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UN-ANTICIPATED CONSEQUENCES AND FALLOUT FROM TAX PLANNING STRUCTURES

EMERGING ISSUES UNDER THE TWIN UPIAS:

Uniform Prudent Investor Act (1994): Restatement (Third) of Trusts and Uniform Principal and Income Act (1997)

By

Susan Porter
Managing Director
U. S. Trust, Bank of America Private Wealth Management
114 West 47th Street
New York, NY 10036
(212) 852-3516
susan.porter@ustrust.com

I. Uniform Prudent Investor Act (1994): Restatement (Third) of Trusts

The Restatement of the Law Third, Trusts – Prudent Investor Rule (hereinafter "Restatement Third") and the Uniform Prudent Investor Act promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) (1994) updated investment guidelines, introducing the prudent investor rule. Section 2(a) of the Uniform Prudent Investor Act provides that a "trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust." Thus the Uniform Prudent Investor Act is designed to accommodate modern portfolio theory: a total return approach to investing. The trustee's primary consideration in investing is the tradeoff between risk and return as applied to risk and reward objectives suitable for the traditional trust. Most states have passed legislation adopting the concepts of the prudent investor rule. Although designed to restore flexibility to the investment process, its principle has important implications for the investment conduct of trustees.

Restatement Third makes five fundamental changes to the criteria for prudent investing:

- The standard of prudence applies to the trust as a whole instead of to individual investments, i.e., the "entity theory;"
- The overall investment strategy should incorporate risk and return objectives reasonably suitable to the trust;
- The duty to diversify is, in general, a part of the investment strategy;
- No investment or category of investments is imprudent per se; and
- The delegation of investment authority is permitted subject to certain safeguards.

A. Inception Assets -- Prior versions of the prudent person rule and many state statutes often treated assets received by the trustee from the grantor or testator ("inception assets") more leniently. Section 4 of the prudent investor act eliminates any such special treatment for inception assets, thereby changing (increasing) responsibility for inception assets. This section applies not only to the initial trustee but also to additional or successor trustees.

1. When enacting the prudent investor act some states have (i) omitted section 4 from their statutes, (ii) negated the duty to diversify inception assets or (iii) expanded section 4 to permit

the trustee to hold both inception assets and assets subsequently added to it or acquired by the trustee.

2. The prudent investor act becomes effective when the act is enacted (unless its application has been waived by the terms of the trust). Does this mean that the trustee of an existing trust must treat enactment of the statute as if it were the inception of the trust and diversify within a "reasonable time"?

   It is difficult to argue that old law (regarding inception assets, for example) should continue when Section 10 of the act is considered.

   Section 10. Language Invoking Standard of [Act]. The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this [Act]: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

   The comment to this section by NCCUSL states that this provision is to facilitate incorporation of the Act by means of the formulaic language commonly used in trust instruments.

B. Diversification – Restatement Third § 227 (b) states: "In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." Diversification is fundamental to the management of risk and is an important consideration in prudent investment management. Diversification reduces variability. The statute gives no guidance as to what "diversify" means. Nor does the Restatement Third provide helpful guidance except in the most general manner. Under what circumstances will a trustee's failure to diversify be acceptable?

   1. Section 1 (b) of the Prudent Investor Act permits a governing instrument to override the provisions of the Act. Therefore the governing instrument can waive the duty to diversify as to all assets, or as to particular assets, or as to inception assets.

a. In *Fifth Third Bank* the grantor created a charitable remainder unitrust ("CRUT"). One of the purposes was to diversify out of Procter & Gamble stock which was the only inception asset. The corporate Trustee was "slow" in selling the stock with the result that at the end of the first year the Trust's value was one-half its inception value. The trustee was replaced and a claim for breach of fiduciary duty was filed and resulted in a jury trial which awarded damages of about $1 million. On appeal the replaced trustee contended that the trust terms exculpated it from liability for losses in value but the appeals court, citing *Wood*, held the language did not clearly indicate the intention to abrogate the duty to diversify.

b. In *Wood*, the grantor created a revocable trust naming himself as trustee. Firstar Bank succeeded as trustee upon the grantor's death. At inception the trust consisted of 80% of Firstar Bank stock and the trust gave the trustee power "to retain any securities in the same form as were received, including shares of a corporate trustee . . . ." The district court held that although the Trustee was allowed to retain the assets, the trustee's duty to diversify remains unless there are special circumstances. The court said there was no indication to abrogate the common-law, now statutory, duty to diversify.

c. The same issue arose in *National City Bank v. Noble*, 2005 Ohio 6484 (Ohio App. 2005) where the trust empowered the trustees to retain:

   "even though such property be of a kind not ordinarily deemed suitable for trust investment and even though its retention may result in a large part or all of the trust property's being invested in assets of the same character or securities of a single corporation. Without limitation upon the generality of the foregoing, the Trustees are expressly empowered to retain as an investment, without liability for depreciation in value, any and all securities issued by The J.M. Smucker Company, however and whenever acquired, irrespective of the proportion of the trust properly invested therein.

The Trustees are empowered to invest and reinvest any part or all of the trust property in such securities *** as they may select, irrespective of any limitation prescribed by law or custom upon the investments of trustees and even though the trust property may be entirely invested in common stocks or other equities".

