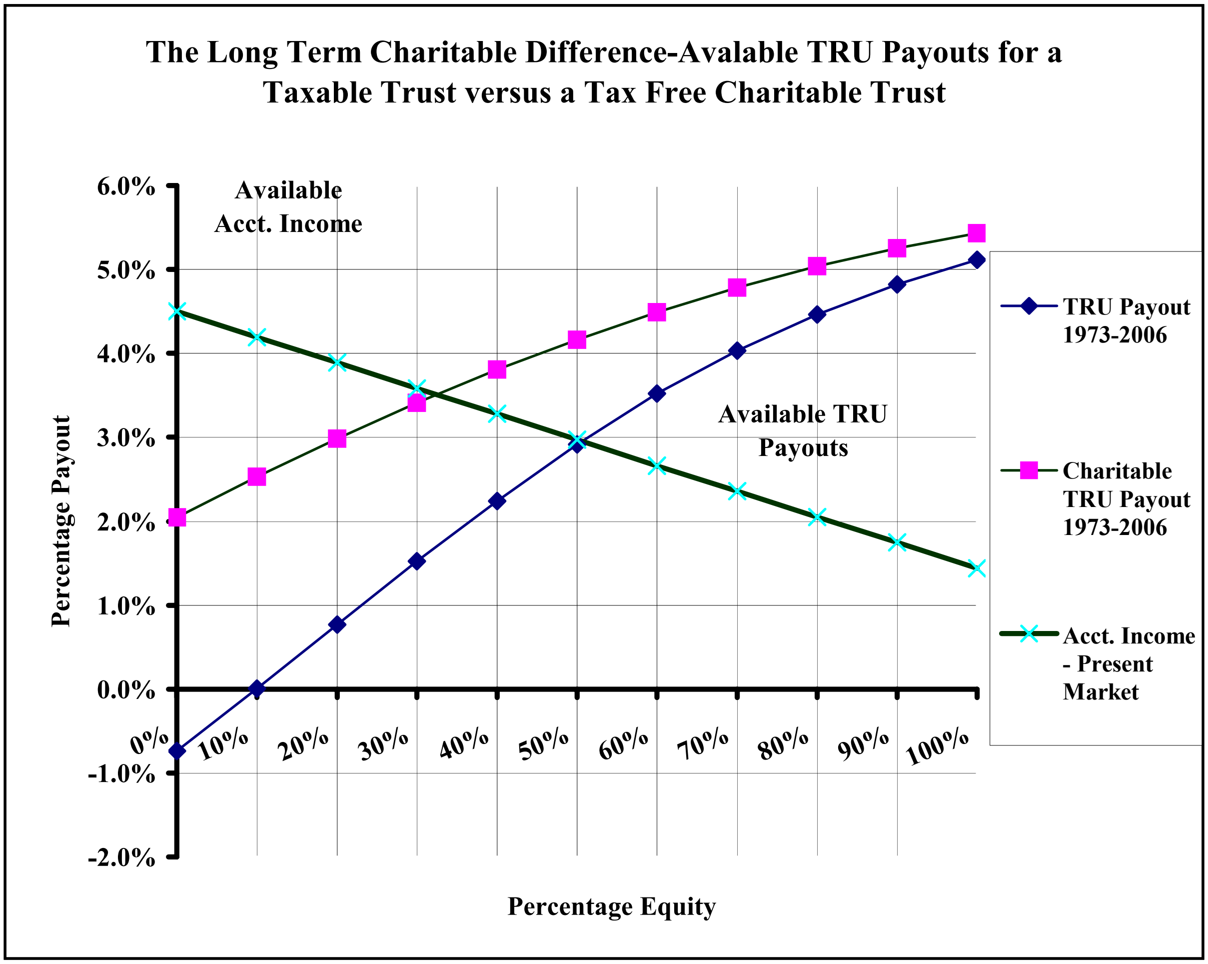
But what happens when we take away the tax burdens on the trust level? To what degree will the guidance and the prudence shift with the tax change? Let us take a look at the long term period from 1926-2006 comparing a taxable with a tax free trust, assuming that capital gains are passed on to the beneficiary as much as possible.



The charitable trust can afford to pay out more than the taxable trust, which is no surprise. The amount of difference diminishes markedly, however, with a higher proportion of equities. At 50/50, the difference is about 73 basis points, whereas at 80% equities, the difference is about 45 basis points. This is because in the case of the portfolios with more equities in them, the higher payouts will pay out the dividend and interest income from the trust and only a portion of the capital gains taxes will remain in the trust. Note also that for this example, a combined federal and state income tax rate assumption of 38% is used for interest and dividend income and a combined capital gains tax rate of 22%, rather than the present lower rates on qualified dividends and capital gains which have been extended by TIPRA through 2010. Had we used the current lower tax rates for qualified dividends and capital gains, the higher equity mixes would be even closer to the charitable trust data. The differences become quite striking for the portfolios with a high proportion of fixed income, which reflects the fact that the bonds illustrated are taxable and eliminating the tax on them would have a very significant impact where the interest would otherwise be taxed in the trust. For a taxable trust, even full reinvestment of all of the fixed income received is not enough to keep the trust up with inflation after taxes and expenses, while for a charitable trust it could afford to pay out a whole 1% to the charitable beneficiary with an all-bond portfolio! Now let us look at the more recent periods and see how they compare.



One notes right away that the split has widened. An 80/20 portfolio in a charitable trust has a 56 basis point edge over its taxable counterpart, and for a 50/50 trust portfolio, the difference is 113 basis points. So for a charitable trust, a more conservative portfolio will not hurt its performance as much as it will for a taxable trust. Going from a 50/50 portfolio to an 80/20 portfolio would rationally allow a taxable trust to pay out 1.4% more and have a reasonable possibility of preserving real value, whereas with a charitable trust, the split is smaller—only about .85% difference in potential payout. Of course that is a 20% increase in potential payout, so it is not a small difference, but for the taxable trust it is closer to a 50% difference in potential payout from 2.7% to 4.1%. That is a huge difference to the beneficiary. Finally, we turn to the most recent period from 1973 to 2004. *(See graph on next page.)*



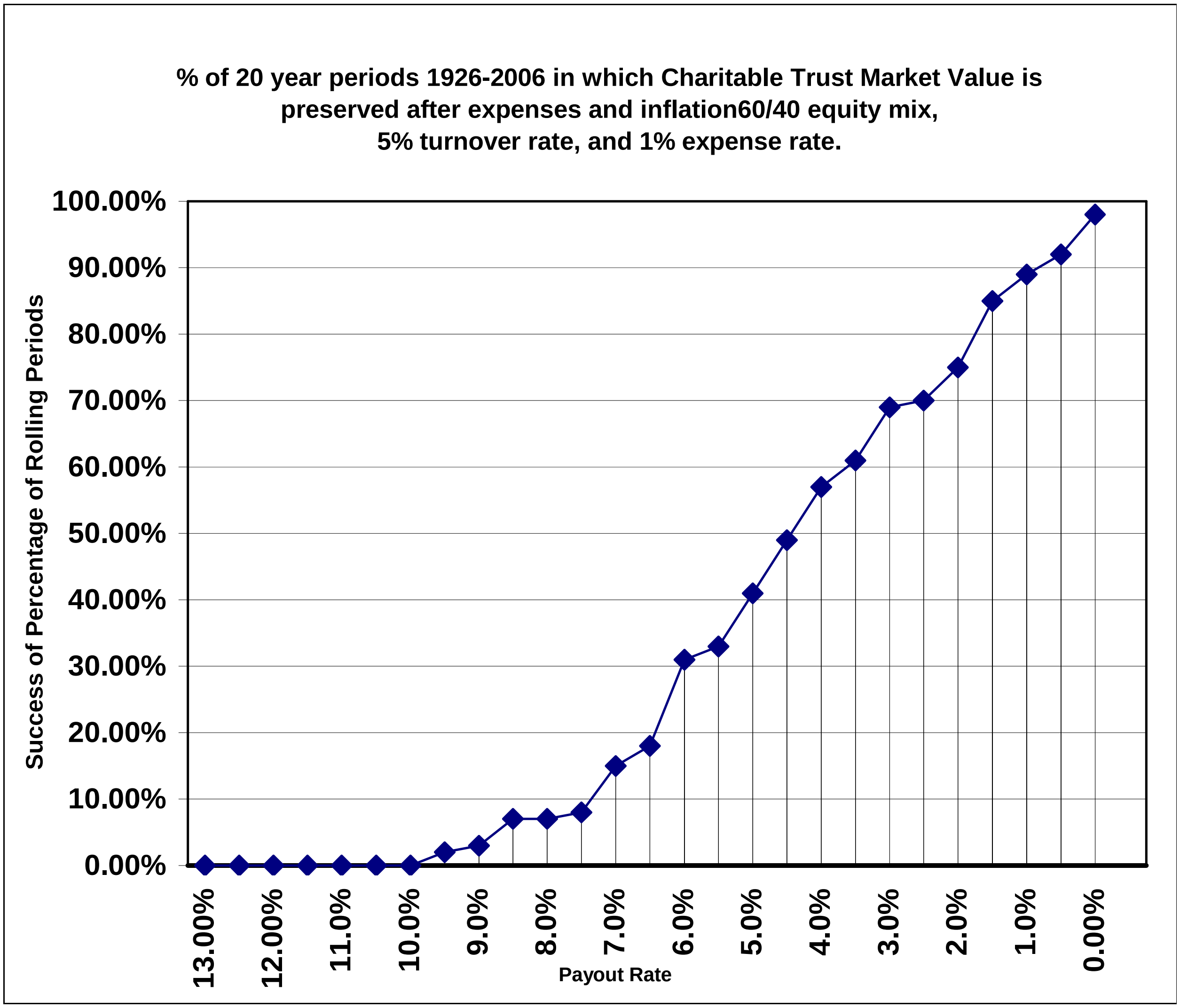
The most recent period since 1973 shows a very similar picture. The reason for the larger splits between the taxable and tax-free trusts for the more recent periods is because of higher interest rates and higher inflation rates during those same periods. With the taxable trust, an all-bond portfolio can pay out nothing or even less than nothing if the goal is to maintain value after taxes, expenses and inflation. There is no return left to do that, since the real return after inflation alone is usually 2%, and rarely more than 3%, which is not enough to pay the taxes and expenses on the total return from those bonds.

Overall, at least based upon the more recent market periods, a charitable payout rate over 5% does not seem like a good bet, just as we have concluded a payout rate for a taxable trust ought not to exceed 4% if it is intended to be a long term trust, and the goal is to preserve real value. The difference on the high equity part of the scale is not so significant, largely because in these high equity high payout situations, the taxable trust is unlikely to be paying out significant taxes, so eliminating those taxes is less significant also. This, of course, is a function of the assumptions used, however, and if the assumption of a low 5% turnover rate were changed to 25% or more, the difference would increase dramatically to over 1% with a 100% equity trust, with a taxable trust being able only to distribute 4.16% while its charitable counterpart could distribute 5.21%. As discussed later in this article, turnover hurts a lot in a taxable trust, even at what might be viewed as historically benign capital gains tax rates. No taxes are benign.

The foregoing simply looks at the ending market value results over a few long term periods. If one were to look at all of the historical periods by examining rolling 20 or 30 year periods, or with a Monte Carlo analysis, examine many hypothetical possible paths of return, one may look at a number of features of the resultant data. Perhaps two of the more important pieces of such data would be the percentage of trials in which the standard or goal is met (a "median" approach), and the average of the results (a "mean" or "expected value" approach). Because the outcomes do not go to zero using a percentage payout, and cannot be negative, and because they may go up more than 100% in some scenarios, the mean type outcome analysis allows for a higher payout than the median outcome, though not dramatically.

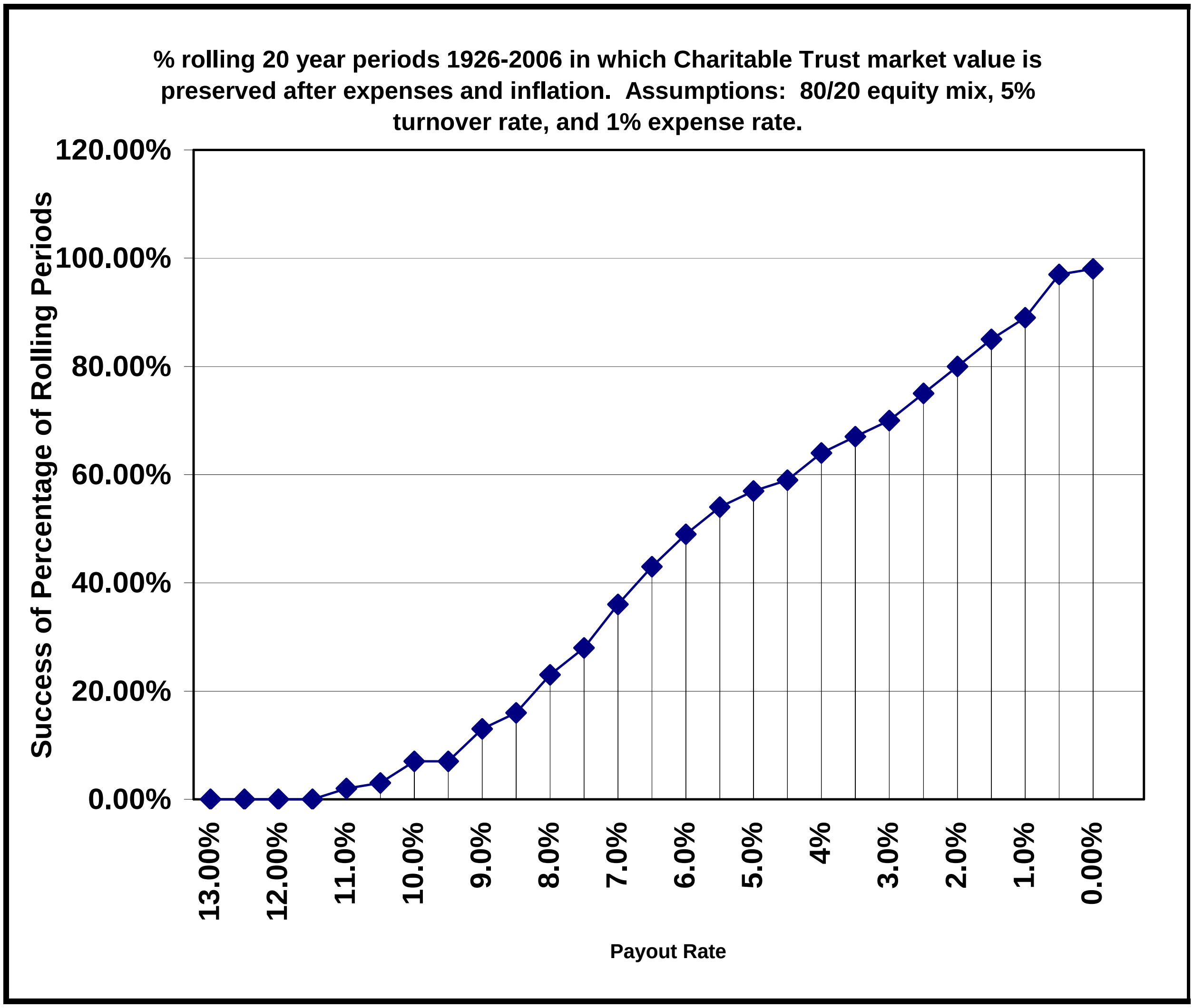
Let's look at the percentage of successful results for all of the 20 year periods since 1926, using the Standard & Poor's 500 Index as the equity proxy and the Intermediate Government Index as the fixed income proxy. We assume 1% expenses, ½ of 1% turnaround cost to the purchases and sales and no taxes, and the consumer price index for all urban consumers as the inflation measure. We will look at different asset allocations and graph payout rate versus percentage success rate of the rolling periods

First we will examine the results for a 60% equity/40% fixed income asset allocation, a fairly standard traditional asset allocation, particularly where the production of income and growth must be "balanced" separately.

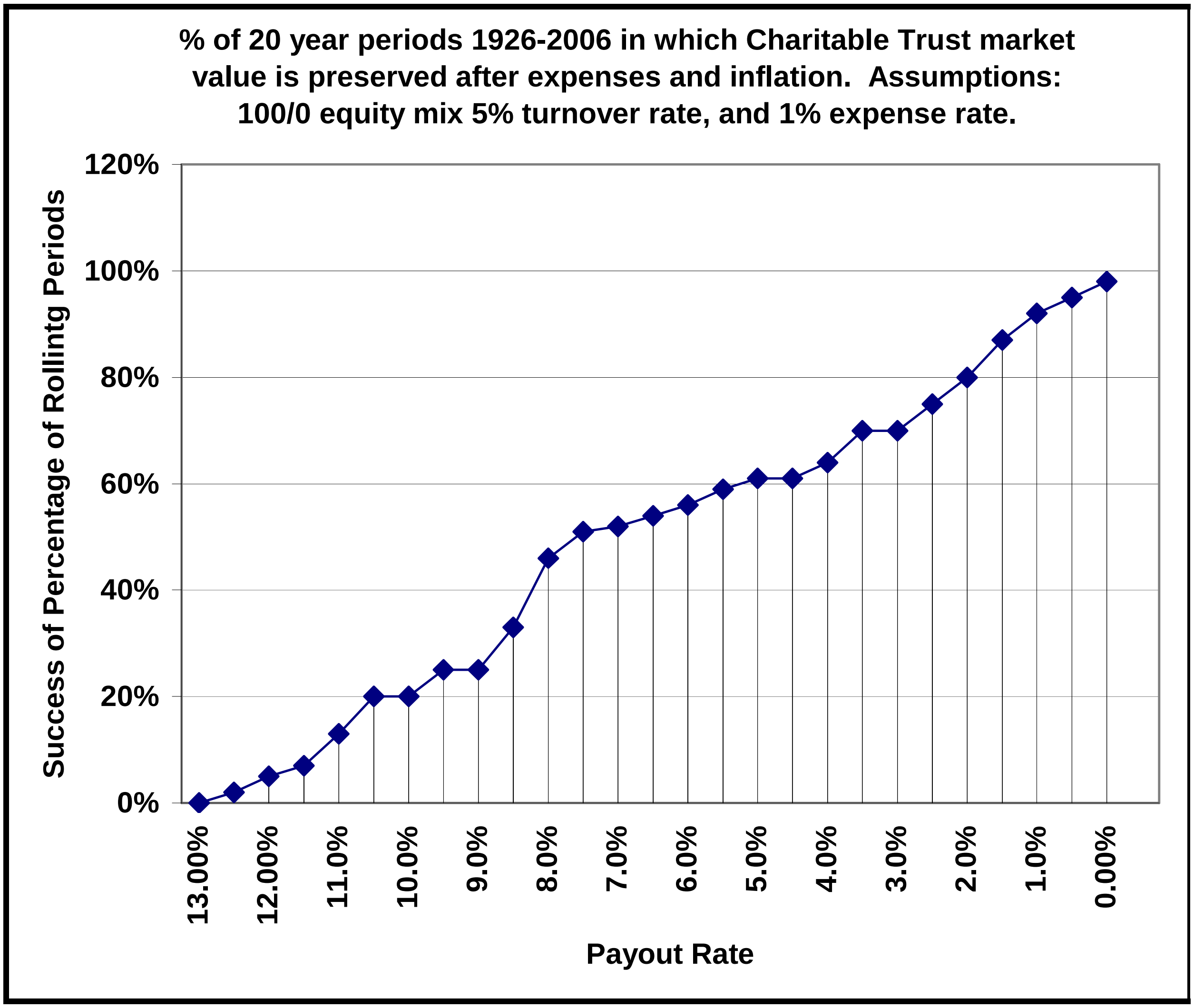


One immediately notices that a 7% payout would have preserved real value with this asset allocation only about one out of every six 20 year periods in history, and at 2% payout real value would have been preserved in about 75% of the 20 year periods. A 4.5% payout would have preserved value in 49% of the periods, while a 3.5% payout would have preserved value in 61% of the periods. So if our "traditional" 60/40 mix is what is chosen, and if the future is like the past, a 4.5% payout would be barely consistent with a goal of preserving real value based upon a "median" type analysis of historical results.

But of course the whole point of our new definitions of principal and income is to free the trustee to invest for total return, not to be required to balance the interests of the income and principal accounts, so let's take a look at the same graphic with an 80/20 "growth" portfolio.



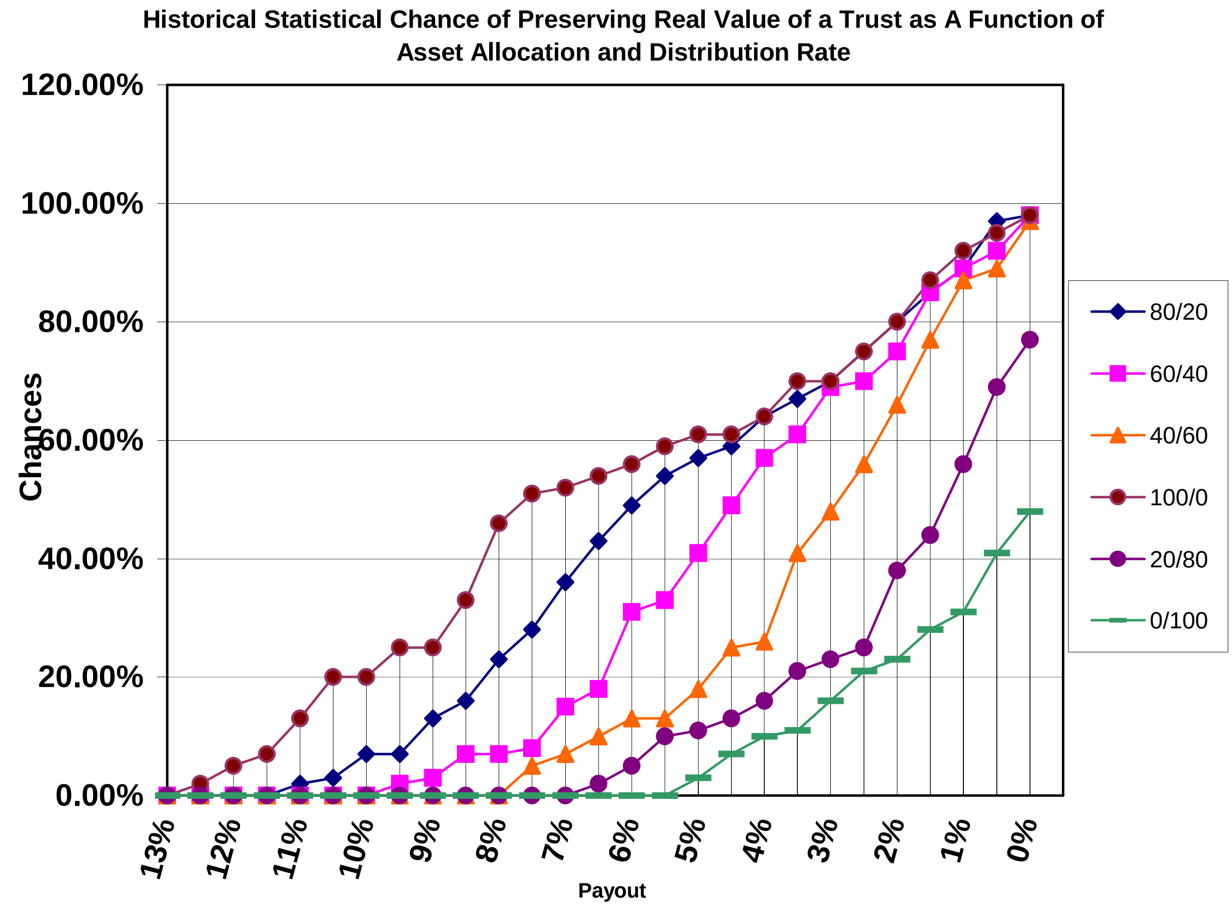
The "Growth" portfolio is obviously a lot more forgiving of higher payout rates, with a 4.5% payout preserving real value in 59% of the 20 year periods while a 5.5% payout succeeds in a full 54% of the periods. Is success in 54% of the periods sufficiently probable if our goal is to preserve real value? Quite possibly, and 59% is even better. Of course this assumes that future returns are equal to those of the past, which is not the consensus opinion at present. What happens if we were to go with an all equity portfolio?



Interestingly, with an all equity portfolio, a payout of 7% would have preserved real value in 54% of the periods. In other words it would have been more likely than not that the payout was "consistent" with the preservation of the real value of the charitable trust.

Let's look at all of the asset allocations graphed together to see the shape of returns and payouts.

