Power to Adjust and Total-Return Unitrust Regimes – What Every Trustee and Advisor Should Know About State Developments, Minimizing Tax and Investment Dilemmas, Reducing Litigation Exposure and More

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1. **Prudent Investor Act Principles Govern Trust Investment**

The Prudent Investor Rule is the law governing the investment of trust assets. It incorporates the principles of “Modern Portfolio Theory” into the fiduciary investment arena. A model Uniform Prudent Investor Act was promulgated in 1994.

Pursuant to Prudent Investor standards, a trustee:

<table>
<thead>
<tr>
<th>Is Required to Pursue an Overall Investment Strategy:</th>
<th>Is Required to Consider all the Facts and Circumstances:</th>
<th>Is Required to Invest for Total Return:</th>
<th>Is Required to Have Investment Skill:</th>
<th>Is Required to Diversify Assets:</th>
<th>Is Authorized to:</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Each investment should not be viewed in isolation *The overall strategy must have risk and return objectives reasonably suited to the entire portfolio</td>
<td>*Size of the portfolio *Estimated duration of fiduciary relationship *Distribution requirements *General economic conditions *Inflation/Deflation *Expected tax consequences of investment decisions and distributions *Expected total return *Needs of the beneficiaries for present and future distributions</td>
<td>*Maximize total return having regard to both income generation and capital appreciation *Preserve purchasing power</td>
<td>*Delegation is permitted, provided the trustee exercises care and skill in (a) selecting the delegee (b) establishing the scope of the delegation (c) periodically reviewing the delegee and (d) controlling costs</td>
<td>*Unless the trustee reasonably determines that it is in the best interests of the beneficiaries not to diversify</td>
<td>* Invest in any type of investment: no investment is inherently imprudent * Consider related trusts and the income and resources of the beneficiaries</td>
</tr>
</tbody>
</table>
The key point about the Prudent Investor Rule is not that it mandates any particular result. Trustees are not judged in hindsight. Compliance with the Rule is determined in light of the facts and circumstances existing at the time of a trustee’s decision. Accordingly, the key to the Prudent Investor Rule is that it sets forth a standard of conduct. If trustees are careful to follow the standard of conduct – and document the fact that they have done so – they may be insulated from liability, even though the consequences of their actions are disappointing.

This fundamental principle is well illustrated in Matter Of The Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (2009). In 1987, Stuart Cochran created an irrevocable trust, pursuant to the terms of which his two daughters were named beneficiaries.

In the spring of 2003, Stuart was 52 years old and the insurance policies had a combined death benefit of over $8 million. The successor trustee had the policies reviewed and determined to exchange them for policies having a reduced but guaranteed death benefit of approximately $2.5 million.

When Stuart died unexpectedly at age 53, the exchange of the policies resulted in a significant reduction in the death benefits paid to the beneficiaries. They sued the trustee for breach of fiduciary duties.

In determining that no violation of the Prudent Investor Act had occurred, the court noted that the trustee was working with the following circumstances:

1. A rapidly declining stock market,
2. Recent losses in the performance of the existing policies with the expectation of further losses,
3. A grantor in his early 50s with a life expectancy of 88 years,
4. A grantor who had suffered economic losses, with no further funds to invest in the trust, and
5. Policies estimated to lapse within five years without a further infusion of cash.

Although in hindsight the beneficiaries clearly would have benefitted from retention of the existing policies, according to the court:

“Although it is tempting to analyze these cases with the benefit of hindsight, we are not permitted to do so, nor should we.”

Interestingly, in a graphic demonstration of the importance of process, the court found:

“[The trustee] examined the viability of the existing policies and investigated at least one other option. Of course, it could have done more,
but nothing in the record leads us to second-guess the trust court’s conclusion, that, while [the trustee’s] ‘process was certainly less than perfect;’ it was adequate.”

2. **Power to Adjust and Unitrust Distribution Tools Revolutionize the Face of Trust Investing**

Although the Prudent Investor Rule *advocated* total return investing, it was very difficult in practice for a trustee to invest for the best overall return for the trust without regard to the source of that return: How does a trustee invest without considering whether return is produced from income or from capital appreciation when the income beneficiaries are pressuring the trustee for more income and the remainder persons are pressuring the trustee for more growth? The duty to treat all beneficiaries impartially often led trustees to structure a balanced 50:50 stock/bond portfolio. One informal indicator that a trustee was performing its job adequately was if *everyone* was unhappy – a balanced portfolio produced too little income for the income beneficiary *and* too little growth for the remainder persons.

Fortunately, the face of trust investing was revolutionized with two immensely valuable tools – the power to adjust and the unitrust regimes. These regimes provided trustees with the means to implement the mandate of total return investing, as embodied in prudent investor principles.