The court rejected a claim based upon a failure to diversify in an amount so that the Smucker holding did not exceed ten percent of the Trust's value.

d. In *In re Scheidmantel,* 868 A.2d 464 (Pa. Super.2005) the court concluded that the sale of an undiversified holding of a single stock by a corporate trustee with "absolute discretion" and a reinvestment in mutual fund shares constituted "gross negligence". The undiversified shares which were sold were shares of the corporate trustee. As a point of interest, Pennsylvania law differs from New York law which applies the Prudent Investor Rule (including the diversification requirement) to preexisting trusts and does not contain a retention provision similar to the one in the Pennsylvania statute. The case makes clear that a significant change in the investments of a trust should not be made without consulting with the trust beneficiaries.

e. In *Suntrust Bank v. Merritt* 272 Ga.App 485, 612 S.E. 2D 818 (2005) a corporate trustee invested all of the assets of a trust in tax-free bonds to benefit the income beneficiary who was also co-trustee. As a result the trust value when the income beneficiary died was close to the inception value. The remainder beneficiaries alleged a breach of trust but the appeals court affirmed the decision of the trial court that no breach occurred because the interests of the remainder beneficiaries were secondary to those of the income beneficiary. The Supreme Court of Georgia denied certiorari by a four to three vote.

2. Because the scope of diversification is unclear, it is helpful if the governing instrument provides guidance as to the testator's or grantor's intent. The draftsperson should focus on whether to negate diversification and, if a decision is made to do so, to provide a standard as to how the trustee's conduct is to be judged. (See the excerpt from U.S. Trust's Trust and Will Provisions manual (c)2008, where the duty to diversify

is negated by referring to the appropriate prudent investor act.)

3. Section 3 of the Uniform Prudent Investor Act imposes a duty to diversify unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. Thus, trusts that have a particular or significant purpose, such as conserving a particular asset for a family or conserving interests of a family business, may not have a duty to diversify. The Nebraska Supreme Court in *In re Trust Created by Inman*, 269 Neb. 376, 693 N.W. 2d 514 (2005), a case involving whether to sell part of a farm over the objections of some of the trust beneficiaries, referred to a provision in the Nebraska Uniform Prudent Act (similar to the model Act which directs a trustee to consider "an asset's special relationship or value to some or all the beneficiaries") which could be utilized as a basis for justifying "non-diversification" of a family farm or ranch. The court noted its agreement with commentator Ronald R. Volkner, <u>The Latest Look in Nebraska Trust Law</u>, 31 Creighton L. Rev.221 (1997). Similarly, multiple grantor retained annuity trusts (GRATs), each intended to have a particular market or security concentration, but all the GRATs taken together represent a diversified portfolio for the circumstances and purposes of the GRATs.

   Under an irrevocable life insurance trust, some commentators contend that a life insurance policy held in trust is subject to the same investment management standards as is any other asset held in trust and that the Uniform Prudent Investor Act applies to the trustees of such trusts. See, Ballsum, Kathryn A., Patrick J. Collins and Dieter Jurkat, "Trustee Administration of Life Insurance," 31 ACTEC Journal No. 4 (Part 1 of 4-part series). These authors further contend that the ideal ILIT corpus might consist of several types of life insurance policies issued by different carriers. Are we sowing the seeds of our own destruction? Is such diversification necessary or required when one considers the special circumstances and purposes of the ILIT?

II. Uniform Principal and Income Act (1997) Emerging Issues

A. Background -- The update of the investment guidelines introducing the prudent investor act represented a huge step toward insuring that modern portfolio investment theory and practice are applicable to prudent investing for trusts and, significantly, most states have passed legislation adopting the concepts of the present investor rule. This investment philosophy, referred to as "modern portfolio theory," takes into account capital appreciation as well as annual return (which is often described as investing for "total return.") Total return investing was one factor which led NCCUSL to integrate he approach of the Uniform Prudent Investor Act into principal and income allocations by modernizing the Principal and Income Act in 1997, ("the Act").

The most significant change is found in § 104 of the Act. The purpose of § 104 is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional accounting income, such as interest, dividends and rent. Section 104 provides a trustee with the power to adjust by making transfers from principal to income and, far less likely, transfers from income to principal. Often this power to adjust implicitly converts the trust to a unitrust. It is important to observe that, essentially, the power to adjust also controls the tax consequences as well as the income pool available for distribution.

B. Conditions to Exercising Power to Adjust – Three conditions must be met before the trustee can exercise the power to adjust under § 104(a). These conditions are discussed in the Comment to § 104 of the Uniform Principal and Income Act.

1. Prudent Investor – The first condition requires that the trustee invest and manage the trust funds as a prudent investor. Negating the duty to diversify ought not cause the trustee to fail to meet this condition. This is because the trustee is still obligated to act prudently, taking into account that the trust instrument has negated the duty of diversification.

   The Comments state that this condition will be met in states that have approved, by statute or case law, the prudent investor rule. Thus, the Comment states, "As a result, there is a basis for concluding that the first condition is satisfied in virtually all States except those in which a trustee is permitted to invest *only* in assets set forth in a statutory 'legal list.'" (Emphasis added.) (N.B. In New York, where the "power to adjust" is placed in the prudent investor rule (EPTL 11-2.3(b)(5)) rather than in the Principal and Income Act, a statement in the governing instrument that "the prudent investor rule shall not apply to the trust" would negate the power to adjust.)

2. Distribution of Trust Income –The second condition requires that the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income.

The Comment provides that this condition will be met when the terms of the trust require all of the income to be distributed at regular intervals; or when the terms of the trust require a trustee to distribute all of the income, but permit the trustee to decide how much to distribute to each member of a class of beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the greater of the trust accounting income and a fixed dollar amount (an annuity), or of trust accounting income and a fractional share of the value of the trust assets (a unitrust amount). Also, the condition will be met if the trust authorizes the trustee in its discretion to distribute the trust's income to a beneficiary or to accumulate some or all of the income.

3. Applying § 103 – The third condition requires that the trustee must determine, after applying the rules in § 103(a), that the trustee is unable to comply with § 103(b). Section 103(b) requires that a trustee administer a trust impartially, based on what is fair and reasonable to all beneficiaries unless the governing instrument manifests an intention to favor one or more beneficiaries. In other words, in order to adjust under § 104, the trustee must determine that, without an adjustment, it is unable to administer the trust impartially or unable to achieve the degree of partiality required or permitted. (N.B. This third condition is not in the New York statute.)