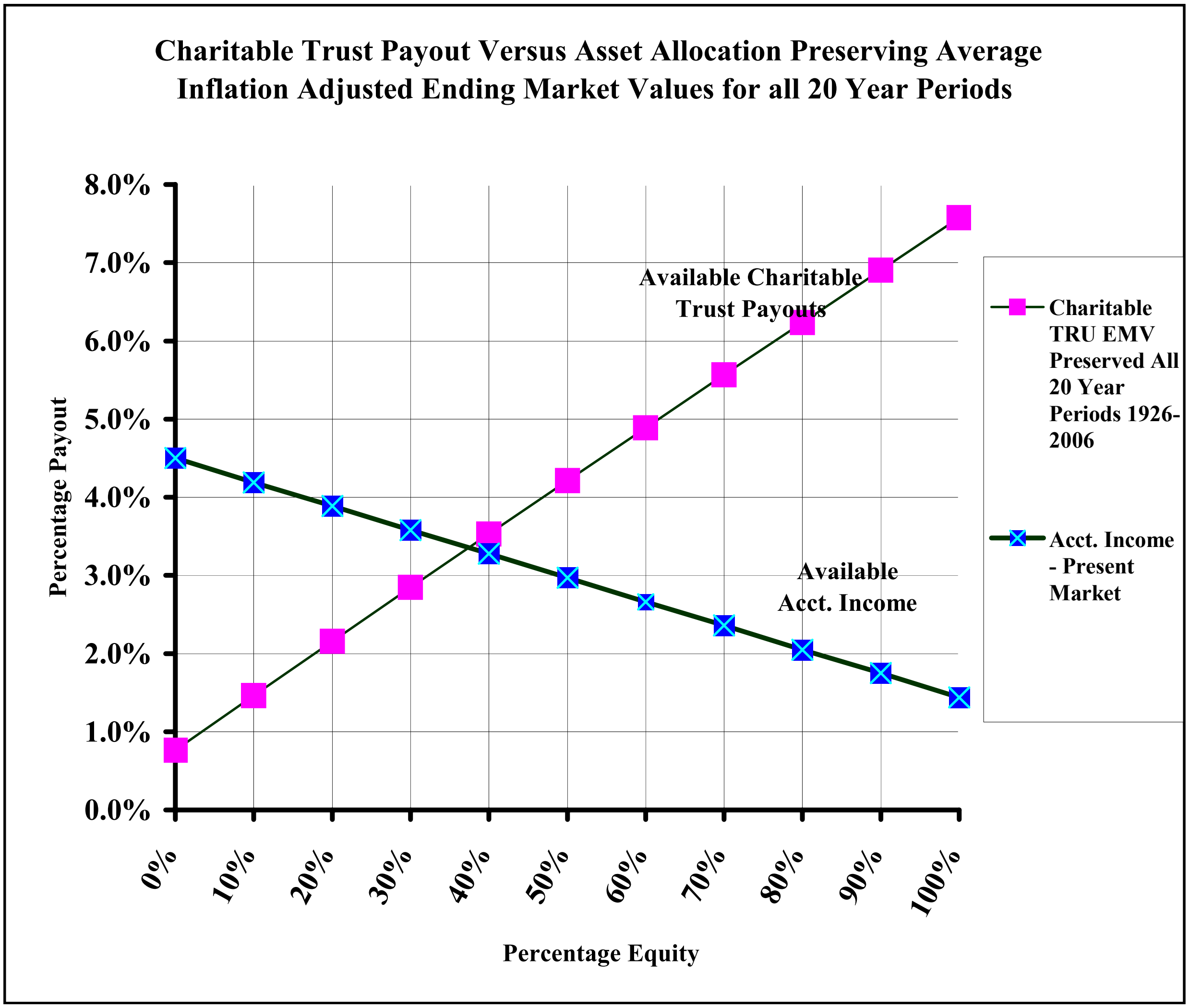
Based upon the foregoing statistical frequency of favorable outcomes, clearly the more growth oriented equity portfolio allows the trustee to pay out a good deal more presently and still maintain a decent chance of preserving real value. The all equity portfolio also seems to have a "bulge" in its probability graph at the high end of the payout range, if the trustee and the beneficiary were able to stand the volatility.



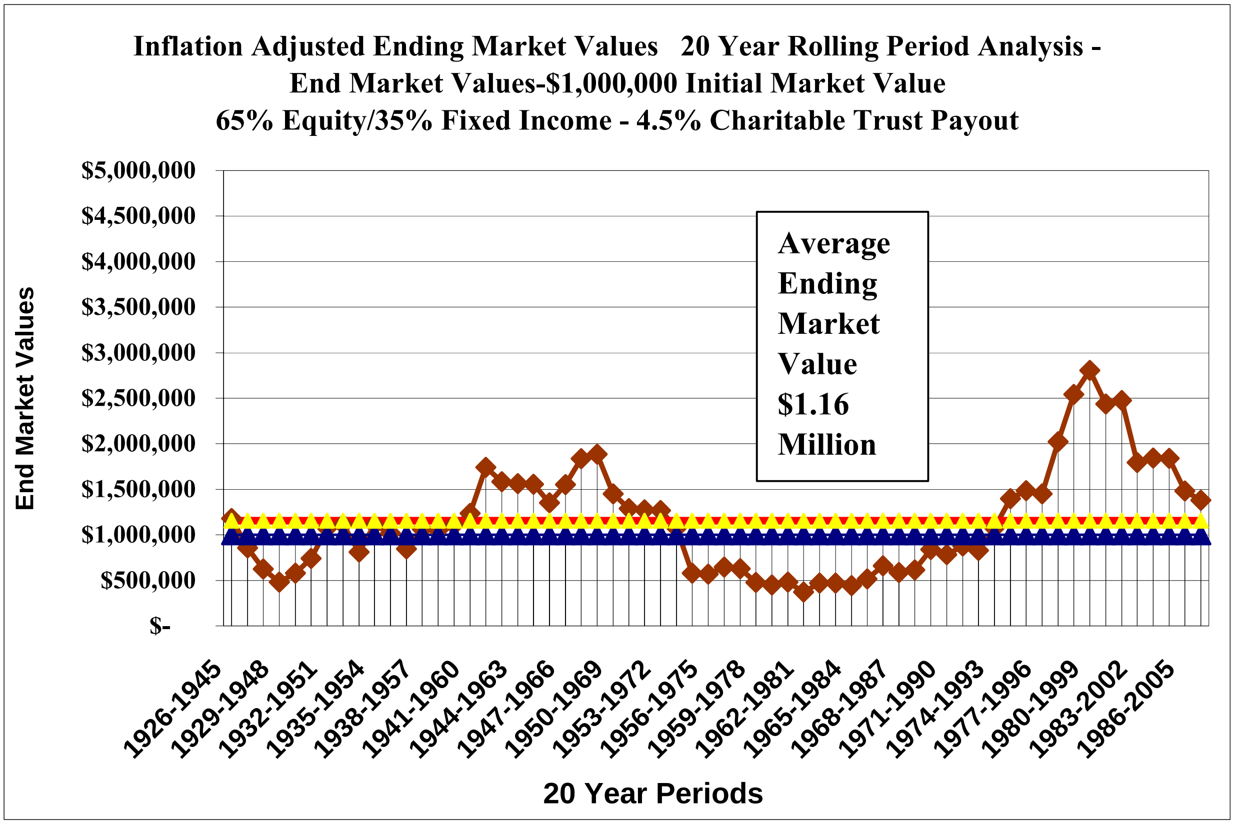
Percent of Rolling 20 year periods 1926-2006 in which TRU market value is preserved after taxes, expense and inflation.
Assumptions: 5% turnover rate, and 1% expense rate.

Another point stands out. No matter what the asset allocation, even at a 0% payout, 100% success based upon all of the historical periods is not achievable. Nor will 100% certainty be possible based upon a Monte Carlo analysis either. Probability yes, but certainty, no.

The foregoing reflect the percentage of successful periods. What about the average or "mean" or expected results? Here the averages will have a different shape than the median, which reflects complex curves. The median is a straight line and it is higher.

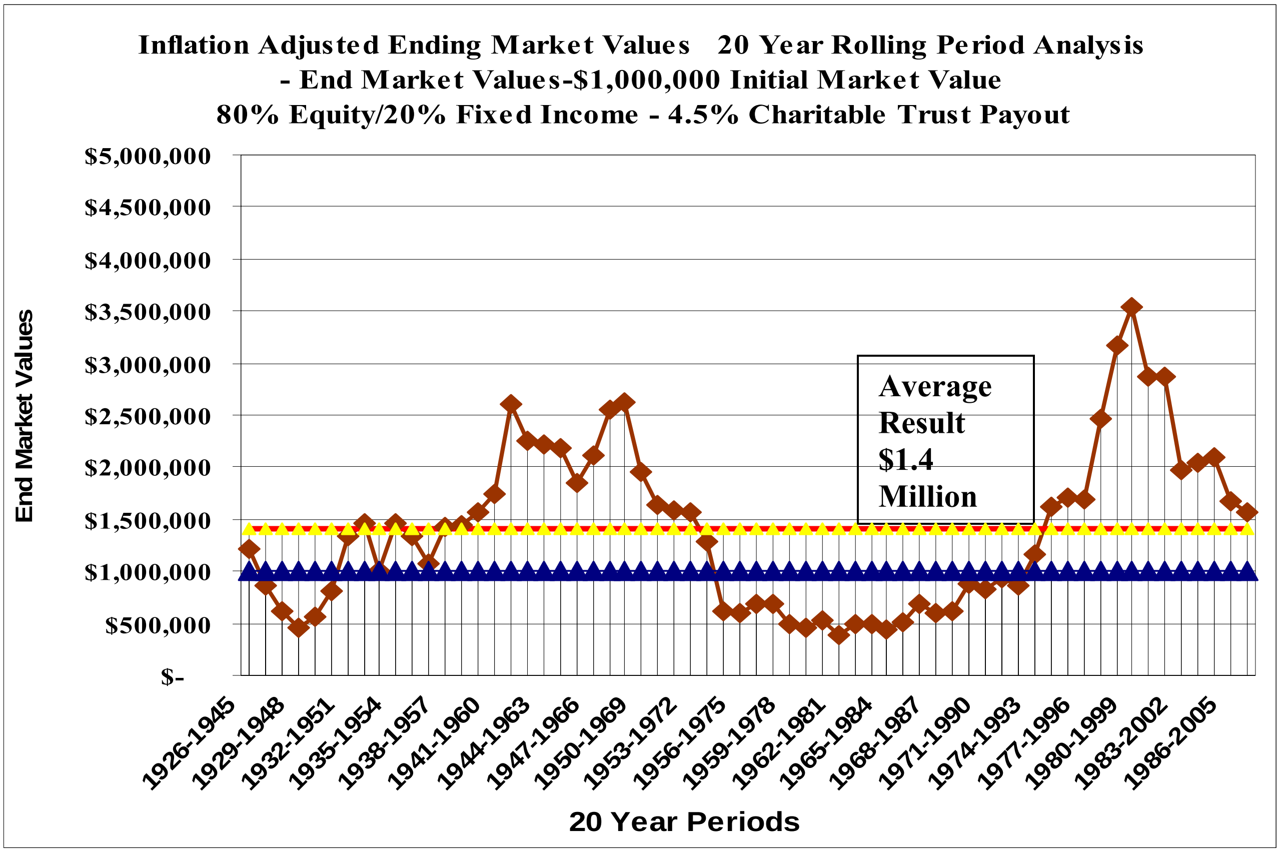


Based upon these average results, with a 60/40 portfolio, one could pay out almost 5% and the "expected" or average result would be equal to the beginning value in real terms, while a quick return glance at the "median" type results shows us that it would have succeeded in preserving real value in only a bit more than 40% of the periods. That again is because of the effect that the average reflects periods in which the real value more than doubled, while for the median probability, the high end results don't matter. Let's look now at the variability of these returns for three portfolios paying out 4.5%. First a 65/35 traditional balanced or moderate asset allocation, then an 80/20 growth portfolio and then an all equity aggressive growth portfolio.



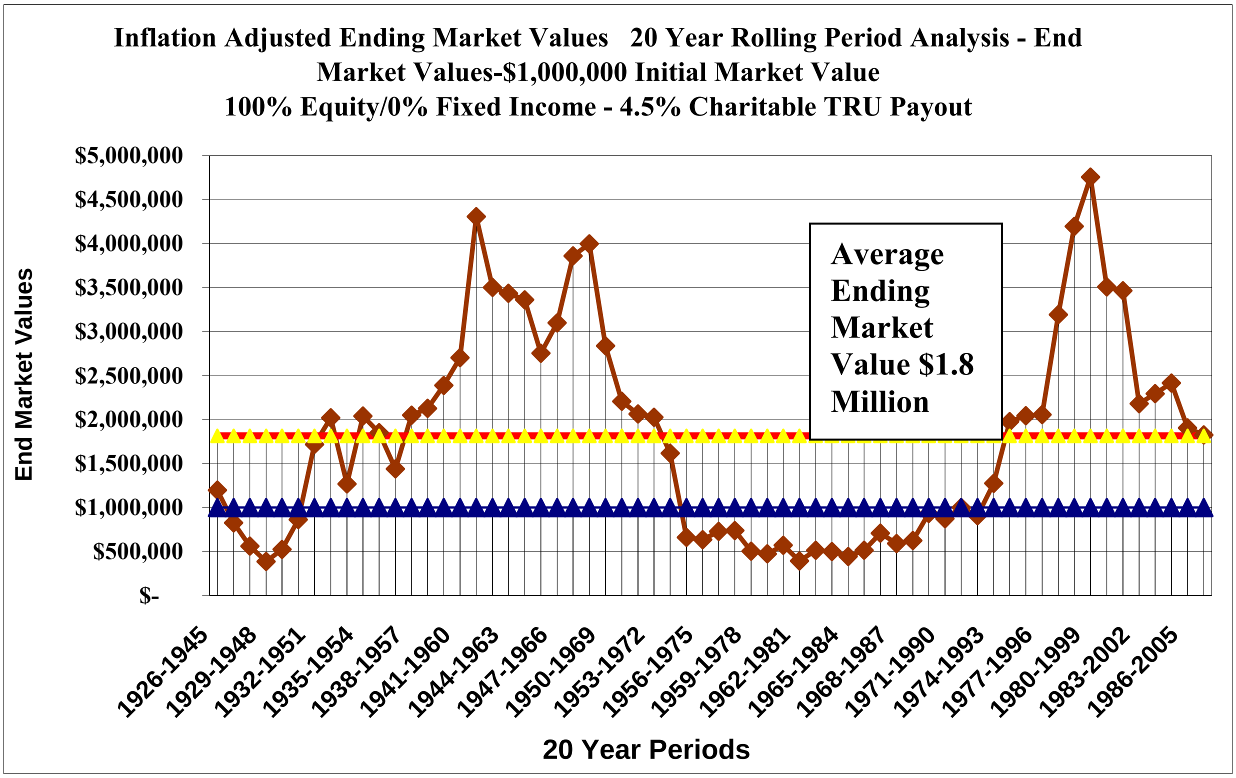
The average result is a 16% increase in real value, which sounds pretty good, but it is obvious that there is a lot of variability to those results, even over 20 year periods. The best result is an increase of 180% ending in 1999, while the worst result is a loss of 63% ending in 1981. The traditional balanced portfolio gives decent results with this payout, but there is still quite a bit of downside.

Turning to a growth portfolio of 80% equities and 20% fixed income, the results predictably get better and the volatility of results increase as well:



Clearly the average result is much better with a 40% increase in real value, while the volatility is much greater also. The best case ending in 1999 was up 253% rather than 180%, but the most interesting point is that the worst case, again ending in 1981, was down 62% in real terms, while with the more conservative portfolio, it was down 63%. *So the downside volatility over 20 year periods gets better with the more aggressive portfolio.* The ride would have been rougher in the meantime, but at the end of all of these 20 year periods, the long term downside "risk" was greater with the more conservative portfolio.

Now let's turn to an all equity portfolio, and see if the pattern persists:



And indeed it does. The average result is up 81%, with the best case up 375% and the worst case down 61%.

Long term, the more conservative portfolios eliminate the upside volatility, but not the downside volatility, when measured in after expense, inflation adjusted values.

Finally, let's compare the results for a 65/35 portfolio, an 80/20 portfolio and an all equity portfolio, with the results for each period side by side for comparison purposes.

Test Drive Side-by-Side
$100,000 Portfolio
After 1% Expense
Ending Values All 20 Year Periods
Adjusted for Inflation

Balanced			**Growth**			**Aggressive**		
65/35 4.5% Payout			80/20 4.5% Payout			100% Equity 4.5% payout		
20 Year Period Results			20 Year Period Results			20 Year Period Results		
AVERAGE	$115,194		AVERAGE	$140,078		AVERAGE	$181,241	
BEST	$280,673		BEST	$353,607		BEST	$475,616	
WORST	$ 37,276		WORST	$ 38,402		WORST	$ 38,673	
PRESERVED	57%		PRESERVED	59%		PRESERVED	61%	
	* Best			* Best			* Best	
3 Wins	Result		**5 Wins**	Result		**54 Wins**	Result	
20 Year Data			20 Year Data			20 Year Data		
1926-1945	$118,067		1926-1945	$122,125	*	1926-1945	$119,696	
1927-1946	$ 85,635		1927-1946	$ 86,668	*	1927-1946	$ 82,499	
1928-1947	$ 62,664	*	1928-1947	$ 61,321		1928-1947	$ 55,939	
1929-1948	$ 48,184	*	1929-1948	$ 44,990		1929-1948	$ 38,673	
1930-1949	$ 57,970	*	1930-1949	$ 56,810		1930-1949	$ 52,197	
1931-1950	$ 74,194		1931-1950	$ 80,775		1931-1950	$ 86,053	*
1932-1951	$107,283		1932-1951	$133,153		1932-1951	$171,532	*
1933-1952	$111,480		1933-1952	$145,908		1933-1952	$201,828	*
1934-1953	$ 81,174		1934-1953	$ 99,561		1934-1953	$126,892	*
1935-1954	$110,798		1935-1954	$145,987		1935-1954	$203,871	*
1936-1955	$101,903		1936-1955	$133,490		1936-1955	$185,050	*
1937-1956	$ 84,477		1937-1956	$107,628		1937-1956	$143,966	*
1938-1957	$106,250		1938-1957	$142,165		1938-1957	$204,756	*
1939-1958	$105,391		1939-1958	$143,932		1939-1958	$212,481	*
1940-1959	$111,049		1940-1959	$155,931		1940-1959	$238,777	*
1941-1960	$123,692		1941-1960	$174,909		1941-1960	$270,411	*
1942-1961	$174,200		1942-1961	$259,708		1942-1961	$430,431	*
1943-1962	$158,386		1943-1962	$225,142		1943-1962	$350,255	*
1944-1963	$156,352		1944-1963	$221,567		1944-1963	$343,414	*
1945-1964	$155,609		1945-1964	$218,884		1945-1964	$336,097	*
1946-1965	$135,157		1946-1965	$185,202		1946-1965	$275,198	*
1947-1966	$155,241		1947-1966	$210,938		1947-1966	$309,742	*
1948-1967	$183,685		1948-1967	$255,345		1948-1967	$386,063	*
1949-1968	$188,408		1949-1968	$262,956		1949-1968	$399,702	*
1950-1969	$144,885		1950-1969	$195,333		1950-1969	$283,685	*
1951-1970	$128,919		1951-1970	$163,926		1951-1970	$220,591	*
1952-1971	$127,620		1952-1971	$158,264		1952-1971	$206,292	*
1953-1972	$126,655		1953-1972	$156,366		1953-1972	$202,664	*
1954-1973	$107,328		1954-1973	$129,139		1954-1973	$161,478	*
1955-1974	$ 57,994		1955-1974	$ 61,964		1955-1974	$ 66,016	*

1956-1975	$ 56,778	1956-1975	$ 60,134		1956-1975	$ 63,348	*
1957-1976	$ 64,677	1957-1976	$ 68,778		1957-1976	$ 72,826	*
1958-1977	$ 62,911	1958-1977	$ 68,087		1958-1977	$ 73,889	*
1959-1978	$ 47,831	1959-1978	$ 49,242		1959-1978	$ 50,199	*
1960-1979	$ 45,102	1960-1979	$ 46,480		1960-1979	$ 47,441	*
1961-1980	$ 48,017	1961-1980	$ 52,193		1961-1980	$ 57,113	*
1962-1981	$ 37,276	1962-1981	$ 38,402		1962-1981	$ 39,159	*
1963-1982	$ 47,105	1963-1982	$ 49,295		1963-1982	$ 51,362	*
1964-1983	$ 46,875	1964-1983	$ 48,591		1964-1983	$ 50,022	*
1965-1984	$ 44,187	1965-1984	$ 44,553	*	1965-1984	$ 44,216	
1966-1985	$ 51,463	1966-1985	$ 51,784	*	1966-1985	$ 51,253	
1967-1986	$ 66,076	1967-1986	$ 68,533		1967-1986	$ 70,688	*
1968-1987	$ 58,742	1968-1987	$ 59,303	*	1968-1987	$ 59,085	
1969-1988	$ 61,412	1969-1988	$ 62,333		1969-1988	$ 62,536	*
1970-1989	$ 84,068	1970-1989	$ 88,562		1970-1989	$ 93,324	*
1971-1990	$ 78,329	1971-1990	$ 82,570		1971-1990	$ 87,087	*
1972-1991	$ 87,680	1972-1991	$ 93,402		1972-1991	$ 99,851	*
1973-1992	$ 82,886	1973-1992	$ 86,685		1973-1992	$ 90,464	*
1974-1993	$107,514	1974-1993	$116,387		1974-1993	$127,470	*
1975-1994	$139,718	1975-1994	$162,642		1975-1994	$197,433	*
1976-1995	$148,438	1976-1995	$170,697		1976-1995	$204,080	*
1977-1996	$145,107	1977-1996	$169,147		1977-1996	$205,723	*
1978-1997	$202,208	1978-1997	$246,963		1978-1997	$319,265	*
1979-1998	$254,108	1979-1998	$316,463		1979-1998	$419,546	*
1980-1999	$280,673	1980-1999	$353,607		1980-1999	$475,616	*
1981-2000	$243,566	1981-2000	$286,154		1981-2000	$350,618	*
1982-2001	$247,563	1982-2001	$287,503		1982-2001	$346,521	*
1983-2002	$179,269	1983-2002	$196,650		1983-2002	$218,027	*
1984-2003	$184,377	1984-2003	$204,354		1984-2003	$229,406	*
1985-2004	$184,118	1985-2004	$208,787		1985-2004	$241,616	*
1986-2005	$148,244	1986-2005	$166,562		1086-2005	$190,436	*
1986-2006	$137,940	1986-2006	$157,012		1986-2006	$182,571	*

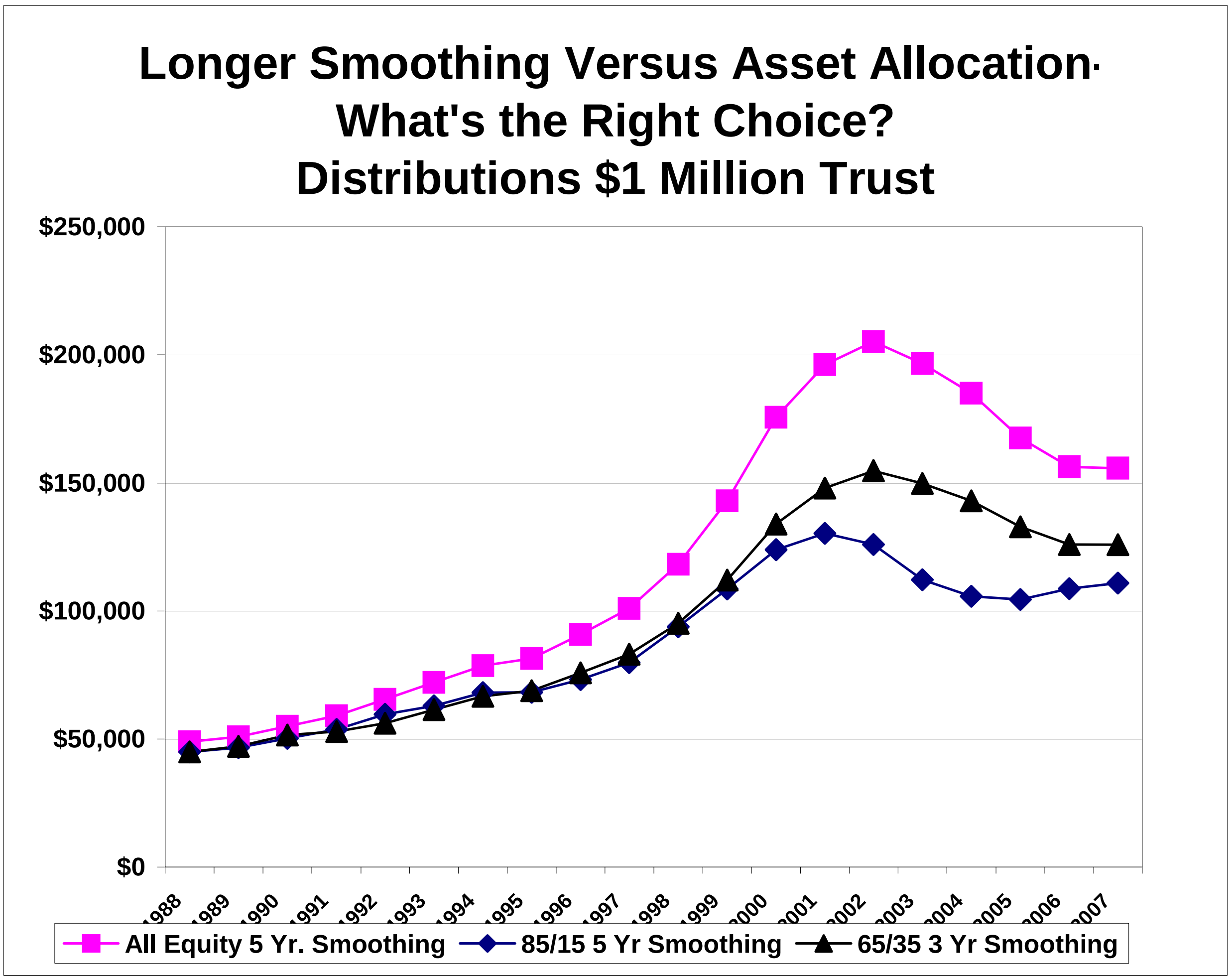
The differences are dramatic indeed. The balanced portfolio is a “winner” only 3 times out of 59 twenty-year periods, the 80/20 only 5 wins and the 100% equity a winner in 54 of the periods, a full 87% of the time. And the average values expected are very different, with the all-equity portfolio having a 57% edge over the conservative portfolio. Over the average twenty year period, this is a very large edge indeed.