C. Subsection (b) of Section 104 lists factors which are to be considered in exercising the Subsection (a) power. It states:
"In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee shall consider all factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:

(1) the nature, purpose and expected duration of the trust;
(2) the intent of the settlor;
(3) the identity and circumstances of the beneficiaries;
(4) the needs for liquidity, regularity of income, and preservation and appreciation of capital;
(5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;
(6) the net amount allocated to income under the other sections of this (Act) and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

(7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;
(8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and
(9) the anticipated tax consequences of an adjustment."

Some of these factors overlap with factors referred to in the Uniform Prudent Investor Act.

D. Subsection (c) of Section 104 lists eight situations in which the power cannot be exercised and, as might be expected, they are tax-driven and inserted to protect against possible adverse tax consequences. The eight situations are:

(1) an adjustment that diminishes the income interest in a marital deduction trust (other than an "estate trust");
(2) an adjustment that reduces the "actuarial value" of a trust income interest intended to qualify for a gift tax annual exclusion;
(3) an adjustment that changes the amount payable to a beneficiary of a fixed annuity trust or a fixed fraction;
(4) an adjustment from any amount "that is permanently set aside for charitable purposes" under a will or trust "unless both income and principal are so set aside";
(5) an adjustment if holding or exercising the power to make it causes an individual to be treated as owner of all or part of the trust for income tax purposes;
(6) an adjustment if holding or exercising the power to make it causes all or part of the trust assets to be included in the estate of an individual for estate tax purposes who has the power to remove a trustee or appoint a trustee or both;
(7) if the trustee is a trust beneficiary; and
(8) if the trustee is not a trust beneficiary but the adjustment would benefit the trustee directly or indirectly.

E. Subsection (d) directs that if the limitations (5), (6), (7) or (8) apply and there is more than one trustee, a disinterested co-trustee may exercise the power to adjust unless the trust prohibits such an exercise.

F. Subsection (e) provides:

> A trustee may release the entire power conferred by subsection (a) or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or

> exercising the power will cause a result described in subsection (c)(1) through (6) or (c)(8) or if the trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (c). The release may be permanent or for a specified period, including a period measured by the life of an individual.

G. Finally, subsection (f) states:

> Terms of a trust that limit the power of a trustee to make an adjustment between the principal and income do not affect the application of this section unless it is clear from the terms of the trusts that the terms are intended to deny the trustee the power of adjustment conferred by subsection (a).

Thus, the grantor of a trust may negate the application of Section 104 by a sentence to that effect, such as:

> The grantor states that [Section 104 of the Uniform Principal and Income Act (1997)] shall not apply to any trust created under this will (indenture).

III. Unitrust Approach

In developing the Act, use of a unitrust interest was considered and rejected in favor of the Section 104 power to adjust. This choice favors a flexible rule over an inflexible rule. Nonetheless, several states have provided for the use of the unitrust definition of income as an alternative to the power to adjust ("the unitrust approach"). Under the unitrust approach, income is defined as a percentage of the trust's value, revalued annually. If the trust distributes its "income" annually, the unitrust amount is the amount distributed, as is the case with a charitable remainder trust.

A. Since the definition of income is not tied to any particular type of receipt, a distribution in satisfaction of the right to income may be made from whatever receipts the trustee determines.

B. The goal of the unitrust definition of income is the same as the goal of the power to adjust: to permit investment for total return without concern that this will unduly favor the income beneficiary or the remainderman.

C. Is there a "correct" unitrust rate? Some states specify a rate (e.g., in New York it is four percent) whereas other states give flexibility to choose a rate (typically within a range of three to five percent).

1. The effect of a higher unitrust percentage is to confer a greater portion of the trust's economic benefit on the current beneficiary.

2. There is no *a priori* division of benefits that is any more correct in principle than another.

3. The actuarial values of the beneficiaries' interests accurately describe the division of benefits for any given projected duration of the trust.

   a. For example, a trust with a 5% payout rate that lasts 20 years will confer 64% of its benefits on the current beneficiary and 36% on the remainderman. A 3% payout rate reduces the current beneficiary's share to 46%, and increases the remainderman's share to 54%. At a 10% payout the ratio is 88% to 12%. One cannot say which division is "correct."

   b. This division remains the same regardless of the rate of return earned by the trust, at least as long as there is a real, positive rate of return after taxes and inflation. Furthermore, varying the composition of the real rate of return (nominal growth minus inflation) does not affect the division. It is the same at 3% nominal growth with zero inflation as at 4% nominal growth with 1% inflation, and so on, so long as there is some positive rate of return after taxes and inflation.

4. Why, then, has there been so much discussion of the "correct" payout rate, and why has it been widely concluded that a 4% rate is "too high"? One answer is that many trustees seek to preserve the real value of trust principal over time, so as to deliver to the remaindermen a corpus with a real value at least equal to what it was at the inception of the trust. Nothing in the language of the Prudent Investor Act mandates this result and nothing in the mechanics of the unitrust approach necessarily produces it. Where, however, the trustee chooses the payout rate without guidance from the grantor, it could be argued that attempting to preserve the real value of the trust corpus is inherent in the duty of impartiality.

5. If taxes are borne disproportionately by the current beneficiary, the value of the remainder will be higher, and a higher payout rate may be consistent with preserving trust value.

6. Unlike the unitrust statutes of many states, New York EPTL 11-2.4 does not limit the power to elect unitrust treatment to non-beneficiary trustees. Nevertheless, the income beneficiary in *Matter of Heller*, 800 N.Y.S.2d 207 (2d Dep't 2005), argued that trustees who were also remaindermen were prohibited from making the election because of their beneficial interest in the outcome of the election. Affirming the Surrogate on this point, the Appellate Division held that neither the statute nor general fiduciary law imposed a bar to an election by an interested fiduciary. In the case, the trustee-remaindermen were the testator's sons and the income beneficiary was their stepmother. The effect of the election, at least under current conditions, was to greatly reduce the distributions to the stepmother. The court remanded the case for a review of the propriety of the election under the criteria set forth in the statute, and said that the trustee's personal interests could be considered by the court in determining whether the statutory criteria had been correctly applied.

IV. Definition of Trust Income under IRC Sec. 643(b)

Proposed regulations revising the definitions of trust income under IRC Sec. 643(b) and distributable net income under IRC Sec. 643(a) and making related changes were issued on February 15, 2001. REG-106513-00, IRB 2001-16 at 1076. Their primary purpose was to accommodate certain aspects of the federal tax law to the enactment by many states of a statutory power to adjust between income and principal and/or to select a unitrust definition of income.

Final regulations (the "Regulations") were released at the end of 2003 and published in the Federal Register on January 2. 2004, T.D. 9102, 69 F.R. 12-22. The core provision of the Regulations is a revision to the definition of "income" under IRC Sec. 643(a) in Treas. Reg. Sec. 1.643(a)1. The regulations also clarify when capital gains are included in distributable net income under IRC Sec. 643(a)(3). Additional amendments are made for pooled income funds, charitable remainder trusts, trusts that qualify for the gift and estate tax marital deduction and trusts that are exempt from the GST.

A. In general, the Regulations apply to taxable years *ending* after January 2, 2004. For calendar year taxpayers (including most trusts), that means the Regulations are in effect for the first time in 2004. Several specific exceptions to this effective date exist, including provisions for pooled income funds.

Under a strict application of this effective date rule, the Regulations would not apply prior to taxable years in which trusts were operated under state statutes granting the power to adjust or to elect a unitrust definition of income. The proposed regulations do not fill the gap; they were not promulgated as temporary regulations and had a prospective “final publication” effective date. This raised a question whether exercises of the power to adjust or elections of unitrust treatment, or perhaps the mere existence of the power to do these things, could disqualify a trust for the marital deduction or cause loss of the GST grandfathering. The Preamble to the Regulations in effect makes the Regulations retroactive in such cases.

The major points made by the Regulations are three. First, a unitrust interest of between 3% and 5% of the annual fair market value of the trusts assets satisfies the income requirement. Second, an adjustment power, such as that contained in section 104 of the Uniform Principal and Income Act, will also satisfy that requirement. Third, an allocation of capital gains to income "will be respected" subject to certain requirements which are easily satisfied.

N.B. The following discussion and analysis of the proposed regulation is excerpted from the April 2001, April and July 2002 and January 2004 issues of Practical Drafting © U.S. Trust, Bank of America Private Wealth Management and used with permission.

B. Income as defined in IRC Sec. 643(b).

The core provision of the Regulations is a revision of the definition of “income” under IRC Sec. 643(b) in Treas. Reg. §1.643(b)-1

1. The general effect of the regulations is to “bless” both the power to adjust and the unitrust approach if applicable state law is within their ambit.

2. The first two sentences in the regulation are a carryover from Treas. Reg. §1.643(b)-1. The balance is new. Read carefully, the regulation requires that the power to adjust or the unitrust payment be created by "state law" rather than the terms of the trust. Stated another way, a unitrust interest created by the trust terms where state law does not deal with the subject is not permitted. Such a reading conflicts with the inclusion of capital gains in distributable net income discussed below where an allocation to income pursuant to the governing instrument is respected.

3. The unitrust amount must be between 3 and 5 percent. Under some state unitrust statutes the unitrust percentage may be changed by the trustee. An unresolved question is whether a fluctuating unitrust amount qualifies under the proposed

regulations if the fluctuation could, but does not, go outside the 3 to 5 percent range.

4. The Regulations make clear that the new definition of income applies to discretionary trusts including spray trusts and trusts that can accumulate income.

C. Marital Deduction

The Regulations "bless" both the power to adjust and the unitrust definition of income for marital deduction purposes.

1. The proposed changes in the estate tax marital deduction regulations are new sentences to be added as follows:

   Treas. Reg. §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.

   The corresponding gift tax regulation refers to "income as defined or determined by applicable local law." Final Treas. Reg. §25.2523-1(f)(1).

   Treas. Reg. §20.2056(b)-7(d)(1):

   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.

2. Absent the regulations, the power to adjust and the unitrust approach could disqualify a marital deduction trust.

3. A governing instrument provision providing for a unitrust payment in a state that has not enacted legislation defining income as a unitrust amount will not qualify, even if drafted to incorporate regulatory requirements.

4. Because both the power to adjust and the unitrust approach could result in distributions of principal to a surviving spouse, they could trigger the deferred estate tax on a Qualified Domestic Trust ("QDOT") under IRC Sec. 2056 A (b). Reg. §20.2056A-5(c)(2) prevents this result.

D. GST Grandfathering.

The Regulations "bless" both the power to adjust and the unitrust definition of income for generation skipping transfer tax purposes.

1. The GST issue is whether the change in state law as to income would cause a loss of grandfather protection under the effective date rule. Treas. Reg. §26.2601-1(b)(4)(i)(D)(2) would be amended by the addition of the following new sentence:

   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.