Perhaps the most impressive statistic, however, is the fact that the worst case scenario for all twenty-year periods *is the worst for the most conservative portfolio*.

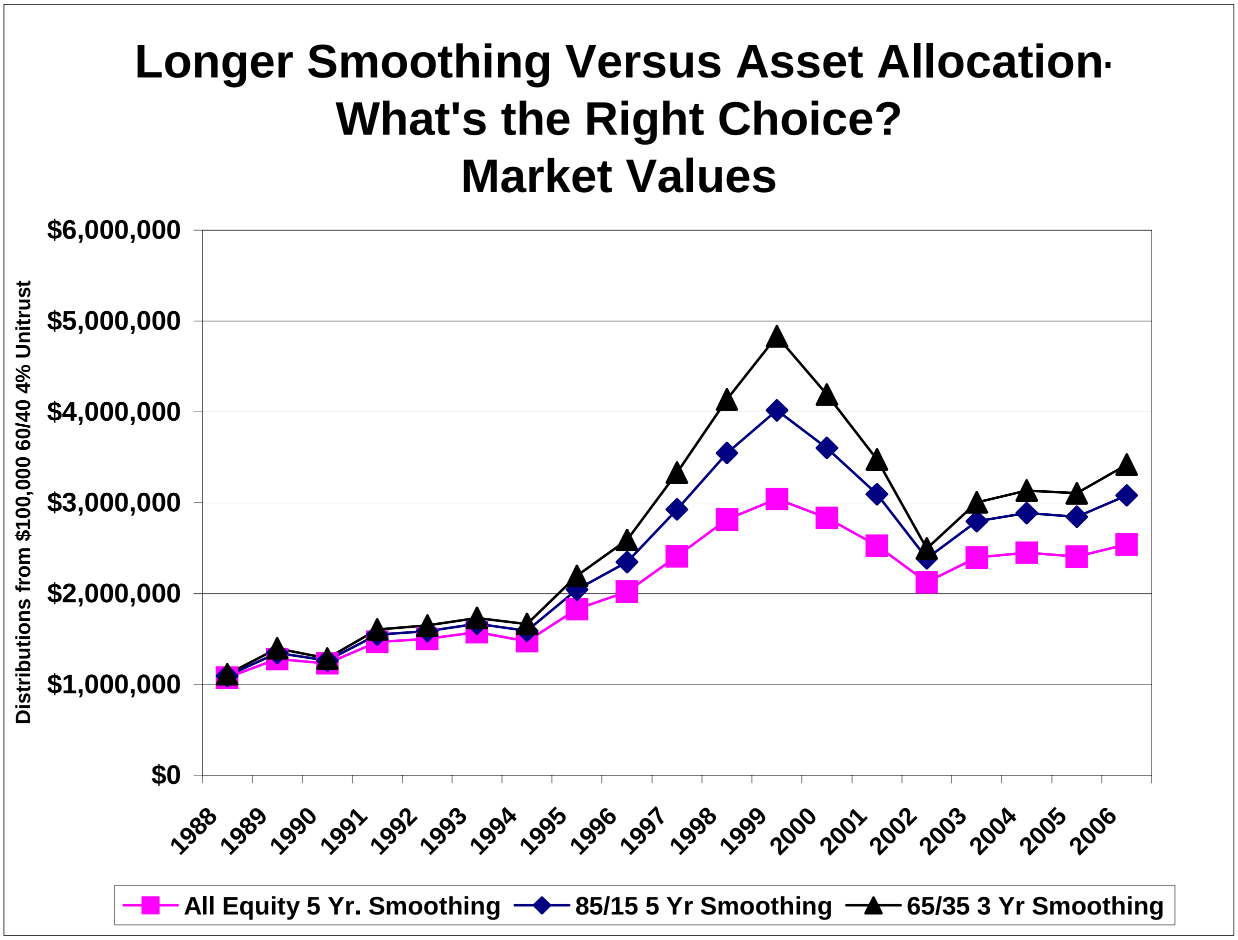
Why, then, do we eschew the aggressive portfolio almost all of the time? It is of course the short term ride and volatility that we fear, and of course the possibility that at some time in the future the equity returns will be awful for a period as long or longer than twenty years. It just hasn’t happened yet, or more accurately, the results for the more conservative portfolio were equally or more awful for the same period.

But for the charitable trust that is perpetual, so that the investment horizon is as long as it gets, should not the long term results be the prize on which we fix our eyes?

Even if the long term results tell us to be more aggressive, we must be concerned not just with the destination, but the "ride" also. What of the volatility in the portfolio value throughout these long term periods? That of course is vitally important to the charitable trustee and the charitable beneficiary, but is it the market value of the portfolio, or the distribution, with which we should be concerned? And if it is the distribution, then we ought to consider a longer smoothing rule as a better answer than a more conservative asset allocation. This conclusion is even more evident than in the typical private taxable trust. Let's take a look at the latest 20 year period from 1988-2007 comparing a 65/35, an 85/15 and a 100% equity charitable trust paying our 4.5% per year, with the 65/35 trust using the conventional 3 year averaging rule and the 85/15 and the 100% equity trust using the 5 year averaging convention.

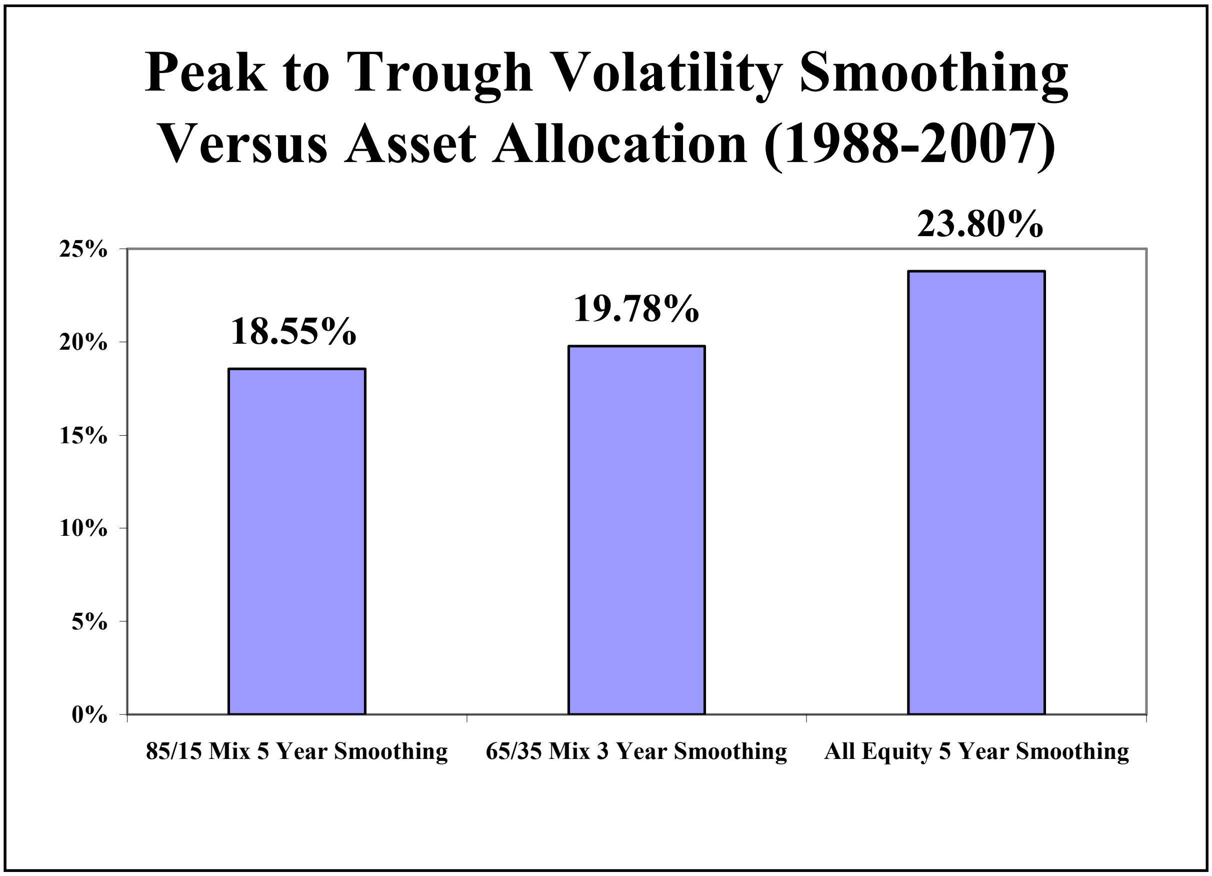


During this most volatile period for the stock market since the period 1926 through 1933, the use of the five year smoothing rule illustrates its value. The bottom line showing the traditional 65/35 asset allocation shows to the eye as great or greater volatility than the 85/15 asset allocation, and not so very much different from the all equity trust that is distributing much more money all along the way. Of course, the market values of the portfolios show the investment volatility.

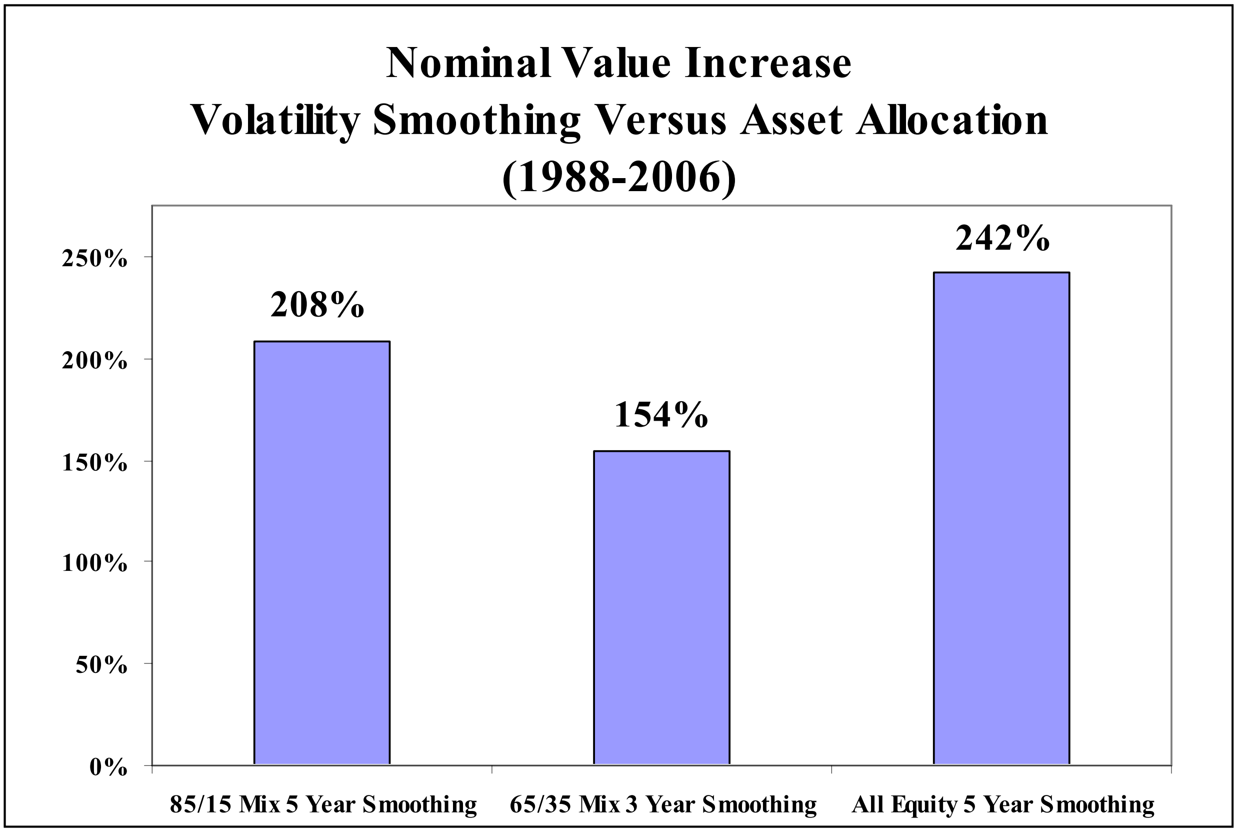


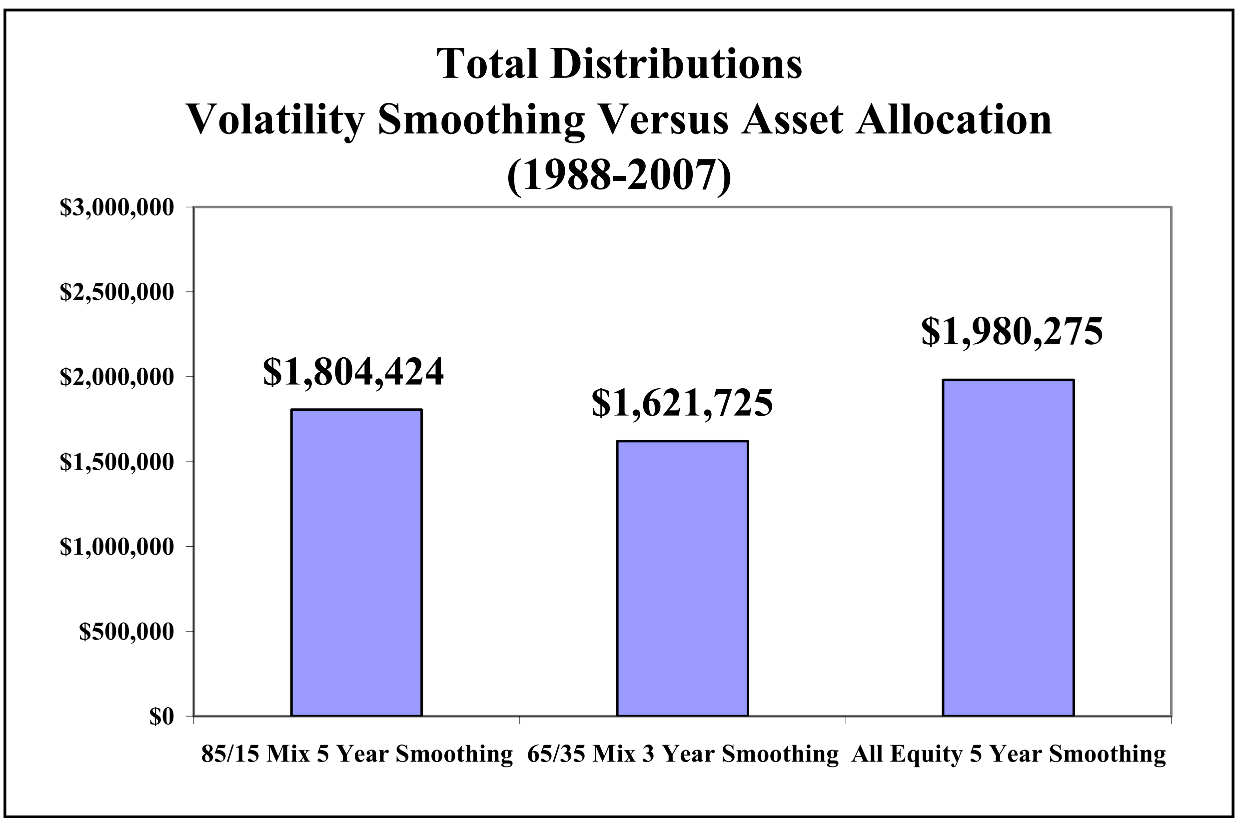
Longer Smoothing Versus Asset Allocation·
What's the Right Choice?
Market Values
Distributions from $100,000 60/40 4% Unitrust
$6,000,000
$5,000,000
$4,000,000
$3,000,000
$2,000,000
$1,000,000
$0
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
All Equity 5 Yr. Smoothing
85/15 5 Yr Smoothing
65/35 3 Yr Smoothing

So if the trustee and the beneficiary are the nervous type, they would have seen lots of ups and downs during the period, particularly with the all equity portfolio, but the impact on the charitable beneficiary is another matter. What impacts the beneficiary of the perpetual charitable trust is not the market value of the trust portfolio with its periodic ups and downs, but rather the quality, sustainability and volatility of the income stream the portfolio produces. And the most important measure of that volatility is not the upside volatility, but the downside volatility. It is the peak to trough decline in the distributions which would matter the most to our charitable beneficiary, so let's compare them.



Predictably, the all equity portfolio shows the highest peak to trough decline of the three portfolios, but the surprising thing is that the 85/15 portfolio shows a slightly smaller decline than the 65/35 portfolio, so that the more aggressive portfolio not only made more money for the short term and the long term, but also had the lower volatility to the charitable beneficiary by virtue of using the longer five year smoothing period. Let's look at the difference in the market values and total distributions over the twenty year period.


Nominal Value Increase
Volatility Smoothing Versus Asset Allocation
(1988-2006)
250%
200%
150%
100%
50%
0%
208%
154%
242%
85/15 Mix 5 Year Smoothing
65/35 Mix 3 Year Smoothing
All Equity 5 Year Smoothing


Total Distributions
Volatility Smoothing Versus Asset Allocation
(1988-2007)
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0
$1,804,424
$1,621,725
$1,980,275
85/15 Mix 5 Year Smoothing
65/35 Mix 3 Year Smoothing
All Equity 5 Year Smoothing

The ending market value shows a 54% greater increase in market value for the 85/15 portfolio over the 65/35 portfolio. Over only a 20 year period, that is a tremendous differential. But to be clear, the ending market value of the 85/15 trust is 21.3% more than the more conservative 65/25 portfolio. The income stream over that period is also much improved, but much less so, with an 11% increase over the more conservative approach. The income stream is less affected in the aggregate because it is received over the entire time period, while the ending market value is measured, by definition, at the end, so the difference at the end benefits from the compounding. Over the entire 1926-2006 period, the difference is over 208%, and we are talking about a perpetual charitable trust after all!

It is particularly important for a charitable trust that is perpetual to look at the question of volatility based upon the way in which that volatility matters to the beneficiary. Volatility in the market value of the trust portfolio may matter to the charitable beneficiary only insofar as it affects the charitable beneficiary's distribution, which is based upon that market value if a unitrust distribution method is used. Once the volatility in the distribution is recognized as the paramount issue, it is clear that the volatility of the distributions should be addressed using smoothing techniques first, rather than moderating the trust portfolio's asset allocation, which in the long run takes away much of the benefit of being able to invest for total return.

E. INCLUDING CAPITAL GAINS IN A TRU PAYOUT—DOES IT REALLY MATTER?

There are both fundamental and tax-specific reasons for including capital gains in distributable net income or "DNI" for a trust which is operating as a unitrust. The foundational premise of a total return unitrust is that the income beneficiary has the right and obligation to share in capital gains taxes if the income beneficiary is going to profit from the capital appreciation produced by total return investing in the trust portfolio. But of course there is no one-to-one relationship of the payout from a unitrust and the capital gains recognized during a particular year. The TRU payout varies with market value, not with capital gains recognized, which is the reason the tax rules had to be changed in order allow the capital gains to be included in DNI. Mutual fund shareholders will well recall the capital gains they recognized, but did not enjoy, in the years 2000 and 2001, while the gains of the 1990s were recognized in an attempt to avoid the pain of the early 2000s. And the same is true for the power to adjust in that the power to adjust is the power to adjust between principal and income: not between capital gains and income.

Because an "income" beneficiary is accustomed to paying tax on most of what the beneficiary receives, it is no particular hardship on the beneficiary to pass capital gains taxation along to the beneficiary to the extent that the beneficiary receives more than traditional DNI. So the idea that the TRU beneficiary receives a dollop of capital gains with his or her distribution is quite consistent both with the conduit principle of taxation and with common sense.

Importantly, if the trust does not have offsetting capital losses and the beneficiary does have offsetting capital losses, including the capital gain in DNI is the only way the beneficiary's capital loss may be used to offset the trust capital gain. In a particular trust situation, this may be quite compelling.

But in the ordinary trust situation, if there is a choice between including capital gain from the trust in the DNI of a unitrust, how much difference does it make to the prudence of a particular level of payout?

This particular issue is difficult to examine on an historical basis, simply because our current very low dividend rates are of such relatively recent vintage. If one were to take the entire Ibbotson period from 1926 to 2006 into account, the average dividend yield over all of those years is 4.21%. As a result, modeling a 4% payout for that period will not give a fair reflection of the issue going forward, since the capital gains for most of those years would be taxed in the trust anyway because of the relatively high dividend yield. One could examine the issue historically, but one would have to isolate a very recent period to do it, such as from 1990 to 2006.

One way to look at this would be to examine the payout rates of a unitrust which produce equivalent ending fair market values of the trust with the capital gains in or out of DNI. Each modeling has a number of variables, and for this purpose, we will employ what has been considered our "standard assumptions"[175] with an 80% equities and 20% fixed income portfolio, and a turnover rate of 5%, roughly equivalent to an S & P 500 Index Fund. We have also assumed that the trust portfolio started with a cost basis equivalent to its starting value, as is the usual case with an estate or a revocable living trust at the settlor's death.

Included in DNI	Not Included in DNI
3.0%	2.76%
4.0%	3.59%
5.0%	4.45%
6.0%	5.34%

Quite clearly, the higher the rate of payout, the more difference it makes to put the capital gains in DNI. Now this makes perfect sense, because the higher rates of payout will allow more of the capital gains to flow to the TRU beneficiary. With the lower rate of 3%, the dividend income is close enough to the payout plus expenses and taxes paid so that the proportion of the capital gains paid out to the beneficiary is relatively small, while with the 6% payout, it is more than the dividend and income produced during many of the years measured, and as a result, the difference is much greater with the larger payout. The 3% payout only shows a 24 basis point difference, while with a 6% payout, it swells to 66 basis points.

[175] 1% expenses per year, ordinary income tax rate 38%, capital gains tax rate 22%, cost of turnover, ½% for each purchase and sale; equity portfolio is the S & P 500 Index; fixed income portfolio is the Intermediate Government Bond Index.

These results are starting with a cost basis equal to the starting market value. But what if we begin with a basis in the trust in which the equity portion of the portfolio has appreciated ten times from its initial fair market value? How much difference will that make in the end?

Low Basis	Low Basis
Included in DNI	Not Included in DNI
3.0%	2.74% (difference 2 basis more)
4.0%	3.56% (difference 3 basis more)
5.0%	4.35% (difference 10 basis more)
6.0%	5.15% (difference 19 basis more)

At first one is surprised at the modest difference the much lower cost basis makes to our comparison, but it is not that the 10 cent on the dollar cost basis does not matter. It is just that it does not matter so much relative to the DNI inclusion in the TRU payout because during this period of time, there were sufficient capital gains incurred even starting the period with a high cost basis to "fill up" the TRU payout most of the time. As a result, the addition of lots of capital gains inside the trust by lowering the cost basis doesn't matter much to this comparison. However, the difference to the trust of lower cost basis is far more than the matter of where a portion of the capital gain is taxed. Even if capital gains are included in DNI to the extent possible, the high cost basis versus low cost basis matters a lot.

High Cost Basis	Low Cost Basis
3.0%	2.35% (65 basis less)
4.0%	3.38% (62 basis less)
5.0%	4.40% (60 basis less)
6.0%	5.46% (54 basis less)

What if we were to employ a higher turnover rate, such as 25%, plus a low cost basis to the equation? How much difference would the DNI inclusion be for this period?

Low Cost Basis and Higher Turnover Analysis

Included in DNI	Not Included in DNI
3.0%	2.84%
4.0%	3.71%
5.0%	4.57%
6.0%	5.43%

These results, which are very close to the same as those with low turnover starting with a current cost basis, are puzzling, simply because one would expect that the lower cost basis and high turnover to be a double whammy against the trust so that the inclusion of capital gains in DNI should be even more critical than with more benign and tax efficient assumptions. Is this result for the period from 1990 to 2006 representative, or is it because of the particular path of returns during this particular period?

In order to check this, we will construct a hypothetical historical path that should test out these results using more markets, and thus more paths. We will take the Ibbotson period since 1926, and then subtract 2% from the dividend yield for all of those years, but with a "floor" of 1%. Then we will try out all of the 20-year periods in this modified history and see whether this phenomenon persists.

All "Modified History" 20-Year Periods

Low Cost Basis and Higher (25%) Turnover

Included in DNI	Not Included in DNI
3.0%	2.78%
4.0%	3.62%
5.0%	4.45%
6.0%	5.27%

All "Modified History" 20-Year Periods

Current Cost Basis and Lower (5%) Turnover

Included in DNI	Not Included in DNI
3.0%	2.80% (2 basis more)
4.0%	3.68% (6 basis more)
5.0%	4.56% (11 basis more)
6.0%	5.42% (15 basis more)

Three conclusions come from this study. First, and not surprisingly, the difference that it makes to have capital gains included in DNI is significant, and for higher payout rates, it is substantial, Second, the difference it makes does not seem to depend very much upon the turnover and cost basis in a portfolio. Third, the period from 1990 to 2006 was not representative of the effect of low cost basis and higher turnover. For most periods in history, a low cost basis and higher turnover portfolio will make the inclusion of capital gains in DNI more important, but not a lot more important, particularly when examining payouts in the desirable 3-4% range. Now that is a good thing because it allows us to generalize as to the relative impact of including DNI in income, at least for a fairly standard 4% TRU with an 80% equity and 20% fixed income portfolio.