2. Also, two new examples, 11 and 12, are added to Treas. Reg. §26.2601-1(b)(4)(i)(E), one approving conversion of an income interest to a unitrust interest under a state statute and the other approving a power to adjust between income and principal under a state statute. The examples demonstrate not only that GST exempt status will not be lost, but they also address the extension to taxes other than the GST tax (e.g., example 11 eliminates any concern that a beneficiary who consents to, or a beneficiary-trustee who initiates, election of a unitrust definition of income, will be deemed to make a gift.)

3. Absent the regulations a trust which is grandfathered from GST tax will lose its protection. To illustrate: a modification that adds or enhances a power to accumulate or which directs accumulation would be a proscribed modification under Treas. Reg. §26.2601-1(b)(4)(i)(D) because it could increase the property passing to a lower generation. Similarly, a conversion into a straight unitrust interest could operate to

decrease the amount distributable to the income beneficiary and would be a proscribed modification under current law.

E. Income Tax.

The Regulations make it easier to include capital gains in distributable net income.

1. Distribution of appreciated property as income

   Appreciated property may be distributed as income pursuant to an adjustment from principal to income or in satisfaction of the unitrust amount. If the trust is required to distribute all of its income, the distribution will cause gain to be realized. Reg. §1.651(a)-2(d) and amendment to §1.661(a)-2(f).

   If the trust is not required to distribute its income currently, a distribution of property as income will not trigger recognition of gain.

   The proposed rules do not distinguish between exercise of a power to adjust and a distribution under the unitrust approach.

2. Capital Gain; DNI

   The subject of capital gains and their allocation to distributable net income (DNI) is dealt with in Reg. §1.643(a)-3.

   Inclusion of capital gains in DNI can shift income tax liability for gains from the trust to the income beneficiary.

   Under the rules, a statutory or governing instrument provision can direct that distributions of income shall be treated as coming from realized gains to the extent they exceed ordinary income for the year. Absent such a provision, the trustee can achieve this result by impartially so treating the distributions, or can achieve the opposite result by not so treating them, so that capital gain remains out of DNI and is taxed to the trust.

   Examples in §1.643(a)-3(e) clarify that gain from different assets may be treated differently and that a trustee of more than one trust may treat some trusts differently from others.

   In general, trustees should decline to include gains in DNI. It is preferable that trust taxes be paid at the trust level to maintain the after-tax “neutrality” of the total return investment approach.

3. Realization of Gain and Gift Issues

Concern was expressed that election of a unitrust definition of income, or election out of a unitrust regime, could cause a taxable gift, or cause realization of income as an "exchange" under the principles of Cottage Savings v. Commissioner, 499 U.S. 554 (1991). (Under the facts of *Cottage Savings*, a financial institution exchanged its interest in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institutions. The court disagreed, finding the properties are "different" in the sense that is material to the code.) Treas. Reg. 1.643(b)-1 removes these concerns. Only an election in or election out under a state statute is protected by the regulation.

V. Issues Concerning Allocation of Receipts and Disbursements

Under § 302 of the Principal and Income Act, periodic payments such as rents, dividends, interest and annuities are not apportioned. This provision changes the requirement in the Revised Uniform Principal and Income Act) (1962) that the pre-death portion of the first periodic payment due after death is apportioned to principal and the post-death portion of such payment is allocated to income. However, the Comments to § 302 of the current Act note that this change is consistent with the original common law rule, citing to Howes, Edwin A., Jr., The American Law Relating to Income and Principal 70 (1905).

To illustrate, assume a decedent dies June 28 owning a $100,000 bond that pays 5% in semi annual installments on January 1 and July 1. For estate tax purposes the executor reports the value of the bond as of date of death plus accrued interest of $2,472 (178/180 x $2500). For accounting purposes the Act requires the entire $2,500 to be allocated to income. The accrued interest of $2,472 is income in respect of a decedent under IRC§691, and the income beneficiary is entitled to a IRC§691(c) deduction for the federal estate tax attributable to the interest. May the executor allocate estate taxes on the accrued interest to income in the absence of a contrary direction in the will? May the executor exercise the power to adjust by crediting principal with the accrued interest even though an allocation is contrary to the specific terms of the statute?

A. Under § 401 of the Act, an "entity" is a defined term (e.g., corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund and any other organization in which a trustee has an interest). Under § 401(b) and (c) money distributions from entities are income and property distributions are principal. However, it is necessary to note that money distributions received in partial liquidation or as a capital gain dividend for federal income tax purposes are principal.

Pursuant to § 401(d)(2), money received from an entity will be deemed to be received in partial liquidation if the total amount of money and property received in a distribution or series of related distributions is greater than 20% of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt. This provision is modified by § 401(e), which section provides that money received will not be received in partial liquidation and cannot be taken into account under § 401(d)(2), to the extent of the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

For example, a partnership distributes $X to a trust, which amount is greater than 20% of the entity's gross assets. But the trust and the beneficiary have to pay an amount of $Y in income taxes on the taxable income of the partnership. When the amount of the income tax paid is reduced from the amount of the distribution, the net amount is less than 20% of the entity's gross assets. As a result, the distribution is not a partial liquidation of the entity.

1. In the fall of 2004 Microsoft Corporation announced a special dividend of $3.00 per share payable December 2, 2004. It was concurrently paying an ordinary dividend significantly smaller than the special dividend. Should the trustee allocate the special dividend to income or principal? It appears that the Microsoft special dividend is a liquidity distribution based on the language of § 401(c) and (d) of the Act. Section 401(d) states money is received in partial liquidation:

   > "if the total amount of money and property received in a distribution or series of related distributions is greater than 20% of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt."

   At the end of June 2004, Microsoft's balance sheet showed gross assets of just over $92 billion, making the total special dividend of $32 billion significantly greater than 20% of gross assets. For income tax purposes the Microsoft dividend qualified for the 15% federal income tax rate since it was anticipated that it would be paid from either current or retained earnings and profits of the corporation. May the trustee exercise the power to adjust by crediting income with the special dividend even though the allocation is contrary to the specific terms of the statute?

2. The meaning of California Probate Code § 16350 (which adopted § 401 of the Act) was involved in Thomas v. Elder, 21 Cal. Rptr. 3d 741 (2004). In Thomas, the trustee of a QSST received a distribution from an S corporation. The total distribution by the S corporation constituted more than 50% of its gross assets, so the trustee allocated the distribution it received to principal. The income beneficiary objected, contending the distribution should be allocated to income because the amount of the distribution to the trust did not exceed 20% of the S corporation's gross assets. The trial court issued an order granting the petition to allocate the receipt to income, the Court of Appeal affirmed and the California Supreme Court declined to review the matter, with the result that the California legislature in 2005 amended the language so that the current version reflects the language recommended by the drafters of the Act.

3. In *Hasso v. Hasso*, the trustee of a marital trust petitioned for instructions about the proper allocation (as income or principal) of millions of dollars distributed to the trust by a subchapter S corporation of which the trust was a shareholder. Although the cash distributed by the entity was an eight figure amount representing proceeds from the sale of assets including a French holding company and an office building in France, the entity's sole advisement was that an asset had been converted into cash for distribution. The Superior Court of Orange County, California determined as a matter of law that the funds were to be allocated to income and not principal. The court held that the distributions or series of distributions did not result from a partial liquidation based on the greater than 20 percent distribution to gross assets ratio test pursuant to California Probate Code, Sec 16350 subd. (d)(1)(B) nor did the advisement provide the notice envisioned by Sec. 16350, subd. (d)(1)(A). The Court of Appeals, Fourth Appellate District affirmed. *Hasso v. Hasso*, 148 Cal. App. 4th 329, 55 Cal. Rptr. 3d 667; 2007 Cal. App. LEXIS 313; 2007 Cal. Daily Op. Service 2495; 2007 Daily Journal DAR 3115; modified and rehearing denied by *Hasso v. Hasso*, 2007 Cal. App. LEXIS 499 (Cal. App. 4th Dist., Apr. 4, 2007).

4. On December 2, 2005 Phelps Dodge paid a special dividend of $5 per share in addition to its regular quarterly dividend. The company described the payment as the first part of "a

program to reward shareholders by returning $1.5 billion in capital to them by the end of 2006." The total of $1.5 billion does not meet the 20% of gross assets test of the Act (it is about 17%). Because of the characterization by the company, should the distribution be credited to principal by the trustee? Section 401(d)(1) provides that money is received in partial liquidation to the extent that the entity, at or near the time of the distribution, indicates that it is a distribution in partial liquidation. Arguably, the statement by Phelps Dodge that it is returning capital to reward shareholders is an indication that the distribution is a partial liquidation.

5. The accounting treatments for REITs is covered in § 401(c). A trustee must allocate receipts from an entity to principal for:

> "money received from an entity that is a regulated investment company or a real estate investment trust if the money is distributed in a capital gain dividend for federal income tax purposes".

   When the distribution is made to the trustee, its tax treatment is unknown. Pending notification of the appropriate tax treatment, should the trustee allocate the periodic receipt to income? to principal? or partially to each?

B. Wills and trusts often contain a provision permitting the spouse as beneficiary of a marital trust to require that unproductive property be converted to income producing property. Many state statutes impose this requirement. The language in the governing instruments and/or state statutes is important for tax reasons effected by Treas. Reg. § 20.2056(b)-5(f)(4).

   1. To preserve the marital deduction, it is necessary to give the spouse the right to make the trust productive. But doesn't the Act already provide the solution (investing for total return and exercising the power to adjust)?

   2. Suppose the surviving spouse of a marital deduction trust which holds unproductive property requests the property be sold. May the trustee respond by electing unitrust treatment under a state statute and then distributing unproductive property to the spouse? If so, then how is the unitrust amount calculated? Does it make a difference if the trust is created after enactment of the new regulations? (Note: In Florida under Fla. Stat. 738.1041(11) the spouse beneficiary can have a trust converted to a unitrust. Is the trustee then compelled to sell the property!)

C. Accounting for Partnerships -- Accounting for partnership distributions was changed significantly by the 1997 Uniform Principal and Income Act from the 1962 Uniform Principal and Income Act. The 1962 Uniform Principal and Income Act provisions regarding the allocation of receipts from partnerships is different than receipts from corporations. By contrast, the 1997 Uniform Principal and Income Act apply the same allocation rules to distributions from partnerships as are applied to distributions from corporations or any other entity.

APPENDIX A

Sample Provisions Regarding Administrative Powers of Fiduciaries*

NOTE: In the absence of a limiting provision in the governing instrument, the laws of many states, including New York and Florida (EPTL 11-1.1(b); FSA 733.612 as to executors and FSA 737.402 as to trustees), grant to executors and/or trustees certain administrative powers. Since these powers are automatically incorporated, a specific enumeration of them is unnecessary. In other states, the fiduciary powers act must be incorporated by reference. Connecticut is such a state. When incorporation is required, words such as "(including those contained in the Connecticut Fiduciary Powers Act incorporated by a general reference)" should be inserted after the words "upon executors and trustees" in M-1a. In states without any fiduciary powers act, the use of powers in addition to the basic powers contained in M-1a through M-1k may be desirable. See M-3a through M-3m. Special powers for specific assets, including closely-held business interests, may also be useful. See M-4a through M-4g. Most states, including New York and Florida (EPTL 11-2.3 and FSA 518.11), have a prudent person statute for investments (including the Uniform Prudent Investor Act). Table I of the General Comments preceding the Will Provisions contains a state-by-state analysis of the existence of a fiduciary powers act and a prudent person rule for investments and may be helpful in determining the necessity for adding powers to the basic powers in M-1a through M-1k. M-2a through M-2e contain provisions (including powers) which may be desirable when trusts that may be subject to the Chapter 13 generation-skipping tax are created.