The bottom line conclusion is that if you practice in a state with a unitrust statute without an ordering rule, or if you use the power to adjust and do not believe that you can allocate capital gains into DNI, then the amount you can distribute as income is less than if the capital gains were includible in DNI, and the larger the split between the traditional "income" earned in your trust portfolio and the total return distribution being made, the more adjustment is needed for this factor. In other words, whether 4% is a fair and prudent distribution rate depends upon many factors, principally asset allocation, expenses, tax rates, cost basis and turnover, but also how the taxes are allocated between the trust and the beneficiary. If the beneficiary helps to pay the capital gains tax, it allows a prudent trustee to pay out more than they otherwise could.

F. TURNOVER—STILL A BIG DEAL, EVEN AT TODAY'S LOW LONG-TERM CAPITAL GAINS RATES

We have isolated very fine planning differences in the last section as to the inclusion in DNI of capital gains. And we were surprised to find out that the adjustment for this factor did not change much depending upon the cost basis of the portfolio and the rate of turnover. However, it would be a very big mistake to conclude that cost basis and turnover are not a critical determinant in how much we can spend over time from a trust portfolio. In fact, they are a very big deal, and they are a very big deal even with our very low current tax rates applicable to capital gains.

LONG TERM VALUES DRAMATICALLY AFFECTED

If we were to compare an index-like 5% to a 30% turnover rate, mimicking a modestly active managed portfolio, from 1926 through 2006, a $100,000 all-equity portfolio paying out 5% with a five-year smoothing rule and 30% turnover would have grown to $1,113,139. While this sounds pretty good, it is 42% less than the identical model with a 5% turnover, which shows an ending value of $1,932,370. At 60% turnover, paying out 5% leaves the trust with an ending market value of $800,136, 59% less than the 5% turnover model. Over shorter periods of time, the results are only slightly less striking. From 1960 through 2005, with 30% turnover in the portfolio, the model ends with a market value of $428,280, versus $629,133 with a 5% turnover. At 60% turnover, the ending market value falls to $345,325.

Table 7 compares the distributions and market values using turnover rates of 5%, 30%, and 60% for a 5% total return unitrust with an all-equity portfolio for the period 1973 to 2006.

TABLE 7

COMPARISON OF 5% UNITRUST PAYOUT FOR THE PERIOD 1973-2006
ILLUSTRATING 5%, 30%, AND 60% TURNOVER–100% EQUITY PORTFOLIO
TURNOVER INCREASES TAXES AND DECREASES RETURNS

Year	5% Turnover Distribution	5% Turnover Market Value	30% Turnover Distribution	30% Turnover Market Value	60% Turnover Distribution	60% Turnover Market Value
Dec 1973	5,000	79,433	5,000	79,226	5,000	78,979
Dec 1974	4,486	53,437	4,481	53,152	4,474	52,811
Dec 1975	3,881	68,707	3,873	68,154	3,863	67,493
Dec 1976	3,360	80,781	3,342	79,918	3,321	78,891
Dec 1977	3,382	70,744	3,354	69,803	3,320	68,687
Dec 1978	3,671	70,848	3,631	69,720	3,585	68,385
Dec 1979	3,706	79,158	3,657	77,692	3,599	75,962
Dec 1980	3,679	99,572	3,620	97,474	3,551	95,007
Dec 1981	4,160	89,538	4,081	87,425	3,989	84,948
Dec 1982	4,471	102,258	4,377	99,583	4,265	96,456
Dec 1983	4,856	119,089	4,741	115,669	4,607	111,645
Dec 1984	5,181	119,737	5,045	114,885	4,884	108,963
Dec 1985	5,685	150,421	5,502	142,279	5,284	134,791
Dec 1986	6,487	169,835	6,214	157,007	5,923	146,796
Dec 1987	7,333	169,646	6,903	153,742	6,509	142,475
Dec 1988	8,165	187,080	7,550	167,262	7,068	155,269
Dec 1989	8,776	233,437	7,967	205,904	7,409	190,488
Dec 1990	9,836	212,403	8,782	183,666	8,137	167,661
Dec 1991	10,549	262,299	9,281	224,822	8,557	206,654
Dec 1992	11,802	265,760	10,240	224,176	9,413	203,926
Dec 1993	12,341	275,350	10,544	229,629	9,637	208,721
Dec 1994	13,390	261,208	11,310	215,856	10,322	196,136
Dec 1995	13,372	340,365	11,161	280,646	10,146	255,028
Dec 1996	14,615	397,342	12,102	322,583	10,998	288,491
Dec 1997	16,649	504,520	13,651	402,264	12,328	355,325
Dec 1998	20,704	616,578	16,758	480,532	14,981	417,868
Dec 1999	25,307	707,510	20,090	538,255	17,695	461,942
Dec 2000	30,477	600,373	23,684	446,536	20,586	380,202
Dec 2001	32,074	487,421	24,422	360,737	21,000	308,223
Dec 2002	29,922	344,180	22,425	254,480	19,173	216,713
Dec 2003	23,866	414,230	17,676	305,420	15,086	259,256
Dec 2004	20,764	433,009	15,344	318,760	13,070	269,687

Dec 2005	19,857	428,449	14,644	315,311	12,428	265,898
Dec 2006	21,261	468,351	15,658	344,646	13,247	289,686
Negative Changes		9		9		10
Negative Changes > 10%		5		5		5

Even a 30% turnover rate makes a lot of difference in result unless the returns in excess of the general market exceed the "drag" of the turnover. And it is a lot of drag, with our low turnover model sporting 36% more than the 30% turnover results over a moderately long period and 62% more than the 60% version.

An even more revealing way to look at the difference is to compare what a trustee can afford to distribute from a trust annually at different turnover rates and still have the same market value of the trust at the end of a long period such as from 1973 to 2006!

EQUIVALENT PAYOUT TO MATCH ENDING MARKET VALUES WITH DIFFERING TURNOVER RATES (100% EQUITIES) (1973-2006)

	5%	30%	60%
Payout equivalents	5%	4.0%	3.4%
	4%	2.9%	2.2%
	3%	1.8%	1.0%

The foregoing tables were compiled using a combined federal and state capital gains rate of 22%. Let us do the same analysis using the present highly favorable lower 15% federal rate on capital gains and qualified dividends and a 3% state tax rate to see how much difference it might make.

EQUIVALENT PAYOUT TO MATCH ENDING MARKET VALUES WITH DIFFERING TURNOVER RATES (100% EQUITIES) (1973-2006)

CURRENT LOW RATES ON QUALIFIED DIVIDENDS AND CAPITAL GAINS

	5%	30%	60%
Payout equivalents	5%	4.1%	3.6%
	4%	3.1%	2.5%
	3%	2.1%	1.5%

Now it might be surprising that the low current rates on capital gains and qualified dividends do not seem to make as much difference as one would think in this analysis, but the majority of the benefit of the lower rate for qualified dividends and capital gains goes out to the income beneficiary, particularly if capital gain is included in DNI. This effect was examined in detail earlier in this article.

Now the really diligent and curious reader might say—how much of that differential is due to turnover costs and how much is the pure tax effect? The results above reflect a ½ of 1% cost of buying and selling, which would likely be very low for retail and very high for an institutional rate. So let us assume that in the present low tax environment on capital gains and qualified dividends there were no turnover costs at all except the taxes. How much does turnover cost then in a very low tax rate and perfect institutional trading world?

EQUIVALENT PAYOUT TO MATCH ENDING MARKET VALUES WITH DIFFERING TURNOVER RATES (100% EQUITIES) (1973-2006)

PRESENT LOW RATES-18% COMBINED RATE FOR CAPITAL GAINS AND QUALIFIED DIVIDENDS AND NO TURNOVER COSTS!

	5%	30%	60%
Payout equivalents	5%	4.4%	4.1%
	4%	3.3%	3.1%
	3%	2.3%	2.1%

It costs a lot.

All of these statistics assume we begin with a tax cost basis equivalent to market value, as in an estate under the current tax regime. But what will happen if we were to make the cost of the portfolio 10% of current market value, reflecting a long term equity portfolio that is just now beginning to distribute based upon total return principles, and as a part of that changeover, is considering much more active management.

EQUIVALENT PAYOUT TO MATCH ENDING MARKET VALUES WITH DIFFERING TURNOVER RATES (100% EQUITIES) (1973-2006)

PRESENT LOW TAX RATES-HIGHLY APPRECIATED PORTFOLIO-NO TURNOVER COSTS!

	5%	30%	60%
Payout equivalents	5%	4.0%	3.8%
	4%	3.0%	2.7%
	3%	1.9%	1.7%

So even with historically low tax rates going for it, and even with no turnover costs, which is never the case, turnover is a really big problem that may very likely keep us from reaching our goal of market value preservation unless the income beneficiary is willing to accept a lot less money to subsidize our proclivity for more active management. Particularly at the lower distribution rates, the income "diet" necessary to support our turnover habit is too severe for most income beneficiaries to accept if they were to be given the payout rate choices indicated by the foregoing research.

Imagine giving an income beneficiary the choice of either receiving $150,000 per year from a low turnover (5%) $5,000,000 trust portfolio or $85,000 per year from a high (60%) turnover portfolio. The high turnover portfolio must produce 1.3% higher return per year in and year out in order to make this problem go away, and remember this is with *no turnover cost (which is never the case) and with the lowest capital gains tax rates in history.*

Given the amount of difference this level of turnover causes in net returns, one would think that a mutual fund with turnover of 60% would be the exception. However this is not the case. The average mutual fund portfolio turnover in 1997 was 85%.[176] How could it be that something so important would be as neglected an issue as the tax effect from this amount of turnover? John Bogle suggests an answer:

> The tax issue is the black sheep of the mutual fund industry. Like a cousin who can't get their life together or an uncle who drinks too much, taxes are kept out of sight and out of mind. But investors cannot afford to turn a blind eye to this issue. For it is the fund shareholder who pays the taxes on a mutual fund's income dividends and on any capital gain distributions generated by the fund's constant staccato of portfolio sales, and - at least in the recent bounteous bull market - by the realization of enormous taxable capital gains. The dichotomy is that a portfolio manager's performance is measured and applauded on the basis of *pre-tax* return - never mind that the Internal Revenue Service confiscates a healthy share of it. Few portfolio managers spend their time agonizing over the tax consequences of their decisions.[177]

Worse yet, my computer modeling above assumes that investment management would take taxes into account at least to the extent that all of the capital gains are long term. Actually, about one-third of the fund gains are realized on a short-term basis, which would of course make the effects even greater.[178] In the present tax environment, where short-term gains are taxed at the maximum tax rate of the trust, and long-term gains are taxed at 15%, short term gains should be anathema to the professional investor in a taxable trust. Unfortunately, this is not yet the case.

So turnover counts a great deal in being able to afford to spend a reasonable amount on the income beneficiary and still have a sensible chance of preserving real after-tax, after-inflation value both to support the income beneficiary in the long run and the remainder beneficiaries. It is inadequately considered by most trustees and investment advisors.

Of course a large portion of all of the financial investments in the United States today are in tax-sheltered vehicles, particularly in retirement accounts or IRAs and for the most part the tax-free vehicles are not invested any differently from the taxable trust in terms of equity management. This should not be true. There should be a great deal more tax sensitivity in the

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[176] John C. Bogle, COMMON SENSE ON MUTUAL FUNDS: NEW IMPERATIVES FOR THE INTELLIGENT INVESTOR, 26 (1999)("COMMON SENSE").
[177] *Id.* at 279.
[178] *Id.* at 284-85.

taxable trust and in private taxable portfolios, and the investment products should be matched to the tax characteristics of their containers.

For example, if one made the investment decision to own an equal amount of the Vanguard Total International Fund, with a turnover of 2%, and the Fidelity Diversified International Fund, with a turnover of 59%, it would make the most sense to own all of the Vanguard Fund in your taxable trust and all of the Fidelity Fund in the IRA, as opposed to owning one-half in each vehicle. The total return from owning both funds would be the same, but the taxes would be significantly reduced if we match the investment product to the tax characteristics of its container. In December of 2006, the shareholders of Fidelity Diversified International Fund (including the author) were treated to a capital gains distribution of $2.51 per share, a payout of 6.38% of the fund, and a tax, even at 18% combined federal and state income tax rate of 1.15% of the total value of the fund. The Vanguard Total International Index Fund, on the other hand, distributed no capital gains to its shareholders in 2006, just as it paid no capital gains distributions for 2002, 2003, 2004 or 2005. So while the Fidelity Fund had a total return of 22.5% for 2006, shareholders didn't get to keep all of it, while the gain in value from the Vanguard Fund, with a total return of 26.6% in 2006 was entirely non taxable with the exception of the modest tax on the dividend yield of 2.38% for 2006. So while the fund had a total return of 26.6% in 2006, the taxes a shareholder paid were about 43 basis points. Not much in anybody's book! And this is perhaps a good place to note that some funds and some managers *may* do well enough to justify the added costs and expenses of the turnover. In this particular comparison, the Fidelity Fund over the last ten years has done better than the Vanguard Fund even after the tax effects. Over the ten years ending August 17, 2007, the Fidelity Fund outpaced the Vanguard Fund 12.37% to 7.52%. But selection of comparison periods make a difference too. Over the last five years the Fidelity Fund edged out the Vanguard Fund by 19.41% to 19.28%, essentially a draw, while over the last three years, the Vanguard Fund edged out the Fidelity Fund at 22.42% to 21.10% annual return.[179]

So there are good reasons to diversify trust investments into different asset classes and styles as well as to consider both active and passive investment styles, and where active management is employed, to diversify among managers too! International funds have more factors that affect their performance so that the variation in total return may dwarf the tax effects. This is far less likely to be the case for the large capitalization U.S. market, where the efficiency of the market is the greatest and the task of outperforming the indices is the most challenging. While a thorough debate of active versus passive investing in the most efficient market segments should be left to other writers with appropriate credentials, it is important for the prudent trustee to consider both active and passive investment styles, particularly in the taxable private trust, and particularly in light of the explosion of exchange traded index investment vehicles particularly in the past five years. Suffice it to say that the costs and tax effects as well as the risks and benefits of active management should be considered carefully by prudent trustees and decisions reached thoughtfully. Trustees should be prepared to answer for any increased costs, including taxes, as a result of higher levels of activity (and therefore taxes and expenses) in their trust investments.

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[179] The foregoing total return statistics were taken from on line Morningstar sources, while the turnover and distribution statistics were taken from the appropriate Vanguard and Fidelity prospectuses.

G. POWERFUL ARGUMENTS FAVOR INDEXING FOR TRUST PORTFOLIOS

1. Active Management is a Zero Sum Game - Index Funds Will Always be Above Average

In order to properly understand the compelling logic and mathematics involved in index fund investing, or as John C. Bogle puts it, the "the relentless rules of humble arithmetic,"[180] one's attention is directed first to the aggregate gross returns of active and passive investors. In order to examine a particular market such as the market of the S&P 500 or the Wilshire 5000, we divide the market participants into two groups, those who invest in index funds and those who do not. These "non-indexers" we will call active managers of the funds, though this group will contain investors whose investment habits are quite different. There are the professional investors, which would include the overwhelming majority of the mutual fund industry. There are also the individual investors who may invest haphazardly and/or occasionally.

Clearly, the gross return earned by the index fund investors as a group will equal the market rate of return - no less and no more except to the extent of any "tracking error" in the index fund. Active managers will vary from the norm - some earning a higher rate of return than the market return and some earning a below-market return. But in the aggregate, the "active managers" will also earn the average market return. This is so because subtracting the index fund investors from the market will leave an equivalent market return for the remaining participants.

So without considering management costs and the costs of buying and selling, and without considering the costs of capital gains taxes, active management on average will always equal the average market return in the market in which the active managers participate.[181] However, since the active managers incur additional costs, both in management and in brokerage costs and in capital gains taxes, actively managed funds *in the aggregate* will always be below the market averages by the amount of their additional costs and the substantial taxes discussed previously which are generated by active management. As a result - practically as well as theoretically -an index fund is like the hypothetical children who live in Lake Woebegone. They are, *and they must be,* all above average!

But note in this connection that this is true, and it is only necessarily true, if the index fund investor invests not only in the same companies as represented in the index, but that she invests in the same proportion as the indices are invested, which are generally based upon market capitalization. Of the primary indices that are watched on a daily basis, only the Dow Jones Industrial Average is not capitalization weighted. By weighting the indices by market

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[180] John C. Bogle, THE LITTLE BOOK OF COMMON SENSE INVESTING, 38 (quoting from Louis Brandeis' OTHER PEOPLE'S MONEY(1914) (John Wiley & Sons, Inc. 2007)("LITTLE BOOK").

[181] If the index investors own a representative share of the market, then the non-index investors must also own a representative share of the market, since the subtraction of the index fund portfolio will not vary the composition of the remainder of the portfolio. Now this logic is not absolutely tight, in that there are portfolios which are not indexed or actively managed and one can argue that it is these portfolios which underperform, but the fact that most mutual funds do underperform the averages most of the time closes the noose.

capitalization, we are insuring that they represent the results of the average investor's dollar, though this method of indexing and benchmarking has been heavily criticized as overemphasizing the megacapitalization companies, particularly during the period of extraordinary up and down volatility from 1995 to 2007, where the megacaps led the charge up the hill and down the hill again.

Whether we like market capitalization indices or we do not, investing in a very low cost index fund that is capitalization weighted is the only method that essentially guarantees that our funds, and our trust funds will earn more after taxes and expenses than the average investor's dollar in the companies represented by that particular index. As we will discuss a little later, new ideas in indexing, such as equal weighting of the companies or the newest trends in "fundamental indexing," in which the weightings of the companies in the index are selected by the amount of their dividends or their earnings or other fundamental economic factors, and not by the investor's dollar, may or may not produce a higher return, or a higher risk-adjusted return, but their performance will not *necessarily* be above average, like those Lake Woebegone children. The net return of the traditional index fund investor, on the other hand, will always be above average.

2. *Empirical Studies Document Conclusively That Index Funds Generally Outperform Actively Managed Equity Mutual Funds*

The concept of the superiority of investing in the market itself to active management goes back a long time.[182] But studies of the actual performance of funds over the past few decades are particularly compelling. Anyone taking a serious look at the question today must read John Bogle's book, Common Sense on Mutual Funds, [183] Burton G. Malkiel's seminal work *A Random Walk Down Wall Street*[184] and Scott Simon's book devoted exclusively to index mutual funds.[185] These three books collectively examine the theory and practice of indexing versus every other method of investing: active mutual funds, selecting funds by Morningstar, technical analysis, newsletters, the folly of market timing and other specific issues related to indexing.

And for those less inclined to the long and technical, John Bogle gives us a break in his most recent book, "The Little Book of Common Sense Investing,"[186] which gives us the statistics, the arguments and a wealth of expert support for the use of index funds, but without the mathematics and without the footnote references most of which are available on his website.

But the most persuasive argument that index funds outperform their mutual fund counterparts is simply the historical record. The S&P 500 index has outperformed equity mutual funds for periods ending December 31, 1997 for five years, ten, fifteen, twenty, twenty-five, thirty, forty and fifty years. While the over performance of 5% *per year* over the last five years of that period is the highest differential, the most impressive figure is the fifteen-year period from December 31, 1982 through December 31, 1997 in which the S&P 500 index averaged

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[182] Perhaps to an article by Charles D. Ellis, Managing Partner of Greenwich Associates entitled *The Losers Game, Financial Analysts Journal* (July/August 1975).
[183] BOGLE, COMMON SENSE *supra* n. 176.
[184] Burton G. Malkiel, *A Random Walk Down Wall Street (1990).*
[185] W. Scott Simon, *Index Mutual Funds, Profiting From an Investment Revolution* (Namborn Publishing Co. 1998).
[186] BOGLE, LITTLE BOOK *supra* n. 180.

17.2% and the average equity mutual fund averaged 13.2%.[187] If we were to measure growth and value funds versus the broader Wilshire 5000 Index over the period of fifteen years ending June 30, 1998, we have a closer contest with the average fund net return of 14.1% while the index averaged 16.0%.[188] But that still allowed only 33 of 200 funds to beat the index.

But what about the recent bear market, surely a fierce bear market will show them indexers! Surely when things are going badly, the mindless index fund will falter badly or somehow fall apart. But that has not proven to be the case. The Vanguard 500 Index fund did underperform its peers in the year 2000, placing itself in the 61st percentile in 2000, but mostly it is above average, just as it must be over time. For example it is above average as I write this on August 18, 2007 for the last day, week, month, 3 month, year to date, 1 year, 3 year, 5 year and 10 year periods.

Virtually all of the advantage can be explained by the differential in costs and expenses of the actively managed fund. If we added back in these dollars that disappear into the pockets of others, the returns would be virtually equivalent.[189] And these figures do not take into effect the additional substantial effect of taxes on an actively managed portfolio. The rate of return of an S&P 500 index fund versus the average mutual fund for the ten-year period ended June 30, 1998 would have given the index fund the advantage of 3.3% before taxes, but 4.2% after taxes.[190] **Looked at another way, if one could afford to pay out 5% from a trust and have a reasonable prospect of keeping up with inflation, the loss of 4.2% would allow one to pay out only .8% diminishing the trust beneficiary's income by 84%!**

The consistency by which most mutual funds underperform their benchmark is really pretty amazing, or rather, discouraging. Morgan Stanley in its most recent quarterly report on exchange-traded funds published the following table:

Open-end Funds that Underperformed Benchmark*

	Value	Blend	Growth
Large	91%	81%	56%
Medium	94%	62%	53%
Small	79%	63%	57%

Based upon Lipper data for the past 10 years, ending December 31, 2006. MSCI Indices were used for comparisons. Sources: Lipper, MSCI, Vanguard.[191]

187 BOGLE, COMMON SENSE *supra* n. 176, at 112, Table 5.1.
188 *Id.* at 125, Figure 5.5.
189 *Id.* at 126, Figure 5.6.
190 *Id.* at 286, Table 13.1.
191 Paul J. Mazzilli and Dominic Maister, Morgan Stanley Exchange-Traded Funds Quarterly Report, 14, May 15, 2007

From 1980 to 2005, the average equity mutual fund had a total return of 10% while the S & P 500 had a return of 12.5% during the same period.[192] And the actual returns earned by investors as measured by the dollar weighted returns on those same mutual funds is only 7.3% due to the fact that fund investors are famously poor timers.[193] Even worse, the "real return" from that 7.3%, *before taxes*, is only 4%.[194]

An objective detailed study should be left to the reader from the cited sources and many others that are available, but the bottom line on it is that on a performance basis, a very low cost well administered index fund, including the exchange traded vehicles discussed below, will inevitably be above average performers, and the only methodology that will *guarantee* the investor that she will receive her fair share of what the financial markets earn in returns, less only the modest cost of the fund itself, and the even more modest share of taxes that will be assessed on these tax-efficient vehicles. The endorsements of indexing for the majority of investors contained in John Bogle's *Little Book* include some pretty impressive folks, including Paul Samuelson, Warren Buffet, Jack R. Meyer, Burton G. Malkiel, David Swensen, Mark Hulbert, Gary Brinson, and Jonathan Clements, among many others.

3. Indexing Eliminates all Non-Market Risk

An index fund which contains all or virtually all of the securities in a particular market index will have only the risk that is present in that market. Based on the Morningstar risk assessments, an S&P 500 index fund or a Wilshire 5000 index fund has shown less risk than the average equity fund.[195] Conceptually it is clear that a managed fund is going to have more than just the market risk because the manager will be betting on certain segments or certain stocks within a category of stocks to do better than the market itself. This provides a considerable opportunity for additional variability of return that is not related to the market as a whole. On the other hand, a pure index fund is the market and has no other risk involved. This is the theoretical basis for the lower risk as actually measured and reflected in the above statistics. The foregoing does not imply that a managed fund may not be managed to have lower risk than a market index fund, because it certainly can be managed to control risk, but because of the greater costs involved in the actively managed portfolio, the temptation is great to undertake greater risk in order to reap the reward necessary to justify the additional costs. It is not surprising that, on average, it does not happen.

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[192] Bogle, LITTLE BOOK, *supra* n. 180, at 44.
[193] *Id.* at 51.
[194] *Id.*
[195] *Id.* at 131, Table 5.2.

4. Low Costs, High Diversification and Tax Efficiency Favor Indexing Under the Prudent Investor Rule

A thorough reading of the Uniform Prudent Investor Act or the Prudent Investor Rule in the *Restatement of Trusts* emphasizes factors which clearly favor index fund investments for trustees. Clearly, index fund investing is not required under the Uniform Prudent Investor Act, despite the fact that the drafters of the Act were in fact adherents of passive investing and some form of the efficient-markets thesis. But a number of the duties imposed upon the trustee as a prudent investor are easily satisfied with the index funds while creating more challenges for the active investor.

(a) The Duty of Diversification

The trustee must take into account that it has the duty to diversify the investments of a trust "unless, under the circumstances, it is prudent not to do so."[196] Within a particular market, clearly the index fund is a superior method of achieving diversification, since in a pure index fund, all of the securities in that market are reflected in the index fund. While there are some index funds that use a representative sample of those securities rather than all of them, most are full replications of the entire index. Using a representative sampling will introduce some statistical non-market risk in such funds. Indeed any error one way or the other is called "tracking error" and is a defect for an index fund if it is of significance. An S&P 500 index fund will typically own all 500 of the large-cap companies comprising the index. Index funds representing the Wilshire 5000 are understandably more likely to own a statistically selected sample of the index than the entire index, attempting to avoid where possible the least liquid of those securities This tremendous diversification rids the trustee of one of its most welcome but thorniest problems; that is, how to deal with the security which grows too much for comfort.

While a trust portfolio may begin with, say, 20 stocks, each with 5% of the portfolio funds, as time goes on, some will go up and some will go down. Eventually, the trustee will be forced over time to deal with its "winners." If one of the stocks grows three or four times faster than the average (and one of them will assuredly do so), the trust will inevitably end up with one stock representing 15% or 20% of the investment portfolio. At that point, the portfolio is no longer nearly as diversified and has significant non-market company specific risk, owning too much of that one stock because of its superior performance. The trustee then has the difficult choice of deciding whether to sell and pay the capital gains taxes or continue to allow the overachiever to become a larger and larger portion of the portfolio. This *never* happens with a market weighted index fund because not only does it start with a far more diversified portfolio, the fund automatically adjusts its holdings to continue to reflect the index. As a result, the trustee never has to face this very common but perplexing problem.[197]

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[196] RESTATEMENT (THIRD) OF TRUSTS § 227(b).

[197] And just because you have one big winner does not mean that the portfolio has outperformed the market averages. In most cases it will not as a whole do so, leaving the portfolio with uncompensated risk.

(b) The Duty to be Cost Conscious

Typically, the use of index funds is the lowest-cost method of obtaining and maintaining a diversified portfolio. They minimize annual operating expenses because they use computers in the place of highly paid stock pickers and market timers employed by active funds.[198] The transaction costs are minimized because stocks are sold only when necessary to match the index changes. Only when stocks are added and subtracted from the index are sales necessary in a market weighted index fund, because the market weights are self-adjusting. That is not the case with other types of index weightings, such as equal weighted indices or "fundamental" indices, discussed in the next section, because they own based upon something other than market weightings, which will require periodic rebalancing to the indexing methodology used. And commission loads are rarely charged for index funds which are usually sold directly to the public rather than through stock brokers or other commissioned sales people. All of this fits in very well with the duty to contain costs under the Prudent Investor Rule.[199] Luther Avery and Patrick Collins of San Francisco focus on the trustee's duty to avoid unreasonable or inappropriate costs in an *ACTEC Notes* article on the subject.[200] As that article details, controlling those costs may require a sophisticated understanding of what all those costs may be and how to spot and avoid them.

(c) The Duty to Consider Tax Consequences

Tax consequences as noted above can have very severe effects on a stock portfolio. Index fund managers, particularly in the larger capitalization markets tend to have turnover of close to 5% and some like the Vanguard Total Stock Market Index representing the Wilshire 5000 Index, shows current turnover of 2%. This significantly betters the performance of the index fund in the real world of trusts and estates. If we lose 1% to taxes, that is 1% less *every year* we can afford to distribute to our trust beneficiary. And 1% is often more than what is left of the dividends on the S&P 500 after trustees' fees!

(d) Index Funds Allow a Trustee to Concentrate its Efforts on Asset Allocation and Selection of Markets

It is a well accepted theory that asset allocation is critical to a successful outcome in an investment portfolio, and that the majority of returns from an investment portfolio correlate most directly from the selection of the asset classes of which it is composed, particularly as between stocks and bonds. It is often quoted that over 90% of the return in a portfolio has been said to result from the decision as to asset allocation, and less than 10% from all other factors including timing and stock selection. As noted in Brinson, Singer and Beebower's seminal work, active management at all levels seems in their view to have little net effect!

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198 W. Scott Simon, *Index Mutual Funds: The Best Investment Strategy for Complying With the California Uniform Prudent Investor Act,* 13 ESTATE PLANNING IN CALIFORNIA PROBATE REPORTER 164, 167 (1998).
199 *Id.*
200 Luther J. Avery and Patrick J. Collins, *Managing Investment Expenses: Trustee Duty to Avoid Unreasonable or Inappropriate Costs*, 25 ACTEC NOTES 123 (1999).

> While active asset allocation contributed a net under performance of 26 basis points, and security selection contributed a gain of 26 basis points, neither figure is statistically different from zero. Active management not only had no measurable impact on returns, but. . . it appears to have increased risk by a small margin.[201]

Utilizing index funds, the trustee can expend its efforts on the factors that produce the greatest proportion of return; that is, the selection of markets and the proportions in which the trust will invest in those markets. Index funds are available to cover virtually any potential stock or bond market.[202] This gives the trustee the ability to spend most of its time on the decisions that are most important, a policy that should make both dollars and sense.

Note should be taken of the fact that while the Brinson et al studies are taken very seriously, there is also serious debate about just how much of the return is governed by asset allocation; but whether it really is 90%, or whether it is instead 60%, does not take away from the fact that it is very important.[203] Nor does it relieve the trustee of the burden to justify unusually high costs and taxes when an alternative approach that will always measure up to the market is easily taken. The real questions are (1) to what degree does the investment manager/trustee exercise active changes in asset allocation in light of its view of economic conditions and prospects, and (2) how does the investment manager/trustee implement that strategy? Do they utilize actively managed portfolios and funds or do they, as John Bogle would advise us, not search for that needle in the haystack, but rather buy the whole haystack!

5. The Prudent Trustee - Why Not a Bulletproof Trust Portfolio

If one were to consider what aspects of a trustee's investment strategy might produce risk not only for the trust and the beneficiaries but for the trustee itself, one is even more swayed towards consideration of index funds. Low cost, low turnover, tax efficient, broadly diversified index funds in a trust portfolio, if rationally allocated, would seem to be virtually bulletproof from beneficiary attack. With these investment vehicles, one literally cannot underperform the market by more than their modest cost. While the Prudent Investor Rule is intended to judge process rather than results, if the asset allocation decision were sensible and effectuated with low cost, low turnover, highly diversified index funds, how could a trustee be held responsible for under performance? Granted, the trustee will not "beat the market" ever, but it will beat most of the competition year after year with such an approach. Even if it did not, it seems difficult to see how the trustee could be held liable for earning a market return, as long as the asset allocation was sensibly matched to the needs of the trust and the beneficiaries. For the active manager, the

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201 *See* Gary P. Brinson, et al., *Determinants of Portfolio Performance*, FIN. ANALYSTS J., July-Aug. 1986, at 44. *See also* Gary P. Brinson, et al., *Determinants of Portfolio Performance II: An Update*, FIN. ANALYSTS J., May-June 1991, at 40.

202 With the exception perhaps of the municipal bond market which has too much state-to-state variation and individual variation to succumb easily to indexing.

203 R. Ibbotson and P. Kaplan, "Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance?" (2000).

duty to justify additional costs and taxes could well be a difficult one to bear, a point made by Scott Simon in his book: *The Prudent Investor Act: A Guide to Understanding:*

> First, while the Prudent Investor Act allows both active and passive styles of investing, there is implicit in the duty to minimize costs the following two-prong test to justify an active investing strategy:
>
> > First, are the extra costs of active management substantial (and by that we must include management costs, direct and indirect costs, and taxes)?
> >
> > And, if so, are they justified by realistically evaluated return expectations?[204]

The foregoing two-prong analysis may become a more and more difficult one for the actively (and expensively) managed trust where the trust has underperformed, since the extra costs will be easy to prove and the realistic return expectations will not be easy to prove.

H. NEW VEHICLES AND VOICES—T EXCHANGE TRADED FUNDS—FUNDAMENTAL INDEXING—TOWARDS "ZERO" CAPITAL GAINS

The first index fund (the Vanguard 500 Index Fund) was started in 1976 by John C. Bogle. In 1992, the first exchange-traded fund, the "Standard & Poor's Depository Receipts" (SPDRs) generally referred to as the "Spider," was started. The idea was to create a vehicle that was much like the traditional index fund, that is, it would have very low costs, high tax efficiency, but could be bought and sold by brokers. In short it could be "traded," and this of course would open up the huge additional market of financial service providers which for the most part has stood by the sidelines and has eschewed index funds despite their obvious benefits.

The traditional index fund and the brokerage community were, and largely still are, the proverbial oil and water that do not mix. The great value of the index fund is the humble arithmetic with the even humbler costs that are justified by the traditional index fund. For the financial services industry and particularly for the retail brokerage community, it was anathema; since there was no way that they could be paid for their services out of the very low expenses charged by the traditional index fund. How, after all, can you sensibly compensate a broker out of the 20 basis points ($200 per year on $100,000) charged from the Vanguard 500 Index Fund, or even more clearly from the 9 or 10 basis points charged by the Admiral Shares from Vanguard for those with over $100,000 to invest or the Fidelity Spartan 500 Index Investor. While there are index funds that have hefty 12b-1 charges and sales loads, it really makes no sense to pay them if you know better, since there is no prospect that they will outperform the market they intend to reflect. Enter the exchange-traded fund, where a similar vehicle could be bought and sold through brokers at any time of the trading day, and for which the broker could charge their customary fees.

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[204] W. Scott Simon, *The Prudent Investor Act: A Guide to Understanding*, pp 109-111, (Namborn Publishing Co. 2002) For a Book review of this book, see *Book Review*, *The Prudent Investor Act: A Guide to Understanding*, by Robert B. Wolf, 29 ACTEC JOURNAL 128 (2003).

This idea of an exchange traded index fund is very attractive to many people for many reasons. For the traditional long term passive index fund investor, it means that you can buy and hold the investment pretty much anywhere, whereas, despite the emergence of mutual fund "supermarkets" where one can purchase and redeem many different funds from many different families, those mutual funds must have some relationship with the financial services company holding the fund, and this has been significantly limiting for the index fund investor. For example, if you held a Vanguard 500 Index Fund but wanted to put it in a UBS brokerage account which held your other assets, you just couldn't do it—oil and water! But the exchange traded funds, because they are exchange traded, and are transferred in the traditional way, and because brokerage and other financial service providers are "authorized participants" in the creation, trading and dissolution of the units of these funds and can therefore be paid in connection with their use, they can be deposited, held, bought and sold by just about anybody. And for many of these exchange traded funds, the costs, once purchased, are very low and the tax efficiency potentially very high.

For the reasons noted above, and others, the previously small exchange-traded fund solar system has literally exploded into a universe of products. Paul J. Mazzilli and Dominic Maister, of Morgan Stanley who produce an excellent quarterly report on Exchange-Traded Funds[205] report that there are now 490 exchange traded funds with over $480 Billion dollars invested increasingly covering every conceivable asset class, with 345 covering the US market, 98 in the international equity market, 22 in the fixed market and 25 alternative asset classes. And the trend and competition for these funds is accelerating dramatically. A total of 95 of the 490 funds were introduced during the first quarter of 2007 alone. Almost one-half of all index funds are now exchange-traded.[206]Barclays Global Investors is clearly the leader of the field with its iShares, with 130 funds and $280 Billion in assets collected. State Street Global Advisors, with the first and still the biggest exchange traded fund, the Spider, has 52 funds and $102 Billion in assets. Vanguard, with its VIPERs, is a relatively new entry into this field, but stands to be a very strong competitor, with 28 Funds and $29 Billion in assets collected in only about a year of entry into the field. And there are other significant competitors in this field, including PowerShares Capital Management, Merrill Lynch, RYDEX, ProShares and Wisdom Tree Asset Management being significant players in this field.[207] There are sector funds, so that if your portfolio were light in technology, you could add one of several technology sector funds. There are style funds, so that if you wanted to give your portfolio a greater growth or value tilt, or to counterbalance existing positions, you could add the iShare S & P 500 Growth or the Vanguard Growth ETF. This makes the new vehicles particularly useful in existing portfolios where for one reason or another, such as a very low cost basis or resistance to sale of a particular security, diversification goals are otherwise difficult to achieve.

With these new vehicles, a trustee holding their funds virtually anywhere can use indexed products for almost any asset class for which they think indexing is the most sensible approach. So if the trustee prefers indexing for the large capitalization US market, it can use the iShare S & P 500 or the Spider, each with an expense ratio of 9 basis points, or the Vanguard Total Stock Market ETF, with an expense ratio of 7 basis points. Because the professional trustee, and even

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[205] Paul J. Mazzilli and Dominic Maister, Morgan Stanley Exchange-Traded Funds Quarterly Report, May 15, 2007.
[206] Bogle, LITTLE BOOK,*supra* n.180 *at 61.*
[207] Mazzilli and Maister, *supra* n.205, at 20.

the more casual trustee, has access to trading costs that are very low indeed, such as 5 cents a share, or a flat rate fee of under $10 a trade in many cases, the overall cost efficiency of these broad portfolio anchors is almost impossible to match.

But for those of us who love numbers but really dislike paying too much in taxes in a trust portfolio, these new vehicles have a tax twist that is particularly appealing. Reviewing the turnover statistics we discussed previously, the average actively managed equity mutual fund on a dollar weighted basis has a turnover of a bit over 60% per year, which, as we discussed previously, is very costly to the trust portfolio, even if we assume today's record low rates of capital gains taxes and even if we assume that all of the capital gains are long term. A well run traditional index fund such as the Vanguard Total Market Index Fund or their 500 Index Fund will typically have a very low turnover of 3-5%. Some turnover is produced by the fact that from time to time stocks are added to or subtracted from the index being tracked, so that the stock that is removed must be sold in the index portfolio. In addition, investor outflows during times of market anxiety will result in the managers having to sell securities to raise cash. But the way the ETF works allows almost all of this turnover to be avoided, as described in the Morgan Stanley Quarterly Report:

> In falling markets, many open-end mutual fund investors seek redemptions, which usually force a fund to sell stock and may create capital gains tax liabilities, which are passed on to remaining shareholders. ETFs can reduce this tax liability through an "in-kind" redemption mechanism, whereby baskets of stocks change hands, as opposed to cash. The redemption process is not a taxable transaction for ETFs, so there is no realization of gains that must be distributed to shareholders. Exhibit 2 contains a comparison of capital-gains distributions made by the oldest ETF, SPY, versus the S & P open-end funds designed to track the same S & P index. While SPY's distributions were almost nonexistent, the open-end funds had average distributions equal to 1.53% of NAV.

Exhibit 2
Capital Gains Distributions as a Percentage of NAV*

	S & P SPDR ETF (SPY)	Open-End S & P 500 Index Fund Avg**
1993	0.00	1.33
1994	0.00	1.33
1995	0.00	4.76
1996	0.12	2.43
1997	0.00	3.72
1998	0.00	2.24
1999	0.00	1.79
2000	0.00	2.20
2001	0.00	.51
2002	0.00	.11

2003	0.00	.14
2004	0.00	.50
2005	0.00	.81
2006	0.00	.99
Average	0.01	1.63

* Year-end NAV   ** Average open-end S&P 500 fund. Source Bloomberg

A capital gains dividend of 1.63% at a capital gains tax rate of 18% produces a "drag" of 29 basis points a year on the portfolio, so it is sensible to assume that even investing in a very low turnover index fund that there will be some capital gains taxes in most years as a result of capital gain dividends which are declared. But, like most things, index mutual funds are not all created or operated entirely equally. A review of the actual capital gains dividends declared by the Vanguard 500 and Total Market Index Funds show no capital gains dividends at all going back to 2002. Why the difference? Probably the restrictions that Vanguard puts on purchases within 60 days of the sale of a fund, which discourages active traders from using its products. While the investor in a well operated index fund will essentially always be an above average investor (or at least his invested dollar will be above average), that is not to say that all index funds are equally well run or equally efficient, so expense ratios, tracking error, and tax efficiency, including potential capital gains should be examined closely in selecting any one of these products in a trust or otherwise. Expense ratios are generally higher for style and sector funds, and their turnover is likely to be higher also, since there is generally more than one variable determining the composition of the fund. Expense ratios of ETFs may reach as high as 95 basis points, though these are for leveraged products and inverse products designed for specialized uses. Such funds are very far removed from the original design of an index fund allowing an investor to buy and hold a share in the entire basket of US businesses.

But the potential ability of the ETF to generate virtually zero turnover, at least as reflected in capital gains distributions to its owners is a very significant feature that is worth considering. If we were to look at the results of all of the 20 year periods in history we would find that if we were to equalize the ending market values of three trusts using our historically low 18% capital gains tax assumptions (15% federal and 3% state) and then start with a baseline 80/20 asset allocation, with a 4% payout and 1/10th of 1% in turnover costs, coincident with very low institutional rates, we would find the following results when comparing our 0% turnover, 5% turnover and 60% turnover:

0%	5%	60%
4%	3.67%	2.62%

Placing this into context of a $1,000,000 trust, the 0% turnover vehicle might be able to afford to pay out $40,000 a year, versus $36,700 with the 5% turnover traditional index fund, and $26,200 in the typically high turnover mutual fund portfolio, *if the gross pre tax, post expense returns were the same.* And this modeling assumes an 80/20 asset allocation that is rebalanced annually, so there is some turnover in any case, including any turnover necessary to produce the 4% distributions and the 1% trust costs assumed.

Based upon the foregoing analysis, one might conclude that the ETF has a 33 basis point edge over the traditional index fund based upon capital gains tax efficiency, and a huge head start on the typical mutual fund with typically high return-chasing turnover. And on an "expected return" (average) basis, that is true, but one should look at the full results to note something that if one thinks about it, is pretty obvious. The average results hold in the average period, but not in worst case scenarios, where there are relatively few capital gains to tax!

All 20 Year Periods in History		$1,000,000 Starting Value		Results Adjusted for Inflation	
80/20 Investment mix		18% Capital Gains Tax Rate			
Trust #1 0% Turnover		Trust #2 5% Turnover		Trust #3 60% Turnover	
Payout 4%		Payout 3.67%		Payout 2.62%	
AVERAGE	1,490,869	AVERAGE	1,490,890	AVERAGE	1,490,338
BEST	3,646,982	BEST	3,544,504	BEST	3,232,484
WORST	423,932	WORST	443,786	WORST	491,648
PRESERVED	61.2903%	PRESERVED	62.9032%	PRESERVED	64.5161%

So while the average or mean results of the three portfolios are essentially identical, the best case scenario is significantly better yet for the 0% turnover portfolio, and the worst case is substantially better for the higher turnover portfolio paying out a much smaller amount (35.5% less) "income" to the beneficiary. Also note that the percentage of the rolling periods in which the values were preserved is higher for the high turnover low payout trust. So the average expected result is not the end of the story. And of course the 0% turnover portfolio will likely some day nonetheless be sold, and the cost basis of the lowest turnover portfolio will be the lowest at that time, unless the trust is one includable in the estate of the beneficiary, such as a revocable trust or a marital trust, in which the large potential capital gain is swept away by Section 1014, assuming section 1014 stays in our tax future.

The foregoing are qualifications to any general conclusion about reaching for the lowest possible cost and the lowest possible turnover. The conclusions are not absolutes, and trusts and their beneficiaries are not all alike. Instead they are heterogeneous, so the principles and calculations must be applied in a thoughtful and focused manner.

But the foregoing equivocations do not in any way imply that 0% turnover is not a significant advantage, as the following tabulation of results demonstrates where the payouts are equalized for all three trusts.

All 20 Year Periods in History		$1,000,000 Starting Value		Results Adjusted for Inflation	
80/20 Investment mix		18% Capital Gains Tax Rate			
Trust #1 0% Turnover		Trust #2 5% Turnover		Trust #3 60% Turnover	
Payout 4.00%		Payout 4.00%		Payout 4.00%	
AVERAGE	1,490,869	AVERAGE	1,419,458	AVERAGE	1,223,829
BEST	3,646,982	BEST	3,395,233	BEST	2,713,480
WORST	423,932	WORST	418,895	WORST	391,411
PRESERVED	61.2903%	PRESERVED	61.2903%	PRESERVED	58.0645%

And here we see that the results are always better for the 0% turnover product, whether we examine the average result, the best result, the worst result or the probability of preserving real value *if the gross returns are the same.*

In recent years as ETFs have become more popular and the mainstream financial service companies have begun to use these funds as building blocks for their investment portfolios, it is not surprising that new products have been introduced to "enhance" the returns of the traditional market capitalization weighted index fund. Even before that, the knock on the traditional market weighted index fund, particularly the ones tracking the S & P 500 Index was that during the tremendous run up of that index from 1995-1999 (slightly over 250% in total return) it became more and more dominated by certain of the big names, such as Cisco Systems and Microsoft. Cisco, as we will remember, was the largest capitalization weight in the S & P 500 when it was selling at $80 or more a share at the beginning of 2000. So the knock on the S & P 500 Index itself, and the funds that tracked it, was that it really reflected primarily these megacap stocks, and since it was capitalization weighted, it did not reflect the market as a whole. The average stock in the S & P 500 was performing very differently than the index as a whole from 1995 to 1999, and for that matter, thereafter from 2000 to 2003. In response to this thought, one of the early variations to "enhance" index returns was to produce an equal weight index fund, such as the Rydex S & P Equal Weight. This fund brought out in 2003 attempts to track the S & P 500 Equal Weight Index and as the name implies owns 2/10ths of 1% in ExxonMobil, just as it holds 2/10ths of 1% of the smallest company of the S & P 500. So while the fund owns all of the same stocks as the conventional S & P 500 index fund, the weightings are drastically different, producing significant variations in the investment results. Every quarter, the holdings are rebalanced to an equal weighting, so a portion of its short term winners are sold and losers are bought. As a result of the constant rebalancing, the turnover is significantly greater, but thus far, because of the differences in the structure of the exchange traded fund from the conventional index fund, the turnover has not resulted in any capital gains dividends with the resulting capital gains tax.

The performance of an equal weighted portfolio in the S & P 500 would have lagged the cap-weighted index during the 1995-1999 period, and then significantly improved upon the cap-weighted portfolio during the period through 2006. Because the weightings are more spread out, there is definitely more diversification, which sounds like it would result in less volatility, but that would not necessarily be the case. Because of the equal weighting, the fund reflects many mid-cap securities much more fully than the conventional index, and because mid caps tend to have on the whole more volatility but somewhat higher returns, the Rydex product charts in between the large cap 500 index and the mid cap indices. So while the company specific risk is reduced, the emphasis on more volatile smaller companies increases the volatility in response to changes in the market generally. On balance, the concept of an equal weighting, despite higher costs (40 basis points versus less than 10 basis points) is interesting and has some merit to it, which becomes particularly obvious if one of the megacaps takes a dive, such as during the technology blow off from 2000-2002 when Cisco went from the top to the bottom of the heap!

But what does an equal weight index do for the investor? It provides excellent diversification and should provide close to average performance of those companies represented, minus the expenses, with whatever enhancement is provided by the quarterly rebalancing, so long as those rebalancings do not start to produce significant short term capital gains, federally taxed at 35% as opposed to 15%. It will be the average performance of the companies in the index, not in the investor dollar, that are matched, so it will over and/or underperform the average investor dollar, unlike the market capitalization index fund, which will track it.

While these equal weight indices are interesting and useful as an academic matter, they have not proliferated significantly since their introduction. Likely the greater impact will be felt by the newest trend of the "fundamental" index fund, such as the Wisdom Tree Funds. Their individual investor site states their case:

> At WisdomTree, we believe that fundamentally weighted indexes avoid the structural flaw inherent to market capitalization-weighted indexes: the tendency to *overweight* overvalued stocks and *underweight* undervalued stocks. As a result, ETFs that track cap-weighted indexes tend to hold more of a company when its market value is high and own less of it when its market value is low. We believe this is counterintuitive to the strategy of buying low and selling high.
>
> In contrast, fundamentally weighted indexes anchor initial component weights to a measure of fundamental value - such as dividends or earnings. WisdomTree believes fundamental values provide a more accurate picture of a company's worth than its market price alone. In our view, this helps address the over/under dilemma of cap weighting. Put simply, we believe this is a better way to index.[208]

The general theory, which Jeremy Siegel calls the "noisy market" hypothesis, as opposed to an "efficient markets" hypothesis, is that often the market responds not to fundamental changes which should influence the value of a particular security, but to short term announcements, news and emotion, what he simply calls "noise." This causes many securities to be overvalued or undervalued at any point in time. He points to research that pokes holes in the "efficient market" hypothesis in failing to explain why certain segments of the market seem to perform better than others, and seem to have consistently better risk-adjusted returns, such as small cap value funds and stocks with low price earnings ratios. And the theory is that if the stocks are owned not based upon how the market values them, but on the weightings of their dividends, or their earnings, that the indices would cancel out the market "noise" and allow better returns for investors. Now immediate note should be taken that the idea that value based investing may provide better returns is hardly new, and there are strong arguments for utilizing a value or fundamental investment selection process, so at least to this author, this is "new" only in the sense that it is old wine in new bottles, particularly in the exchange-traded index fund. Nevertheless Dr. Siegel is not exactly shy in describing the results of this alternative indexing theory:

> Current attempts to explain the hidden risks in value stocks remind me of the astronomers in the 16th century who attempted to save the earth-centered Ptolemaic view of the universe. They were forced to add complicated "epicycles" to the orbits of the planets to rationalize their movements in the evening sky; the model collapsed

[208] Quoted from Wisdom Tree Website at http://www.wisdomtree.com/press/newfunds-letter.asp.