A. Basic powers.

[M-1a] My executors <u>and my trustees</u> may exercise in their sole discretion and without prior authority from any court, as to property in my estate <u>or any trust</u>, or otherwise in their possession, all powers conferred by law upon executors <u>and</u> <u>trustees</u>, or expressed in this will, and I intend that such powers (including the following) be construed in the broadest possible manner:

(If the will creates no trust, omit the underlined words.)

[M-1b] (1) Power to determine what property is covered by general descriptions in this will.

(If the will has no bequest or devise expressed as a general description, this power may be omitted.)

[M-1c] (2) Power to pay my debts and funeral and burial expenses (including the expenses of my last illness, which shall be paid out of my estate) as soon as the convenience of my estate will permit and without regard to any limitation in applicable law as to the amount of such expenses, and to pay or deliver any legacy without waiting the time prescribed by law.

(If the testator is not married, the words in parentheses should be omitted. If the law of the state in which the wife's estate is being administered follows the common law principle that a husband is primarily liable for her funeral expenses and expenses of her last illness, a deduction will not be allowed for such expenses without a direction to pay them in the wife's will. Rev. Rul. 76-369, 1976-2 C.B. 281.)

(In some states limitations are imposed on the amount of funeral or burial expenses in the absence of a contrary provision in the will.)

[M-1d] (3) Power to invest in securities or other property, real or personal (within or without the United States), <u>whether or not the same be income-producing</u> (and any diversification requirement that would otherwise apply, including one imposed by a Prudent Investor Act, is negated).

(When a marital deduction trust (other than an "estate trust") is created, the underlined words should be deleted or the following should be added at the end of the paragraph: "and provided that in the case of the marital deduction trust my trustees shall have no power to invest in or to retain non-income producing property without the consent of my spouse." See Treas. Reg. Sec. 20.2056(b)-5(f)(5). The underlined words should also be omitted in charitable remainder trusts.)

(The relationship between the Prudent Investor Act and a negation of the duty to diversify is unclear. The decedent's intent in waiving this duty may be clarified by adding the following sentence:

My intent in negating any duty to diversify is for any undiversified holding to be considered as being five percent of the principal of the trust, namely, as a holding that is not undiversified.)

(The testator may, of course, accept the approach of the Prudent Investor Act and the requirement of diversification, whatever its scope. If this is to be done, the second parenthetical negating the duty to diversify should be omitted. If the duty to *whatever its scope. If this is to be done, the second parenthetical negating the duty to diversify should be omitted. If the duty to* *diversify is not negated, guidance as to its scope is desirable, and the following language should be considered:*

> *I recognize that my executors and trustees have a duty to diversify my estate and the trusts created under this will. In carrying out this duty, I do not intend that they be subject to specific maximum or minimum percentages as to holdings of any given stock or asset type or industry or sector, or that they be required to achieve the maximum possible diversification or to eliminate all diversifiable risk, or that they be required to adopt a passive or indexed approach to investing. Rather I intend that the duty be applied pragmatically, and that my executors and trustees have discretion and flexibility in discharging the duty particularly with respect to assets received by my executors and trustees from me.)*

(In an appropriate case, add: "I authorize them to retain for such period as they determine any securities of XYZ Corporation, or any successor corporation, and to purchase additional securities of any such corporation, even though as a result my estate or the trust may be invested largely or entirely in such securities, without liability for loss resulting from lack of diversification and to participate in or consent to any voting trust agreement affecting such securities." If the words in the second parenthesis are not included, the words "without liability for loss resulting from lack of diversification" should be added at the end of this sentence.)

(Where a corporate fiduciary is acting, consider adding M-3a to authorize investments in the fiduciary's proprietary funds.)

APPENDIX B

Sample Expanded Investment and Administrative Powers Language of U.S. Trust, Bank of America Private Wealth Management and U.S. Trust Company of Delaware

Expanded Investment and Administrative Powers to be included in instruments nominating Bank of America, N.A. or U.S. Trust Company of Delaware in a Fiduciary Capacity

(These Provisions Are Intended for Distribution to and Use by Licensed Attorneys Only and Do Not Constitute Estate Planning or Other Legal Advice)

For *Inter Vivos* Trusts:

1. Power to invest in or retain any securities or other property, real or personal (within or without the United States), including by way of illustration, but not limitation: any security as defined by the Securities Act of 1933 or other applicable law, any contract of sale of a commodity for future delivery within the meaning of the Commodity Exchange Act, shares or interests in any private investment fund, private equity or venture capital fund, hedge fund, common trust fund, joint venture, general or limited partnership, limited liability company, statutory or common law business trust, statutory trust, real estate investment trust or an open-end (including any mutual fund) or closed-end management type investment company or unit investment trust, whether registered under the Investment Company Act of 1940 or unregistered, any money market instrument, bank deposit account (including but not limited to savings, time, certificate of deposit and transaction accounts), precious metal, foreign exchange, structured product, insurance contract, options, options on futures and variable forward contracts, swaps, caps, collars and other derivative instruments of a financial nature, notwithstanding the fact that the trustee, investment manager or custodian, its respective parent or any affiliate, is an issuer of such investment or provides services (whether as manager, underwriter, distributor, custodian, advisor, agent, servicer, trustee or otherwise) with respect to any such investment and further notwithstanding that the trustee, investment manager, custodian or its respective parent or any affiliate may receive compensation with respect to any such investment (in addition to trustee's commissions), so long as the total compensation received is reasonable. To the extent permitted by applicable law, this provision is intended to override any contrary provision of law prohibiting such additional fees or otherwise requiring either a reduction in trustee's commissions or an election between such additional fees and such commissions. Any diversification requirement that would otherwise apply, including one imposed by a Prudent Investor Act or similar applicable law, is negated.