> when Copernicus showed that a simple sun-centered solar system was an easier explanation. As with Copernicus, there is now a new paradigm for understanding how markets work that can explain why small stocks and value stocks outperform capitalization-weighted indexes.
>
> This new paradigm claims that the prices of securities are *not* always the best estimate of the true underlying value of the firm. It argues that prices can be influenced by speculators and momentum traders, as well as by insiders and institutions that often buy and sell stocks for reasons unrelated to fundamental value, such as for diversification, liquidity and taxes. In other words, prices of securities are subject to *temporary* shocks that I call "noise" that obscures their true value. These temporary shocks may last for days or for years, and their unpredictability makes it difficult to design a trading strategy that consistently produces superior returns. To distinguish this paradigm from the reigning efficient market hypothesis, I call it the "noisy market hypothesis."
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> *　　　　　　　*　　　　　　　*
>
> With the advent of fundamental indexes, we're at the brink of a huge paradigm shift. The chinks in the armor of the efficient market hypothesis have grown too large to be ignored. No longer can advisers claim that capitalization-weighted indexes afford investors the best risk and return tradeoff. The noisy market hypothesis, which makes the simple yet convincing claim that the prices of securities often change in ways that are unrelated to fundamentals, is a much better description of reality and offers a simple explanation for why value-based investing beats the market.[209]

Morgan Stanley in its quarterly ETF Report describes its own detailed study of the characteristics of these Fundamental Index Funds and compared them to the S & P 500 cap weighted index, the S & P/Citibank 500 Growth and Value, the S & P 500 Equal Weight for the large cap market, as well as correlative studies of the mid-cap and small-cap markets. The bottom line of this study is that while the fundamental indices generally performed well during the last 12 years, there was a very high correlation with the other value indices that are already out there, with correlations between .94 and .97 with the S & P 500/Citigroup Value index. Interestingly, they lumped the S & P 500 equal-weight in with this group of fundamental index funds, which does not seem correct, though the S & P Equal Weight definitely has a smaller capitalization tilt as well as a value style tilt, as contrasted with its market-weighted brother. It was not designed that way, however; that is just the way the equal weight S & P 500 index works out. And the sector weightings are predictably skewed rather significantly in the fundamental indices, where technology is weighted at just 6% of the Wisdom Tree Large Cap Dividend index compared with 15% in the market weighted index. The bottom line on these “new Copernicans”, as John Bogle calls them is more likely that the methodologies used to comprise the “new” indices either will or will not over time work out to have better risk-adjusted returns than the other value style indices. Unlike the basic S & P Index funds, or those replicating the Wilshire 5000, the funds that cut the market into different slices invariably have an element of judgment in comprising the indices,

[209] Jeremy J. Siegel, The “Noisy Market’ Hypothesis, Commentary, Wall Street Journal, June 14, 2006 at http://webreprints.djreprints.com/1497650936231.html.

and this will impact the results. They do not strive to own everything; but rather a particular slice of everything. For example, if one compares the iShare Large Cap Growth with the Vanguard Large Cap Growth, the portfolios have significantly different compositions, which will likely lead to different investment results. The Vanguard Growth ETF reflects an average capitalization of $36 Billion while the iShare boasts a megacap average of almost $60 Billion. And the top holding in the iShare is ExxonMobil, while Microsoft is the top holding in the Vanguard Growth ETF and ExxonMobil is nowhere to be found! The Vanguard Growth and Value ETFs can be combined and will replicate the core ETF, while a combination of the Growth and Value iShares do not equal the core iShare.

John Bogle puts it this way:

> The new paradigmists have never explained why these fundamental factors have been systematically underpriced by the market in the past. And, if they have been underpriced, why investors, hungry to capitalize on that apparent past inefficiency, won't bid up prices until the undervaluation no longer remains. Put another way, if these promoters of the purported new paradigms actually have been right in the past, won't they therefore be wrong in the future?[210]

Time will tell, but it is fair to note that anything other than an index fund that has all of the stocks in a market-weighted proportion is not really the same thing as the classic index fund. And this includes all of the value and growth indices. The new fundamental indices are really a particular method of quantitative investment management. They may do better or worse than the classic market-weighted index, but they all seem to do it with higher expenses and higher turnover, which, one way or the other, is likely to translate into a hurdle that has to be overcome by higher gross returns. If the overvaluation and undervaluation of securities goes on consistently long enough and strong enough, it will, particularly in the large capitalization markets attract buyers who will inevitably bid up the prices closer to where they ought to be. In doing so, all of these investment players with all of their different theories constantly looking for an edge or an arbitrage profit help to make the markets fairer and more efficient. Whether we should place our trust dollars with them is less obvious.[211]

One other point in connection with the evaluation of all manner of costs, including management costs, turnover costs and tax costs is that the majority of economists and financial gurus and prognosticators expect lower returns over the next decade than we have experienced in history. The reasons for this are fairly easy to understand. The fundamental return from an incorporated business equals three components. The dividend yield, the rate of increase in its earnings, and the speculative return—that is, the change in how many dollars an investor is willing to pay for each dollar of earnings, or in other words, the price/earnings ratio. The dividend rate today is slightly under 2%, well under the 4.5% average over the last 100 years, and if we assume an earnings growth rate of 6% is reasonable, we have a total fundamental return of 8% if the price earnings ration stays as it is at approximately 16.7 currently. The overall

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[210] Bogle , LITTLE BOOK, *supra n.* 180 at 159. .

[211] *See also* the skepticism of David Frye of *ETF Digest* who notes that the backtested data for Wisdom Tree from 1996 to 2006 is stated to be proprietary and unavailable to potential purchasers or professionals to evaluate. One would have hoped for greater transparency, especially from Professor Siegel.

average of the S & P index back through 1936 is 15.7, so if we assume that it were to revert to a 15.7 times price earnings ratio during the next decade, the total return would end up at 7%, versus the historical total return of 10.4% from 1926. While an estimate of total return from US equities of 7-8% is on the conservative side, it does not appear that anyone is suggesting that returns will be as robust as the historical averages, and if this is so, does not the trustee have to take that into account in addressing cost consciousness? The math is relatively simple. If we assume a total return of 8%, trustee's fees of 1% and inflation of 3%, what can we afford to pay in extra costs and taxes on a yearly basis if our active investing fails to offset its costs with corresponding additional returns? And if we end up with part equities and part bonds, with an expected return closer to 5 or 5.5%, it seems clear that the duty to be cost conscious ought to be sharpened in an era of lower returns. And it does seem likely that the lower returns are a reasonable expectation, whether it is 7%, 8% or 9%, and costs matter! The low cost, high tax efficiency exchange traded index fund is particularly attractive in an era of lower gross returns.

I. SOME THOUGHTS ON SPENDING RATES AND METHODS—NEW AND OLD VOICES

One of the really good things to come out of the debate and change in the trust and investment world about total return investing and distributing is the fact that there are more and more people in the legal, trust and investment world giving serious and scholarly thought to the problem of how much one can spend from a given portfolio and have the portfolio be a successful one for the trust or endowment or the individual considering retirement. This was not always the case. It was more or less accepted dogma for many, many years that the "income" from a trust or a portfolio was that which one could spend. Nothing more and nothing less. And in a world without inflation or expenses or taxes, and where most of corporate earnings were paid out in dividends, that was a sensible mantra that worked. Not any more. No one is satisfied with those answers anymore. And while it is a more scary and uncharted world out there as a result, that is still a good thing, as it is the truth, however little we understand of it.

In the world of investments and retirement planning, more and more discussions are brought to the investor in routine newsletters and correspondence.[212] And in a general sense the publications tend to point the investor in the right direction, and suggest the difficulties in making a withdrawal rate subject to inflation adjustments. The American Association of Individual Investors (AAII Journal) recently published an article by Jonathan Guyton entitled *Withdrawal Rules: Squeezing More From Your Retirement Portfolio,*[213] which notes that the now conventional wisdom is for a distribution rate to be sustainable when adjusted for inflation, that most of the portfolio has to be invested in stocks and the maximum "safe" withdrawal rate is around 4%. This of course is entirely consistent with my modeling and those of others. Guyton further notes that a prospective retiree can pay out significantly more if the retiree modifies the rules for their inflation-indexed withdrawal rules as follows:

1. No inflation adjustment is taken for any year in which the portfolio total return is negative. Nor is there any catch up provision for such a year.

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[212] For example, *Deciding on a Withdrawal Rate*, UBS FINANCIAL SERVICES, OUTLOOK, March/April 2005.
[213] Jonathan Guyton, *Withdrawal Rules: Squeezing More From Your Retirement Portfolio,* AAII JOURNAL, August, 2005.

2. No inflation adjustment will be taken in excess of 6% per year and no make up is allowed.

Using these modifications, and testing the thesis during the years 1973 to 2003, Guyton concludes that as much as 5.8% could be withdrawn initially and inflation adjusted with the foregoing qualifications, and have the portfolio last at least 40 years.[214] While the computations and observations are no doubt correct, one should note that 1973 and 1974 were both dramatically down years for the stock market at the same time the CPI inflation rate was 8.8% in 1973 and 12.2% in 1974, so that at the end of the first two years, the income beneficiary would have already been down in inflation-adjusted terms by 20 % and would never catch up. And the second qualification capping the inflation adjustment at 6% would have literally allowed the beneficiary's income stream to be destroyed by the inflation of 13.31% in 1979, 12.4% in 1980 and 8.94% in 1981. It is definitely true that tempering or eliminating inflation adjustments makes the trust or retirement portfolio much safer, but *there are no magic bullets to allow us to painlessly "tweak" our distribution rules and make ourselves both eat and sleep really well.* If the income stream is critical to the beneficiary or retiree, the Bernstein Collar or the TRUCAP unitrust are both better models for dealing with long term payouts and attempting to compromise the need for the income beneficiary to have the income beneficiary's income stream keep up with inflation and the critical need for the trust or retirement plan assets not to be exhausted. But note that neither of those models allow us to safely use a really high initial payout rate. You just can not have it both ways. You can have a relatively high payout with a unitrust, but you have to put up with the volatility involved, and if you can't do that, you have to settle for a smaller payout rate. Risk and return are related in spending rate and method, just as they are in the investment portfolio.

James P. Garland, who has published significant articles in the past advocating the use of a dividend yield spending rule,[215] recently suggested in a published article that the amount that one can spend from a stock portfolio is somewhere between the dividend rate and the earnings rate of the corporation, noting that for long term trusts, the issue is not so much the value of the portfolio at the end, but how much one can spend along the way, a concept he labels "fecundity:"

> "The primary objective of most endowment funds, and of many long-duration trust funds, is to provide spendable cash for their owner and beneficiaries for a very long time. . . . Fecundity is a measure of the spendable cash that a fund can provide today without unduly threatening its ability to provide similar amounts—adjusted for inflation—in the future."[216]

And his analysis, citing a number of others who have examined the issue in scholarly journals, concludes that the issue of what one can spend is admittedly "fuzzy" but that for a stock it lies somewhere between the dividend yield and the earnings yield of the underlying company. On

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[214] *Id* at 9.
[215] James Garland, *A Market-Yield Spending Rule for Endowments and Trusts*, FIN. ANALYSTS J., July-Aug. 1989, at 45, 50;.James Garland, *The Problem With Unitrusts*, J. OF PRIVATE PORTFOLIO MANAGEMENT (Spring 1999); James Garland, *A Market-Yield Spending Rule Revisited*; (Update through 1998) J. OF PRIVATE PORTFOLIO MANAGEMENT (Winter 1999).
[216] James P. Garland, *Long-Duration Trusts and Endowments,* J. OF PORTFOLIO MANAGEMENT, Vol. 31, No. 3, Spring 2005. *See also,* Joel C. Dobris, *Why Five? The Strange, Magnetic, and Mesmerizing Affect[sic] of the Five Percent Unitrust and Spending Rate on Settlors, Their Advisors, and Retirees,* 40 REAL PROP. PROB. & TR. J 39 (2005).

reflection, this seems correct. In fact, if the earnings of companies grew as much as inflation, one would be inclined to conclude that the earnings yield would be an appropriate payout rate, at least after subtracting for taxes and expenses. Unfortunately, neither earnings nor dividend payouts are all that stable. Today, for the S & P 500 index at the moment, it would dictate a payout between 1.79%, representing the S & P 500 current dividend yield, and 6.18%, the last 12 months operating earnings year from the same source. So while true, the notion is not sufficiently precise to be of much help. Indeed, there may be no real effective market-based spending rule that works for all times and all conditions, including tax rates and policies that influence dividend rates in a critical way.

A recent article in ACTEC Notes by Edward A. Moses, J. Clay Singleton and Stewart Andrew Marshall, III contains a helpful case study of a thoughtful trustee needing to respond to the demands of the income beneficiary while not unfairly prejudicing the remainder beneficiary. The second spouse income beneficiary is dissatisfied with her 3% payout rate, and the trustee with the help of his financial experts are able to analyze the probable outcomes of adopting a higher return portfolio that will produce a "win-win" situation for the current and remainder beneficiary in which the expected values to be received by both the current and remainder beneficiaries are both increased by the change.[217] And this is perfectly possible, because the rule of income generally depresses the total return from the trust by mandating too much of the portfolio be invested in fixed income. While it is helpful to go through the illustration, there are many places where one can slip in the process:

> Tom had also managed the trust so that historically all capital gains had been offset by capital losses and the portfolio did not incur capital gains taxes. Though perhaps slightly unrealistic, for illustrative purposes, John assumed that the trust would continue not to be liable for capital gains taxes. Neither would it be liable for income taxes, as it was expected that all income would be distributed within the anticipated withdrawal amount.[218]

This is of course a critical error, not just a slightly unrealistic assumption, and it is particularly so where the case study includes a substantial shift in the asset allocations to a higher return portfolio, a process that can rarely be done without substantial initial capital gains and consequently capital gains taxes to the portfolio. The case study also assumes that the power to adjust is used in order to distribute a fair portion of the total return, which is likely to mean that the capital gains taxes will stay in the trust portfolio, causing it to have an even greater effect over time.

There are no easy answers, no easy methods of distribution that guarantee success. And the truth is that you cannot pay out a whole lot to the beneficiary on a yearly basis and still have a reasonable shot at preserving the real value of what you have and what you can spend in the future. Three percent may be all one can spend, perhaps 4% or higher if you use a unitrust method of distribution and invest mostly in equities, but only if you can stand the volatility. And the more we constrain that volatility for the income beneficiary, the more risk of depletion the

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[217] *The Appropriate Withdrawal Rate-Comparing a Total Return Trust to a Principal and Income Trust*, Edward A. Moses, J. Clay Singleton and Stewart Andrew Marshall, III, ACTEC JOURNAL, Fall, 2005, 118.
[218] *Id* at 121.

portfolio will take in the process. Even in an ideal world of investing and distributing, where everyone takes all of the considerations into effect, considers a prudent investment policy and distributes based upon a reasoned and well thought out plan of total return investment and distribution, there is no guarantee. But we do not live in anything close to an ideal world, even in this tiny corner of it that deals with investing and distributing from trusts, as the following final chapter of this article illustrates all too well.

IV. ARE WE REALLY PRACTICING DIFFERENTLY? A SCARY LOOK AT A COUPLE OF UNSCIENTIFIC SURVEYS!

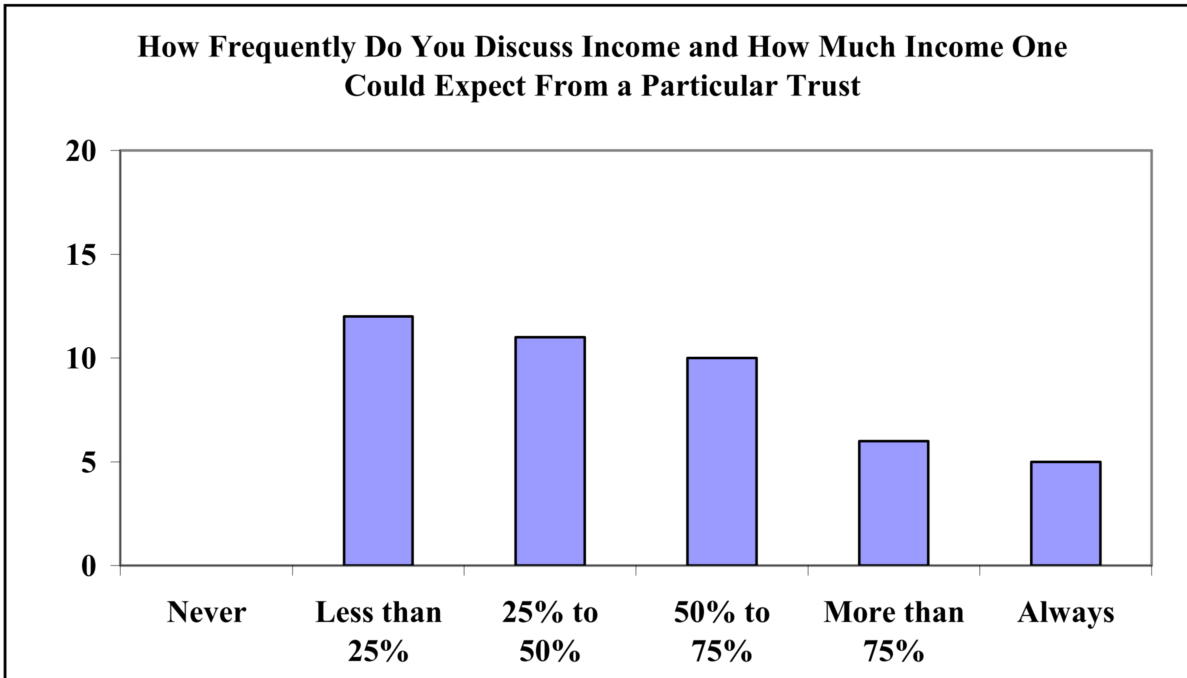
In late 2004, I and a number of my co-speakers from the Pennsylvania Bar Institute and the American College of Trust and Estate Counsel, surveyed estate and trust practitioners to try to measure their response to the revolutionary changes that had occurred in the laws concerning the investment and distribution of trust portfolios. We polled Pennsylvania practitioners in connection with a Pennsylvania Bar Institute course about the new Principal and Income Act in Pennsylvania, which had been in force for two years at that time. Separately, we polled the attendees at a session on the topic of "Planning, Administering and Litigating the Total Return Trust" at the Fall 2004 Meeting of ACTEC.[219] The purpose of these surveys was to measure the effects that the dramatic sea changes in the laws in investing and distributing trusts had on how practitioners spoke to their clients about the planning choices and about the concept of "income" in the planning process, and to measure the response of practitioners and the trustees they represent to the changes in the laws regarding principal and income. To what degree had they communicated the new choices to their client trustees, particularly non-professional individual trustees, to what degree did the trustees respond, and to the extent that there was a response, what was it, and did it impact the way the trusts were invested?

The responses to the survey were relatively light in all venues in which it was introduced—between 5% and 10%. In general, the responses came for the most part from practitioners whose level of competence was well above average. This is perhaps obvious for the survey taken at an ACTEC meeting, but the survey results from the Pennsylvania practitioners in Pittsburgh and Philadelphia was similar in that the responses were not a cross section, but were populated generally by the more highly experienced and well-regarded practitioners. That having been said, the fact that the respondents were who they were made the survey results all the more striking. If these results are in any way reflective of estate and trust planning and administration; the answer to the question, "Are we there yet?" is an emphatic "No." Not even close. The full survey results are set out in the Appendix to this article, but the high spots will be discussed in this section.

[219] Margaret E. W. Sager, Jane K. Anastasia, *Litigating the Total Return Trust* American College of Trust and Estates Counsel, Fall Meeting 2004, Session I-MEWS; Robert B. Wolf, *Total Return Trusts-Meeting Human Needs and Investment Goals Through Modern Trust Design,* American College of Trust and Estates Counsel, Fall Meeting 2004, Session I-RBW; Paul S. Lee, *Implementing Total Return Trusts,* American College of Trust and Estates Counsel, Fall Meeting 2004, Session I-PSL.

A. ARE WE TALKING TO OUR CLIENTS ABOUT "INCOME"?

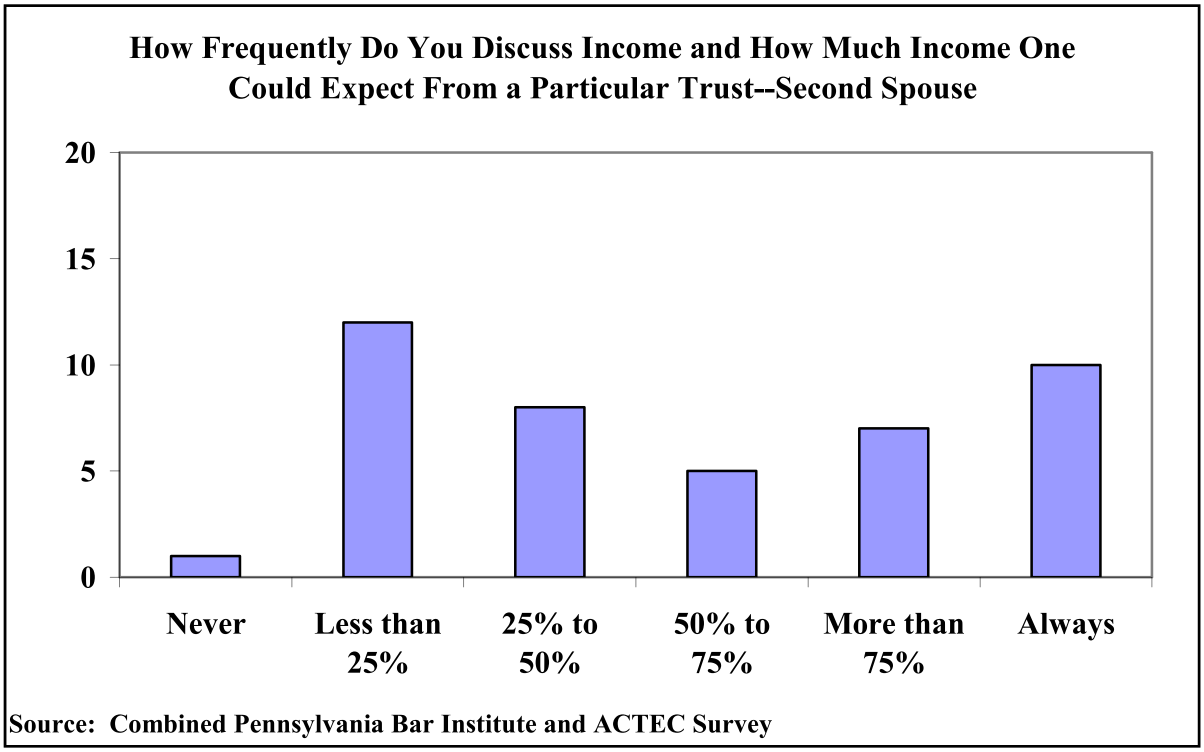
One might sensibly ask why we need to talk to our clients about the trust concept of income at all? And indeed we perhaps do not need to talk to them about it to the extent that our documents do not define what beneficiaries are to receive in terms of income, but for the most part our documents do talk about income, and often treat income differently than principal. So if we have a trust for the client's spouse that says to hold the principal and pay the "income" to the spouse, then it may be quite important to the client and spouse that they understand what the term "income" means, and particularly so if the client actually does not have an understanding of what trust "income" means. And do we think they do know what it means? I for one do not. For every 10 clients asked whether capital gains is part of "income" in such a trust, seven of them would say that it is and the rest would not know. Most would think that it is a part of "income" because they know that they pay tax on it. "Income tax," in fact. But of course they would be wrong about that in the traditional income and principal world. They would know that dividends and interest were "income" but many would probably not have a clue as to how much of that "income" they might expect to receive from a $2,000,000 trust. And if they lived in a state that had a new principal and income act, the possibility that they would understand about how the power to adjust or the power to convert to a unitrust would operate is really remote.



Source: Combined Pennsylvania Bar Institute and ACTEC Survey

The results shown above were actually significantly improved according to the surveys from what they were prior to the passage of new state laws about income and principal, but there were still more than half of the estate planners who discussed it with their clients less than half of the time. This obviously allows a greater probability of disappointment on the part of the beneficiary because they may have no basis to know what income they should expect from the trust left them by their spouse or whether the goals they may have for the trust may be satisfied.

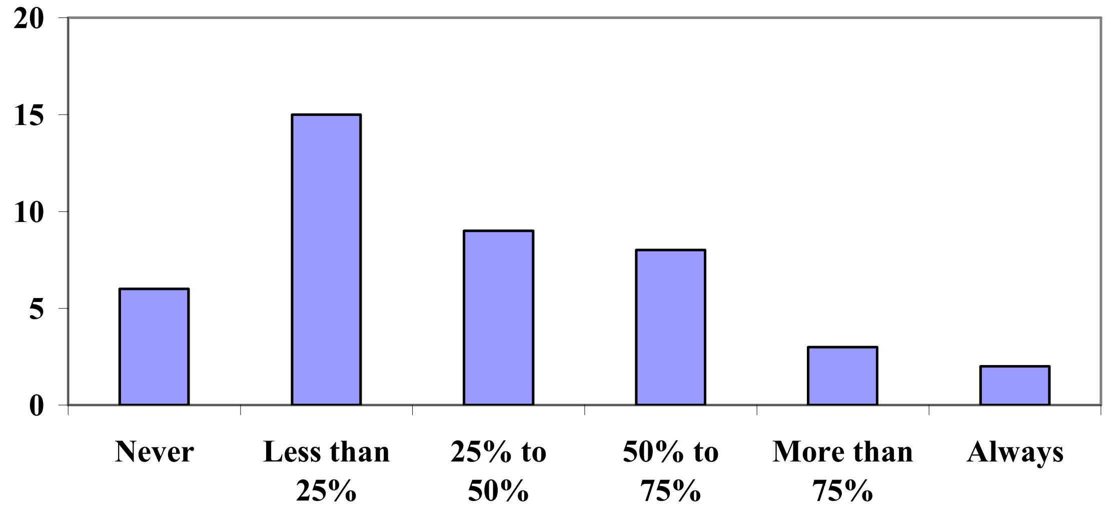
What if the situation involves a second spouse? Surely then the discussion would revolve around income and expectations from the trust being drafted?



Clearly overall a better result, with quite a few people saying that they did it all the time in this situation, yet again almost half did not do it most of the time.

So if in the drafting of our trusts the income needs of the beneficiaries is important, then for the most part estate planners surveyed are not asking the questions they need to ask in connection with those needs, and even more clearly, they are not discussing them with the client's investment advisors.

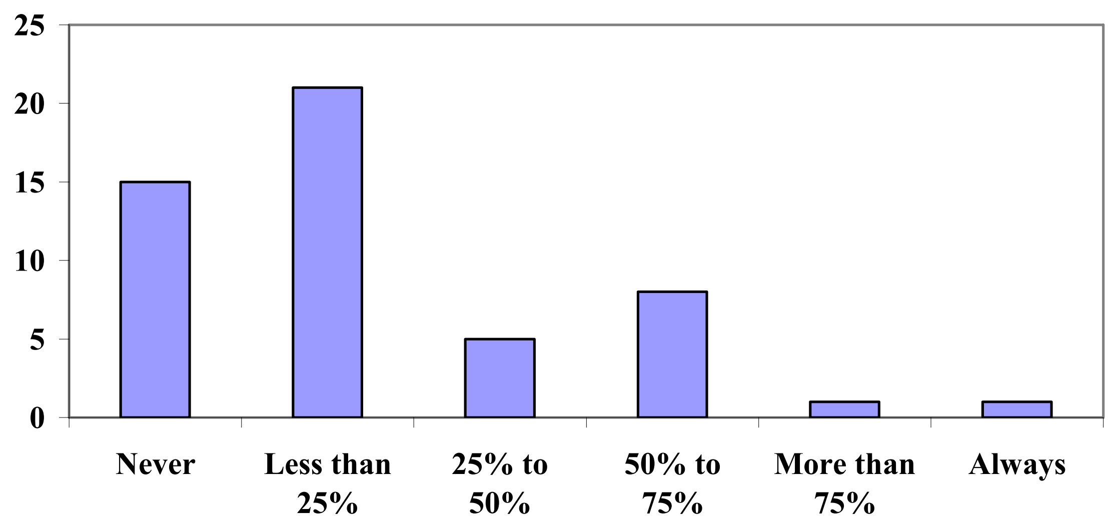
Do You Discuss Income Needs With Clients' Investment Advisor?



Source: Combined Pennsylvania Bar Institute and ACTEC Survey

Because, for the most part, estate planners do not talk to their clients or their financial advisors about what income is about and about what they can expect from a given trust portfolio, it is not surprising that relatively few trusts are currently drafted as unitrusts.

How Frequently Do you Draft a Non-Charitable Unitrust For a Marital Trust?

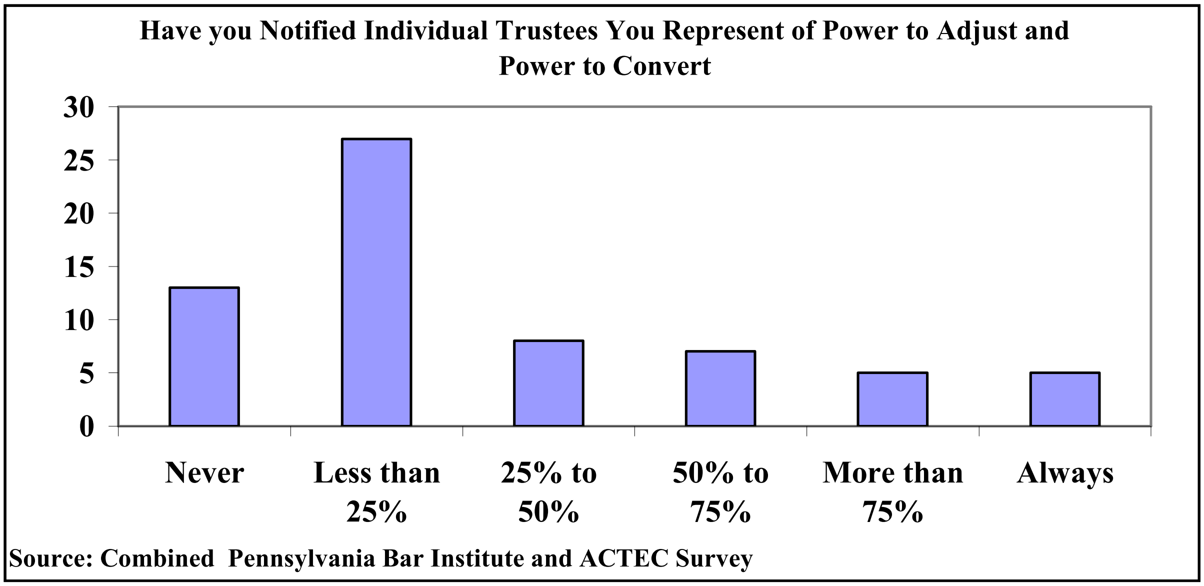


Source: Combined Pennsylvania Bar Institute and ACTEC Survey

Overall, the foregoing results are discouraging and indicate that we have a long way to go as a profession before we can say that we have internalized these new theories of investing and distributing from our trusts. Obviously, those who have studied the matter in depth believe in the importance of the issue and in the new tools to invest prudently and distribute fairly, but it has a ways to go before the knowledge filters through to the everyday life of the estate planner. Now one might say that with the new tools that we have, we do not have to deal with the issue of "income" since the trustees will have the ability to "cure" the problem we have created by failing to discuss it with our clients by using the power to adjust or the power to convert to a unitrust, if that seems like a good idea at the time. On one level, that is true enough, but we are leaving the client out of the process. What does the client think about giving the trustee the power to transfer principal to income, or to convert to a 4% unitrust under a state statute? Surely, if the client knew about the issue and the "remedies", the client would have an opinion about them, and the time when the trust is drafted is the right time to deal with it, rather than when the trust has gone into effect and the client can no longer be consulted!

B. ARE WE TALKING TO OUR INDIVIDUAL TRUSTEES ABOUT THESE NEW LAWS AND THE NEW OPTIONS THEY OFFER?

The most disconcerting part of the survey responses was with respect to the estate and trust practitioners' failure to advise individual trustees of the changes in the law. A corporate trustee is much more likely to be well informed about the changes in the laws and much more likely to have procedures put in place to deal with them. An individual trustee, on the other hand, is very unlikely to know about changes in the Prudent Investor Act or the Principal and Income Act in their state of residency. While these changes have found their way into the mainstream press, it is not big news to most of the population, and as a result, it is quite unlikely that a family member tapped to be a trustee for a surviving spouse (often the spouse herself or himself) will have any awareness of the changes in these laws. If that is so, the trust is very likely to be administered without the investment and principal and income options afforded by the new laws. As a result, permanent harm may be done to the trust, the trust beneficiaries and potentially to the trustee. Ignorance of major changes in the law will not be a defense to a surcharge action against the trustee at a later time when someone discovers that the trustee could easily have invested for total return, rather than investing and balancing investment for income needs and principal growth separately. The estate planning attorney is likely to be the only one in a position to inform the trustee of these new options. But are they doing it?

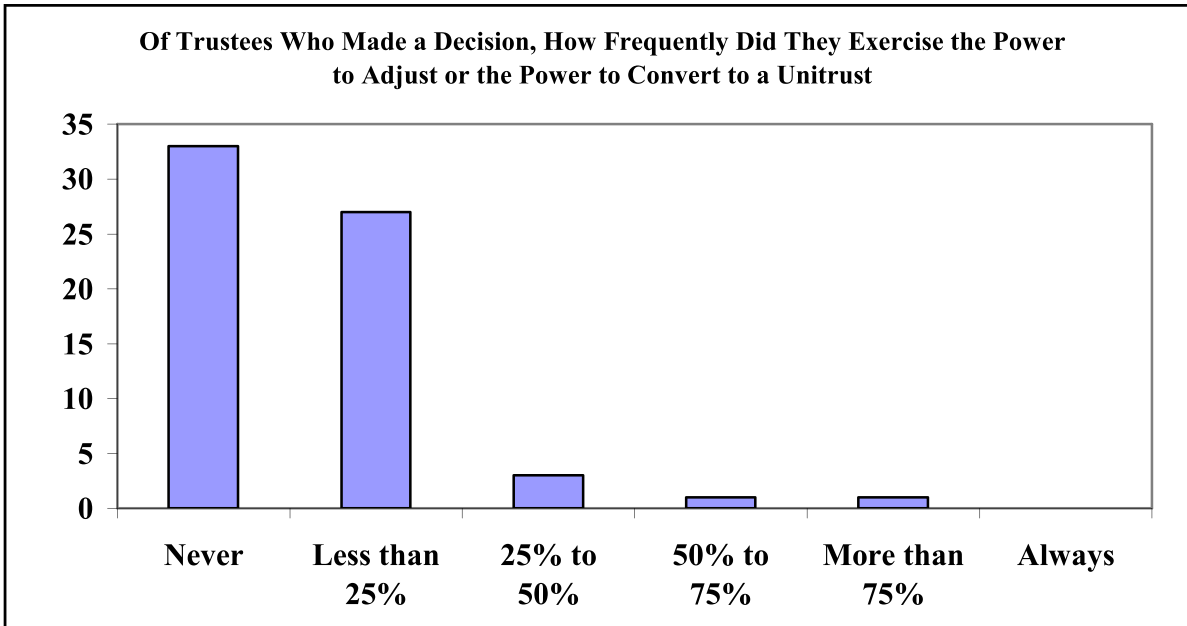


Some of the practitioners stated that they *never* advised individual trustees of the power to adjust or the power to convert to a unitrust. This is perplexing, particularly since the question includes the assumption that the trustee is someone *you represent* And the overwhelming majority of the practitioners informed less than a quarter of their clients about these critical changes in the law. The ACTEC and PBI survey results are combined because the results were virtually identical. The results in the ACTEC survey are also combined as to the states with the power to adjust and the power to convert, because, again, there seemed to be little difference between these categories either.

What does one conclude from this? One would assume that the practitioners just have not done this yet, and that the few individual trustees who were informed up to that time were likely the ones who needed to know the news the most.

C. AND WHAT DID THE INDIVIDUAL TRUSTEES DO ABOUT IT?

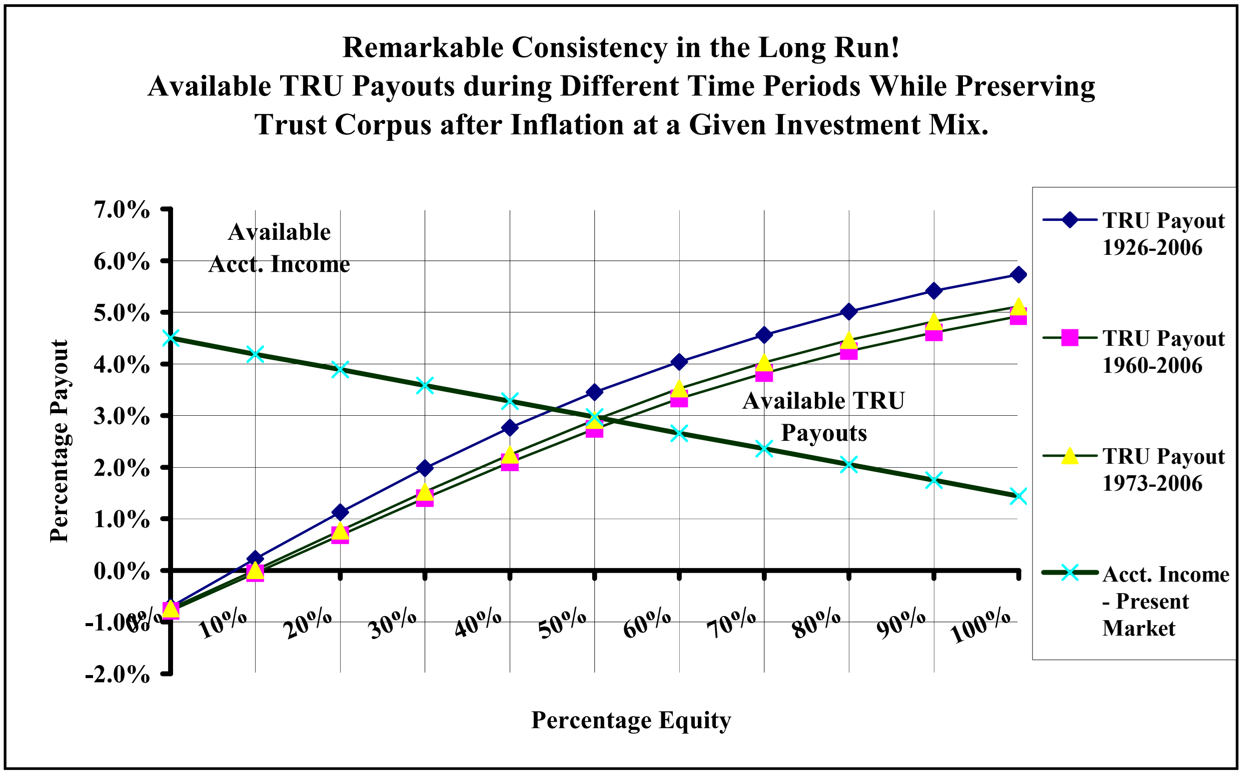
But of those who have considered the matter, most of the trustees have not made a decision as of the time of the survey, and of those who have made a decision, most of them did not exercise the power to adjust or the power to convert to a unitrust.



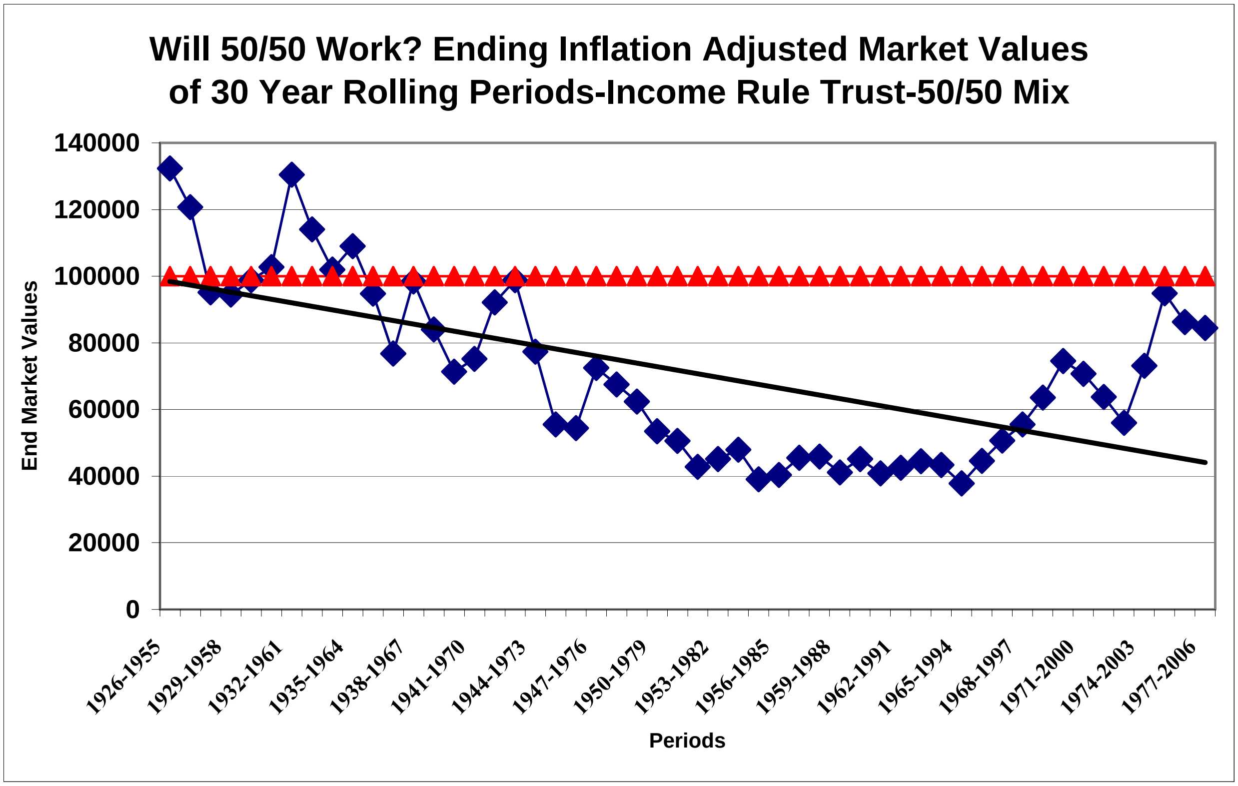
Source: Combined Pennsylvania Bar Institute and ACTEC Survey

The responses to the power to adjust and the power to convert to a unitrust have been combined because, while the responses to the unitrust were slightly more favorable than the responses to the power to adjust, the majority of trustees who were informed of their new options and made a decision decided to do nothing.

What is the likelihood that doing nothing was the right decision? If the trust were invested appropriately with proper regard for diversification and risk and return appropriate to the particular trust, which of course is possible, what is the chance that the trust is distributing the right amount of income to the current beneficiary? Well, if the trustee is paying out the income, and only the income, the following graph likely illustrates the probability in a general way:



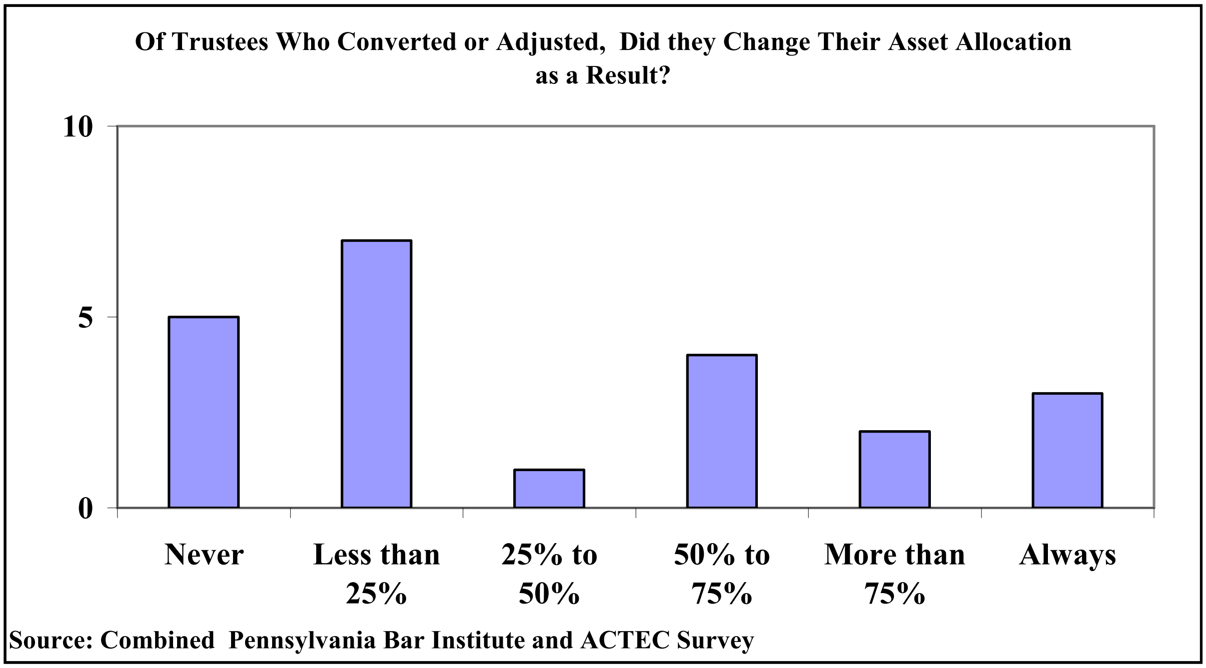
The foregoing graph shows three long periods and the available accounting income from a current stock and bond portfolio. Based upon these slices of history, the accounting income might have been the "right" amount to distribute wherever those lines intersected, and at no other places. Worse yet, the foregoing graph is not a graph of trusts paying out all of the income, but rather of trusts paying out a unitrust amount, and the appropriate amount to distribute would have been around 3%, which would be the available accounting income for a 50/50 asset allocation currently. And we also know that paying out all of the income in a 50/50 asset allocation is highly *unlikely* to preserve the real value of the trust, if that is the goal. Again we take a look at all of the rolling 30-year periods in history with this asset allocation and find that it has been 42 years since the last 30-year period in which this worked, and it is very unlikely to work today, simply because the bond portion of the portfolio is paying out all of its return to the income beneficiary, and will depreciate in real value every year.



But it is still certainly possible that the asset allocation employed in a particular trust is just the right asset allocation from the point of view of risk tolerance and the goals of the trust, and it is also possible that the income thrown off from that portfolio is just the right income to treat the beneficiaries impartially, or in a manner consistent with the intent of the settlor as expressed in the terms of the trust.

But it is very, very, very unlikely.

And what of those trustees who have used the power to adjust or the power to convert to a unitrust, did they change their asset allocation as a result? Surely they would change their asset allocation once they were free to do so, because prior to the exercise of the power to adjust or the power to convert to a unitrust, they were bound to invest the trust impartially given the need for income and the desire for principal growth that was appropriate to the terms and goals of the trust.



The decision to not change the asset allocation once the distinction between income and principal no longer mattered is very unlikely to be the right decision, unless the trustee was previously ignoring her responsibilities to the current beneficiaries or the remainder beneficiaries in setting the asset allocation previously. Let us say that a trust is currently invested primarily for growth with an 80% equity and 20% fixed income portfolio. The current income return on the fund is likely to be about 2%. This might well be considered an appropriate asset allocation for a long term trust, and one might suppose there are some income beneficiaries who think that a 2% income distribution is a fair and impartial distribution given the total return from the trust, but it is submitted that hitting both of these bulls' eyes by accident is not very likely.

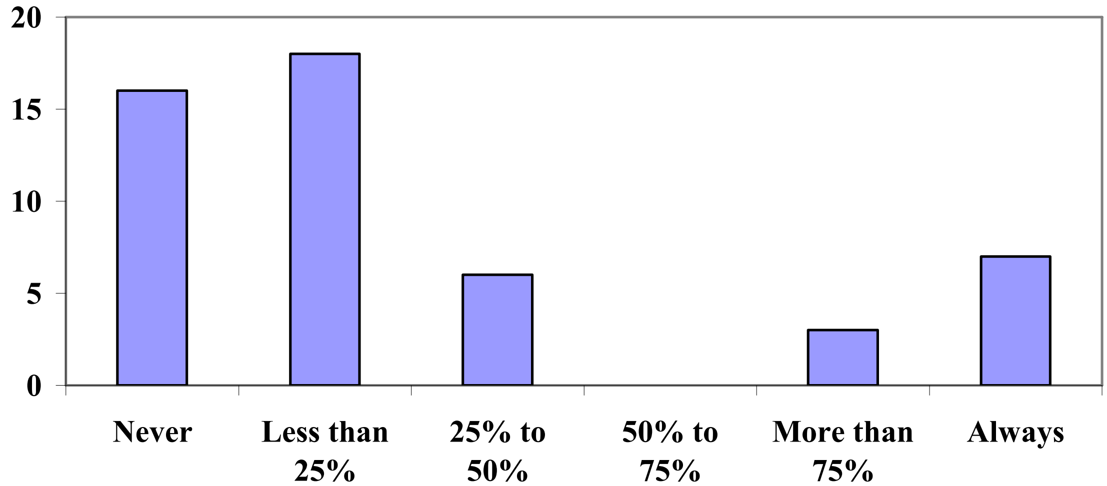
One is more inclined to think that the attorney and the trustee in this process got off the train when they got tired of thinking about all of this. Note the number of responses by the time we got to this point from both the PBI and the ACTEC survey, and this calls for responses for both the power to adjust and the power to convert to a unitrust.

D. WHAT ABOUT THE CORPORATE TRUSTEES?

It is without a doubt much more likely that the corporate or other professional trustee will know about the changes in the law and have imposed some sort of a process or a regime to deal with it than would be the case with an individual trustee. And it is safe to say that most if not all corporate trustees have responded in some way to these substantial changes in the laws, at least by adopting a policy they deem appropriate to this process.

But from the attorney and estate planning practitioner's viewpoint, the process does not appear to be thoroughgoing or complete. Again we will combine the power to adjust and the power to convert to a unitrust and inquire as to how frequently corporate trustees have made a decision either to convert or adjust or do nothing?

How Often Have Corporate Trustees Made a Decision on the Power to Adjust or the Power to Convert to a Unitrust?