***[Add the following as a final sentence if the Grantor is a Florida resident:**

"This provision is intended to provide the Trustee with broad and express authority to engage affiliates and invest in affiliated investments and investment instruments pursuant to Fla. Stat. 736.0802(2) without regard to any restrictions, limitations, notices or approvals that may otherwise be imposed by statute (such as 736.0802(5)(a), (b), (c), (d) (e) or (f)), or common law."]*

(2) Power to employ such agents, advisors and other counsel, including but not limited to entities affiliated with any trustee, and to pay out of income or principal or both the reasonable charges and fees of such agents, advisors and counsel, as it shall in its sole discretion determine, including the power to select brokers and dealers affiliated with any trustee for the sale or purchase of any securities or other investment property in the trust. This authorization shall include, but shall not be limited to, an affiliated broker acting in a principal or agency capacity for equity and fixed income securities, routing orders for over-the-counter (OTC) stocks to a market maker affiliated with any trustee, routing listed stocks to specialists affiliated with any trustee, routing listed options through a proprietary trading operation affiliated with any trustee, or routing after-hours orders to a proprietary trading operation in which any trustee or an affiliate owns an equity interest. In such case the trustee or an affiliate may receive both monetary and non-monetary "payment for order flow," including, without limitation, an inter-company transfer of funds in connection with orders routed to an affiliated market maker; monetary compensation (including fee sharing) from, and participation in the profits of, certain affiliated and independent exchange specialists who execute orders; other compensation as part of reciprocal order routing arrangements with various exchange specialists and dealer firms; and rebates and credits against fees paid by various exchanges to member firms. To the extent permitted by applicable law, the trustee's compensation shall not be reduced by any additional compensation received by the trustee, its parent, or any affiliate thereof, or any agent, principal, advisor, counsel, broker, dealer, market maker or specialist (including exchange specialist) affiliated with the trustee, its parent or any affiliate thereof, for providing any of the services authorized in this paragraph.

<u>For Wills</u>:

1. Power to invest in or retain any securities or other property, real or personal (within or without the United States), including, by way of illustration, but not limitation: any security as defined by the Securities Act of 1933 or other applicable law, any contract of sale of a commodity for future delivery within the meaning of the Commodity Exchange Act, shares or interests in any private investment fund, private equity or venture capital fund, hedge fund, common trust fund, joint venture, general or limited partnership, limited liability company, statutory or common law

business trust, statutory trust, real estate investment trust or an open-end (including any mutual fund) or closed-end management type investment company or unit investment trust, whether registered under the Investment Company Act of 1940 or unregistered, any money market instrument, bank deposit account (including but not limited to savings, time, certificate of deposit and transaction accounts), precious metal, foreign exchange, structured product, insurance contract, options, options on futures and variable forward contracts, swaps, caps, collars and other derivative instruments of a financial nature, notwithstanding the fact that the fiduciary, investment manager or custodian, its respective parent or any affiliate, is an issuer of such investment or provides services (whether as manager, underwriter, distributor, custodian, advisor, agent, servicer, trustee, or otherwise) with respect to any such investment and further notwithstanding that the fiduciary, investment manager, custodian or its respective parent or any affiliate may receive compensation with respect to any such investment (in addition to fiduciary commissions), so long as the total compensation received is reasonable. To the extent permitted by applicable law, this provision is intended to override any contrary provision of law prohibiting such additional fees or otherwise requiring either a reduction in fiduciary commissions or an election between such additional fees and such commissions. Any diversification requirement that would otherwise apply, including one imposed by a Prudent Investor Act or similar applicable law, is negated.

***[Add the following as a final sentence if the Testator is a Florida resident:**

"This provision is intended to provide the Trustee with broad and express authority to engage affiliates and invest in affiliated investments and investment instruments pursuant to Fla. Stat. 736.0802(2) without regard to any restrictions, limitations, notices or approvals that may otherwise be imposed by statute (such as 736.0802(5)(a), (b), (c), (d) (e) or (f)), or common law."]*

(2) Power to employ such agents, advisors and other counsel, including but not limited to entities affiliated with any fiduciary, and to pay out of income or principal or both the reasonable charges and fees of such agents, advisors and counsel, as it shall in its sole discretion determine, including the power to select brokers and dealers affiliated with any fiduciary for the sale or purchase of any securities or other investment property in the trust or my estate. This authorization shall include, but shall not be limited to, an affiliated broker acting in a principal or agency capacity for equity and fixed income securities, routing orders for over-the-counter (OTC) stocks to a market maker affiliated with any fiduciary, routing listed stocks to specialists affiliated with any fiduciary, routing listed options through a proprietary trading operation affiliated with any fiduciary, or routing after-hours orders to a proprietary trading operation in which any fiduciary or an affiliate owns an equity interest. In such case the fiduciary or an affiliate may receive both monetary and non-monetary "payment for order flow," including, without limitation, an inter-company transfer of funds in connection with orders routed to an affiliated market maker; monetary compensation (including fee sharing) from, and

participation in the profits of, certain affiliated and independent exchange specialists who execute orders; other compensation as part of reciprocal order routing arrangements with various exchange specialists and dealer firms; and rebates and credits against fees paid by various exchanges to member firms. To the extent permitted by applicable law, no fiduciary's compensation shall be reduced by any additional compensation received by any fiduciary, its parent, or any affiliate thereof, or any agent, principal, advisor, counsel, broker, dealer, market maker or specialist (including exchange specialist) affiliated with any fiduciary, its parent or any affiliate thereof, for providing any of the services authorized in this paragraph.