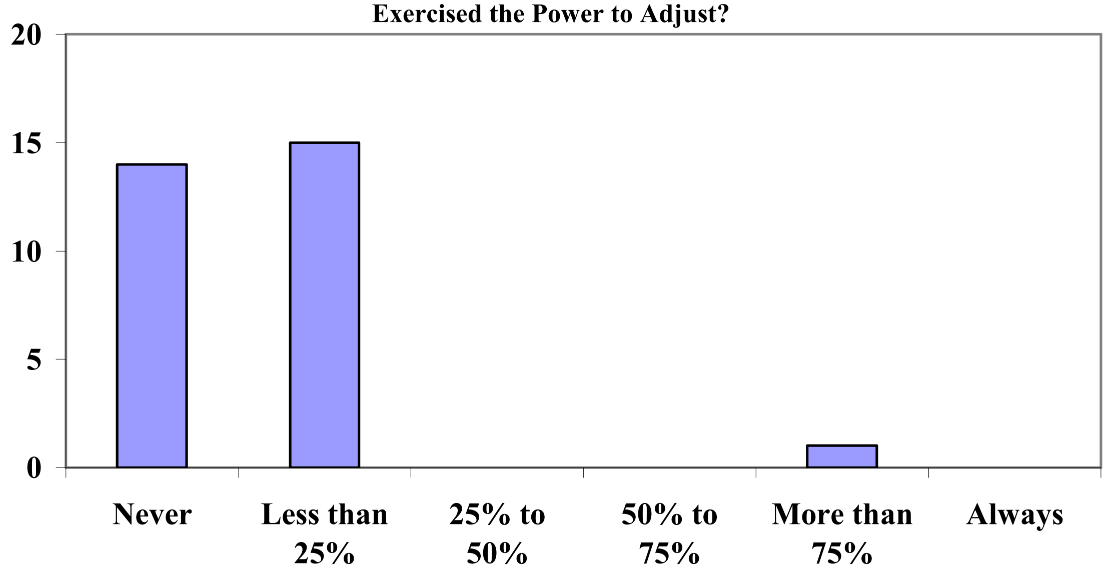


Source: Combined Pennsylvania Bar Institute and ACTEC Survey

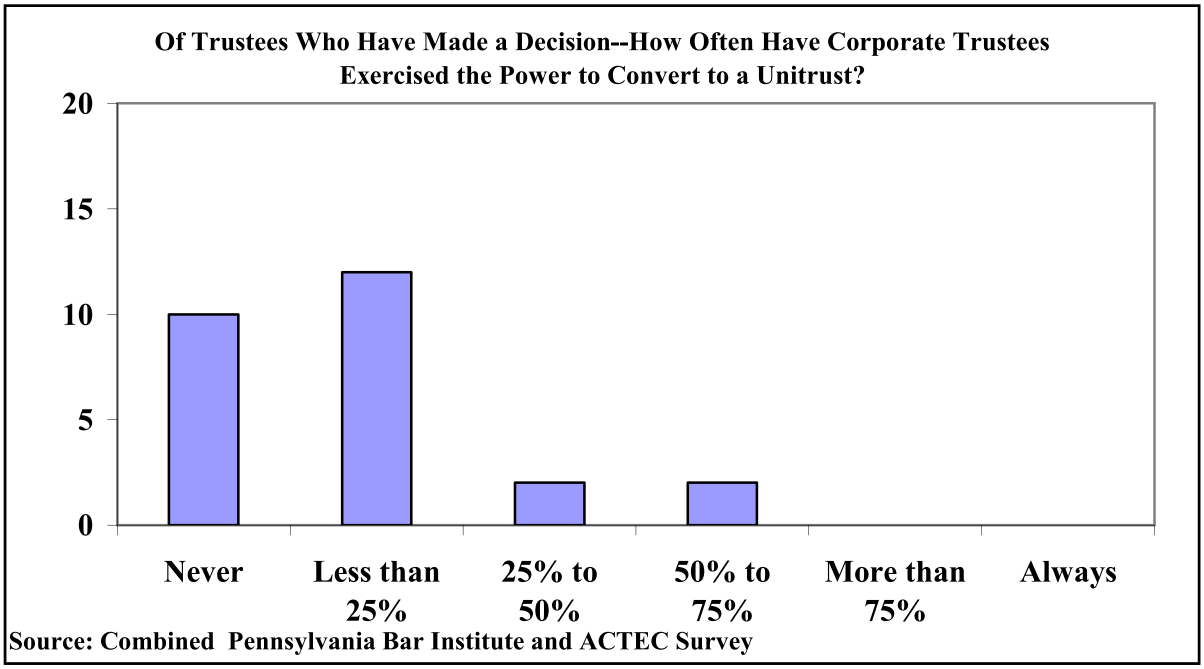
If the practitioners' perceptions of the corporate trustee decision making process is at all accurate, the process is nowhere near complete. Of course, it is quite possible that the corporate trustee has reviewed the matter thoughtfully, made a decision and not communicated it to their legal counsel, which is not ideal either, particularly if it is also not communicated at all to the trust beneficiaries.

But if a decision is made, how often have corporate trustees exercised their abilities to use these new tools? Unfortunately, the answer seems to be very infrequently. (*See Graphs which follow.)*

Of Trustees Who Have Made a Decision--How Often Have Corporate Trustees Exercised the Power to Adjust?

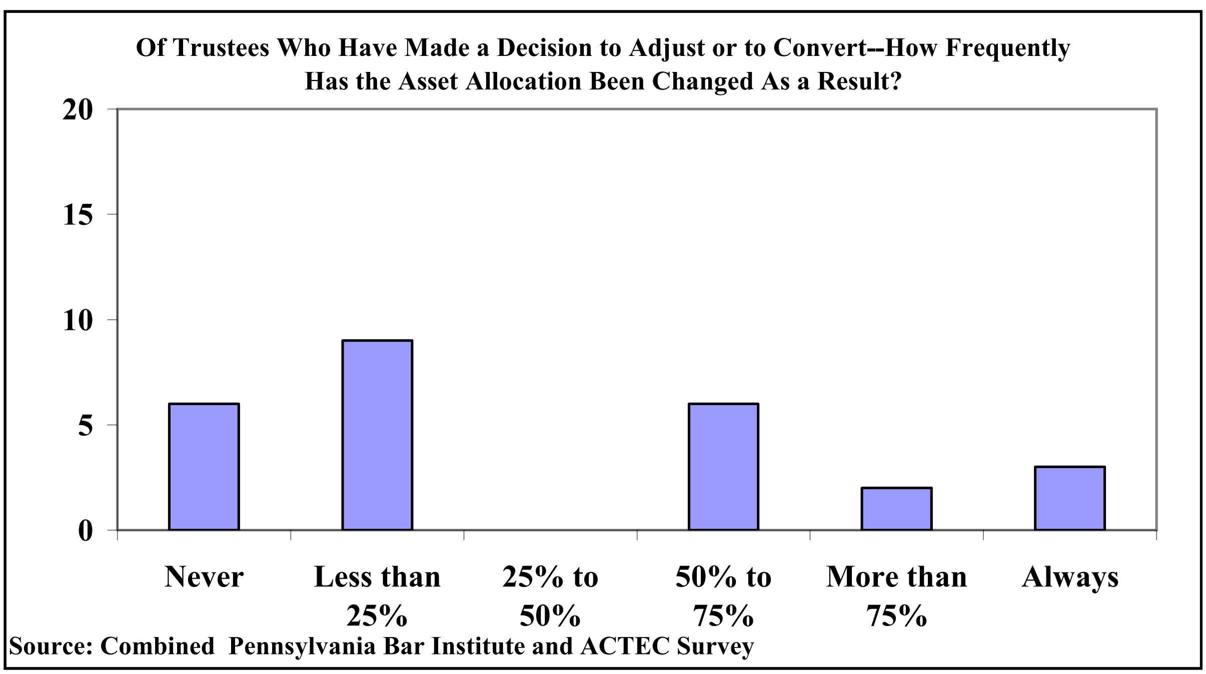


Source: Combined Pennsylvania Bar Institute and ACTEC Survey



So the statistics are not encouraging as to the corporate trustees either, and for the most part there is no particular split between the power to adjust and the power to convert to a unitrust. Mostly it appears that the trustees are just not using their new powers.

And of those who have exercised their powers, how many have changed their asset allocation as a result?



That is the same dismal-appearing result as we saw for the individual trustee who had exercised the power to adjust or the power to convert to a unitrust.

E. TO A STARTLING DEGREE, WE JUST DON'T GET IT!

How would one summarize all of these results, apart from saying that when it comes to advising about, deciding upon and implementing total return investment and distribution policies? We (they) just don't get it!

F. WHAT WILL THIS MEAN IN THE LONGER RUN FOR TRUSTEES AND BENEFICIARIES?

Failure to properly advise, decide upon or implement total return policies can and will cause a lot of harm to trusts, beneficiaries, trustees and their counsel over time, but it is the decisions that directly affect the investment of the trust funds, rather than the distribution of the returns, that are by far the more dangerous to all concerned.

While state laws differ with respect to the extent to which the trustee may be held responsible for discretionary decisions, such as the decision to convert or not to convert to a unitrust or the decision to adjust or not to adjust, the distribution decisions are generally reparable by simply making an additional distribution or withholding or reducing a distribution in the future. And Section 105(c) of the Uniform Principal and Income Act affirms this principle by directing additional distributions to make up for a distribution that was too small, and the withholding of future distributions to make up for a distribution that was too large. Only if neither of these remedies will make the parties whole should a surcharge of the fiduciary be imposed. And generally, this will not be necessary even if an abuse of discretion is found in distributing too much or too little. There is no loss to the trust beneficiaries in the aggregate, but only to one party while benefiting the other party.

It is on the investment side of things that damage can be done that cannot necessarily be undone or adjusted between the parties. And this is where the real danger to the trustee and the trustee's counsel may lie. There are likely to be many instances in which the trustee continues to invest the trust assets on the assumption that the trustee must balance the need for the production of a certain amount of traditional income from the portfolio with the need to preserve and build principal value in the trust. And that may result in the trustee investing in a traditional 50/50 portfolio or something similar, whereas if the trustee knew that she had the ability to adjust from principal to income, the more prudent portfolio might have been 80% equities and 20% fixed income, given the various factors involving the trust under the Prudent Investor Act.

The difference in return from such a difference in investment portfolio may raise the stakes to all concerned quite considerably. A 50/50 asset allocation and an income payout over all of the 20-year periods in history would have produced an average ending value of $178.995 starting with $100,000 without adjusting for inflation, while an 80/20 investment portfolio paying out 4% on a unitrust basis with a five-year smoothing rule would have produced an average ending value of $292,309, a difference of over 63%! And the income beneficiary would not have collected the difference because the income beneficiary probably also received less money than would have been the case had the trust been better invested. And if the trustee invested imprudently because the trustee did not know about the "new" laws, the trustee probably has no defense against a later suit by the remainder beneficiary for the damage suffered to the trust portfolio, unless the defense was that the trustee relied on the advice of counsel that this was a prudent and lawful course of action, and that chain of events would be an unpleasant one for counsel as well. What, after all is the obligation of an attorney to keep his or her clients who are trustees up to date on the laws that affect the trust administration? Certainly that may depend upon the nature of the engagement,[220] but if the engagement is an active one on behalf of an individual trustee, the risk to the attorney may be significant.

And what of the measure of damages where there is a breach of fiduciary duty in investing the trust? Is it merely the loss in value from the initial value of the trust estate? Or is it the difference in value and return that might have been enjoyed if the trust had been invested as it should have been as opposed to the way it was invested? That is an active debate that for the most part is yet to be decided. The Restatement (Second) of Trusts left the question of lost profits open, whereas the Restatement (Third) of Trusts opens the door to calculate damages based upon performance of relevant assets in the trust or in comparable trusts, or the performance of appropriate securities indices.[221] And the cases across the country to date take different views on the measure of damages, with some allowing for damages for lost profits, and some not allowing such damages.[222] It seems that the nature and extent of the breach of fiduciary duty found by the court may well affect the scope of the damages. The more flagrant the breach, the more likely it is that there will be an imposition of damages based upon lost profits. It is a natural inclination of the courts to be hesitant to allow a flagrant breach of duty to escape liability based upon the damage being difficult to determine or speculative in nature.

But the real answer to these questions of liability and damage is to have a properly informed process for developing a total return investment and distribution policy for the trust. The vast changes in the laws over the past decade give trustees the legal, trust and investment tools they need to do the job, but in practice, "We're not there yet."

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[220] Margaret E. Sager, *supra n.* 220, at 14-16.

[221] *See* Dominic J. Campisi and Patrick J. Collins, *Index Returns As a Measure of Damages in Fiduciary Surcharge Cases,* TRUST & EST., June 2001.

[222] *Compare Nickel v. Bank of America*, 290 F.3d 1134 (9th Cir. 2002) (holding that such damages were too speculative), and *Williams v. J.P. Morgan & Co., Inc.*, 199 F. Supp. 2d 189 (S.D.N.Y. 2002)(finding lost profits allowable only where there is self-dealing or bad faith) with *In re Estate of Scharlach,* 809 A.2d 376 (Pa. Super. 2002) (allowing damages based upon what the court found to be the total return from an appropriate portfolio during the relevant period) and *In re Williams*, 2000 WL 1920038 (Minn. Dist. Ct. 2000) (allowing damages based upon what the value of the trust would have been if properly diversified). *See generally* Margaret E. Sager, *supra* n. 220, at 25-38.

APPENDIX A

Pennsylvania Bar Institute
The Pennsylvania Uniform Principal & Income Act

Survey of Attorneys in Private Practice

Tom Hiscott and John Shaffer and I will be speaking on the Pennsylvania Uniform Principal & Income Act at a PBI programs (www.pbi.org) in October in Pittsburgh, Philadelphia and Mechanicsburg, and we are trying to assemble data on how practitioners may have changed their approach as a result of the Act.

All responses to the survey will be kept anonymous.

The goal of this survey is to assemble data on how attorneys in private practice may have changed their approach as a result of the Act. Therefore, lawyers who are not in private practice (or non-lawyers) should not complete the survey.

You may email the completed survey to rwolf50@aol.com, or fax it to (412) 281-6115 or mail it to:

Robert B. Wolf
Tener, Van Kirk, Wolf & Moore
920 Oliver Building
535 Smithfield Street
Pittsburgh, PA 15222-2368

If you wish to respond to the survey via email, you will need to save the attached survey as a Word document, complete the survey and then attach that new Word document/completed survey to your email to Bob

If we have a sufficient number of responses to generate some meaningful results, we will share those results with you on the Hot Tip List as well as at the PBI programs.

We appreciate your help in making this survey a success.

PLACE AN “X” UNDER YOUR RESPONSE.

1. Prior to the adoption of the 2002 Pennsylvania Uniform Principal and Income Act, how often did you discuss the meaning of trust "income" with estate planning clients, and the amount of income that one could expect a particular fund to generate?

Never	**Less than 25%**	**25%-50%**	**50%-75%**	**More than 75%**	**Always**
1	**12**	**2**	**3**	**3**	**4**

2. How often do you currently discuss the meaning of trust "income" with estate planning clients, and the amount of income that one could expect a particular fund to generate?

Never	**Less than 25%**	**25%-50%**	**50%-75%**	**More than 75%**	**Always**
	9	**5**	**4**	**2**	**4**

3. How often do you currently discuss the changes in the meaning of trust "income", the power to adjust and the power to convert to a unitrust with estate planning clients?

a. Generally?

Never	**Less than 25%**	**25%-50%**	**50%-75%**	**More than 75%**	**Always**
2	**11**	**3**	**3**	**3**	**2**

b. In the context of Outright Marital/ credit shelter planning?

Never	**Less than 25%**	**25%-50%**	**50%-75%**	**More than 75%**	**Always**
3	**12**	**2**	**4**	**1**	**2**

c. In the context of QTIP / credit shelter trust planning?

Never	**Less than 25%**	**25%-50%**	**50%-75%**	**More than 75%**	**Always**
2	**10**	**4**	**3**	**1**	**4**

d. In the context of generation-skipping trusts?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
5	7	4	4	2	2

e. In the case of second marriages?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
2	5	5	3	3	6

f. Do you discuss income needs with clients' investment advisor, or seek his or her input?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
5	7	3	5	2	2

4. How often do you currently draft a private (non-charitable) unitrust in lieu of paying out the "income"?

a. In trusts that ARE NOT intended to qualify for the marital deduction?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
9	13	2			

b. In trusts that ARE intended to qualify for the marital deduction?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
14	8	2			

THE FOLLOWING QUESTIONS APPLY TO TRUSTS FOR WHICH YOU ARE COUNSEL IN WHICH THERE IS NO CORPORATE TRUSTEE.

5. Have you notified individual trustees you represent of the existence of the power to adjust / power to convert to a unitrust?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
6	9	2	3	2	2

6. Have the trustees discussed the possible exercise of the power to adjust/ power to convert to a unitrust?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
8	7	4	3	1	1

7. In how many of the trusts have the trustees made a decision?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
9	9		2	1	3

8. Of those trusts in which the trustees have made a decision, what percentage:

a. Have been converted to a unitrust, or is conversion in progress?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
11	7	2	1		

b. Has the power to adjust has been exercised?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
12	8				

c. Have the trustees decided to do neither one?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
6	3	2	1	5	3

d. In those cases in which the trustees have decided to do neither one, how often was the decision based upon tax concerns?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
10	5	3		1	1

e. Is the trustee's decision concerning the power to adjust and the power to convert to a unitrust reviewed on an annual basis?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
13	4	2		1	1

9. If the trustee has exercised the power to adjust or the power to convert to a unitrust, has the trustee also changed the asset allocation of the trust? (DO NOT ANSWER THIS QUESTION FOR TRUSTS WHICH HAVE NOT USED THE POWER TO ADJUST OR THE POWER TO CONVERT TO A UNITRUST)

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
3	3	1	2	2	1

THE FOLLOWING QUESTIONS APPLY TO TRUSTS FOR WHICH YOU ARE COUNSEL IN WHICH THERE IS A CORPORATE TRUSTEE:

10. Have the trustees discussed the possible exercise of the power to adjust/ power to convert to a unitrust?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
3	6	3		4	3

11. In how many of the trusts have the trustees made a decision?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
5	7	3		1	2

12. Of those trusts in which the trustees have made a decision, what percentage:

a. Have been converted to a unitrust, or is conversion in progress?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
6	9	1	1		

b. Has the power to adjust has been exercised?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
9	7				

c. Have the trustees decided to do neither one?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
2	3	1	1	7	2

d. In those cases in which the trustees have decided to do neither one, how often was the decision based upon tax concerns?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
7	4	3	2		

e. Is the trustee's decision concerning the power to adjust and the power to convert to a unitrust reviewed on an annual basis?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
5	4	2	2		2

13. If the trustee has exercised the power to adjust or the power to convert to a unitrust, has the trustee also changed the asset allocation of the trust? (DO NOT ANSWER THIS QUESTION FOR TRUSTS WHICH HAVE NOT USED THE POWER TO ADJUST OR THE POWER TO CONVERT TO A UNITRUST)

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
3	3		4	2	1

APPENDIX B

ACTEC FALL MEETING
Survey of Practices Concerning Principal and Income & Total Return Statutes

The goal of this survey is to assemble data on how attorneys in private practice may have reacted to the evolutionary changes in the law concerning principal and income represented by the Uniform Principal and Income Act and unitrust conversion statutes. If you do not have either the power to adjust under Section 104 of the UPAIA, or a power to convert to a unitrust in your state, do not fill out this survey. Return the completed survey to the ACTEC Registration Desk and we will tabulate the results and report them appropriately in the ACTEC Journal or on the private side of the ACTEC Website.

If you practice in a state with the power to adjust, please fill out PART A and PART B. If you practice in a state with the power to convert to a unitrust, please fill out PART A and PART C. If you live in a state with both the power to adjust and the power to convert to a unitrust, please fill out PART A, PART B and PART C.

Please Indicate the State Where You Practice ____. If you are employed by a Corporate Fiduciary, please insert name of corporate fiduciary here ____________________ (to avoid duplication) and answer only those questions which are appropriate with reference to your role with a corporate fiduciary.

PART A—FOR EVERYONE—PLACE AN "X" UNDER YOUR RESPONSE.

1. Prior to the adoption of the your state's version of the Uniform Principal and Income Act, or unitrust conversion legislation, how frequently did you discuss the meaning of trust "income" with estate planning clients, and the amount of income that one could expect a particular fund to generate?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
2	11	6	3	1	2

2. How frequently at the present time do you discuss the meaning of trust "income" with estate planning clients, and the amount of income that one could expect a particular fund to generate?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
	7	6	7	4	1

3. How frequently at the present time do you discuss the changes in the meaning of trust "income" that were brought about by your state's version of the Uniform Principal and Income Act or unitrust conversion statute with estate planning clients?

a. Generally?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
2	11	5	5	1	

b. In the context of Outright Marital/ credit shelter planning?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
2	13	5	2	2	

c. In the context of QTIP / credit shelter trust planning?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
1	12	3	4	3	1

d. In the context of generation-skipping trusts?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
2	14	3	2		3

e. In the case of second marriages?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
	9	3	4	4	4

f. Do you discuss income needs with clients' investment advisor, or seek their input?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	Always
2	11	6	3	2	

4. How frequently do you currently draft a private (non-charitable) unitrust in lieu of one paying out the "income"?

a. In trusts that ARE NOT intended to qualify for the marital deduction?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
2	19	3			

b. In trusts that ARE intended to qualify for the marital deduction?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
5	14	3		1	1

5. How frequently do you the specify the goals and priorities of a trust in the governing instrument (such as favoring one beneficiary over another, one class over another, or one set of purposes for distribution over another)?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
2	4	4	3	6	5

PART B—FOR THOSE IN A STATE WITH THE POWER TO ADJUST

THE FOLLOWING QUESTIONS APPLY TO TRUSTS FOR WHICH YOU ARE COUNSEL IN WHICH THERE IS NO CORPORATE TRUSTEE.

6. Have you notified individual trustees you represent of the existence of the power to adjust?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
2	14	3	3	1	1

7. Have the trustees discussed the possible exercise of the power to adjust?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
5	13	4	1		1

8. In how many of the trusts have the trustees made a decision?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
12	9		1		2

9. Of those trusts in which the trustees have made a decision, in what percentage:

a. Has the power to adjust has been exercised?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
5	8			1	

b. In those cases in which the power to adjust has not been exercised, how frequently was the decision based upon tax concerns?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
4	7		1		1

c. Is the trustee's decision concerning the power to adjust reviewed on an annual basis?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
7	6	1		1	1

10. If the trustee has exercised the power to adjust, has the trustee also changed the asset allocation of the trust? (DO NOT ANSWER THIS QUESTION FOR TRUSTS WHICH HAVE NOT EXERCISED THE POWER TO ADJUST)

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
1	4		1		1

THE FOLLOWING QUESTIONS APPLY TO TRUSTS FOR WHICH YOU ARE COUNSEL IN WHICH THERE IS A CORPORATE TRUSTEE:

11. Have the trustees discussed the possible exercise of the power to adjust?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
3	7	5	2	2	

12. In how many of the trusts have the trustees made a decision?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
6	8	2			3

13. Of those trusts in which the trustees have made a decision, in what percentage of the trusts:

a. Has the power to adjust has been exercised?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
6	6	2	4	1	1

b. In those cases in which the trustees have decided not to exercise the power to adjust, how often was the decision based upon tax concerns?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
8	6	2	2	1	

c. Is the trustee's decision concerning the power to adjust reviewed on an annual basis?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
8	5	3	1		2

14. If the trustee has exercised the power to adjust, has the trustee also changed the asset allocation of the trust? (DO NOT ANSWER THIS QUESTION FOR TRUSTS WHICH HAVE NOT EXERCISED THE POWER TO ADJUST)

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
	4	3		1	2

PART C—FOR THOSE IN A STATE WITH THE POWER TO CONVERT TO A UNITRUST

THE FOLLOWING QUESTIONS APPLY TO TRUSTS FOR WHICH YOU ARE COUNSEL IN WHICH THERE IS NO CORPORATE TRUSTEE.

15. Have you notified individual trustees you represent of the existence of the power to convert to a unitrust?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
2	4	3	1	2	2

16. Have the trustees discussed the possible exercise of the power to convert to a unitrust?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
4	5	3			

17. In how many of the trusts have the trustees made a decision?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
5	4	2		1	1

18. Of those trusts in which the trustees have made a decision, in what percentage:

a. Has the power to convert to a unitrust been exercised?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
5	4	1			

b. In those cases in which the power to convert to a unitrust has not been exercised, how frequently was the decision based upon tax concerns?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
3	4	1			

c. Is the trustee's decision concerning the power to convert to a unitrust reviewed on an annual basis?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
2	5	1			

19. If the trustee has exercised the power to convert to a unitrust, has the trustee also changed the asset allocation of the trust? (DO NOT ANSWER THIS QUESTION FOR TRUSTS WHICH HAVE NOT EXERCISED THE POWER TO CONVERT TO A UNITRUST)

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
1			1		1

THE FOLLOWING QUESTIONS APPLY TO TRUSTS FOR WHICH YOU ARE COUNSEL IN WHICH THERE IS A CORPORATE TRUSTEE:

20. Have the trustees discussed the possible exercise of the power to convert to a unitrust?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
3	4	2	2	2	

21. In how many of the trusts have the trustees made a decision?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
5	3	1		2	2

22. Of those trusts in which the trustees have made a decision, in what percentage of the trusts:

a. Has the power to convert to a unitrust has been exercised?

Never	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
4	3	1	1		

b. In those cases in which the trustees have decided not to exercise the power to convert to a unitrust, how often was the decision based upon tax concerns?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
3	5	1			

c. Is the trustee's decision concerning the power to adjust reviewed on an annual basis?

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
4	1	1		2	

23. If the trustee has exercised the power to convert to a unitrust, has the trustee also changed the asset allocation of the trust? (DO NOT ANSWER THIS QUESTION FOR TRUSTS WHICH HAVE NOT EXERCISED THE POWER TO CONVERT TO A UNITRUST)

No Trusts	Less than 25%	25%-50%	50%-75%	More than 75%	All Trusts
2	2				1

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