A model Uniform Principal and Income Act (the “UPAIA”) was originally promulgated in the 1930s and most recently substantially revised in 1997. The UPAIA includes the power to adjust approach in Section 104. The unitrust approach is not contained in the UPAIA. Some states have enacted either the power to adjust regime or the unitrust regime; in other states, the trustee has a choice of regimes. As of January 2011, only Mississippi has not adopted any form of total return legislation. However, on January 4, 2011 a bill was introduced in the Mississippi legislature to enact the “Mississippi Principal and Income Act of 2012.” The bill includes a power to adjust regime.

Under a power to adjust regime, the trustee is permitted to make adjustments between income and principal in order to be fair and reasonable to all beneficiaries, by “redefining” a portion of principal as income (or vice versa). Under the unitrust regime, the trustee can convert the income beneficiary’s interest into a unitrust payout of a fixed percentage of the trust’s principal. A sampling of state statutes is set forth below:

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1 See the Appendix for a comprehensive 50-state comparative analysis
Typically, the state statutes provide a number of factors for a trustee to consider in determining whether or not to make an adjustment or opt into the unitrust regime.

With respect to the power to adjust, the factors a trustee is to consider generally include the factors which are set forth in Section 104(b) of the UPAIA:

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

<table>
<thead>
<tr>
<th>State</th>
<th>Power to Adjust</th>
<th>Power to Adjust Guidelines</th>
<th>Unitrust Regime</th>
<th>Unitrust Regime Guidelines</th>
<th>Unitrust Regime Court Approval Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Yes Cal. Probate Code §16336</td>
<td>No guidelines</td>
<td>Yes Cal Probate Code §16336.4</td>
<td>4% Unitrust (Default) 3%-5% if all beneficiaries consent in writing</td>
<td>No</td>
</tr>
<tr>
<td>Delaware</td>
<td>Yes DEL. CODE ANN. tit. 12, §6113</td>
<td>No guidelines</td>
<td>Yes DEL. CODE ANN. tit.12, §3527</td>
<td>3% - 5% Unitrust</td>
<td>No</td>
</tr>
<tr>
<td>Florida</td>
<td>Yes FLA. STAT. ANN. §738.104</td>
<td>No guidelines</td>
<td>Yes FLA. STAT. ANN. §738.1041</td>
<td>3-5% Unitrust or 50% of AFR</td>
<td>No</td>
</tr>
<tr>
<td>New York</td>
<td>Yes EPTL §11-2.3</td>
<td>No guidelines</td>
<td>Yes EPTL §11-2.4</td>
<td>4% Unitrust</td>
<td>Yes, except for trusts created after 1/10/02 if election is made within 2 years</td>
</tr>
</tbody>
</table>
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.

Similar considerations are generally applicable with respect to a unitrust determination.

The UPAIA also offers protection for trustees. Pursuant to Section 105, a trustee’s exercise or non-exercise of a discretionary power is subject to an abuse of discretion standard. Individual states may also offer additional protections for a trustee. In New York, personal liability will attach to a trustee only if the trustee acted dishonestly, arbitrarily or capriciously. In New Jersey, a trustee’s determination to adjust income within a 3%-5% range is presumed fair and reasonable to all beneficiaries.

With respect to the unitrust regime, individual states may also offer protection for a trustee. In Florida, Delaware and Virginia, for example, a trustee is protected from liability if there is no objection within a given time-frame to notice of an election. In Maryland, the sole remedy available to a beneficiary is for the court to direct, deny or revise a conversion or reconversion to a unitrust regime.

A. But Conflicts of Interest Can Still Persist

In Matter of Jacob Heller, 800 N.Y.S. 2d 207 (App. Div. 2005), aff’d, 849 N.E.2d 262 (Ct. App. 2006), trustees defended a challenge to their determination to opt into the unitrust regime. Jacob Heller created a trust under his will for the benefit of his second wife, Bertha Heller, and his children from a prior marriage. The trust provided that Mrs. Heller was to receive the greater of $40,000 or the entire income of the trust annually. Mrs. Heller’s four step-children were named as remainder beneficiaries.

When Mrs. Heller’s two step-sons became trustees of the trust, Mrs Heller’s annual trust payment was $190,000. In 2003, the co-trustees (also step-sons and remainder beneficiaries) opted into the unitrust regime pursuant to EPTL §11-2.5(e)(1)(B)(I), and opted to make their election retroactive to January 1, 2002 (the date the unitrust regime became effective in New York). As a result of the unitrust election, Mrs. Heller’s annual income from the trust was reduced from $190,000 to $70,000. As result of making the election retroactive, Mrs. Heller would have owed the trust $360,000 ($120,000 a year from the date of the 2005 decision, back to each of the three preceding years).

Mrs. Heller commenced a proceeding seeking to annul the unitrust election on the grounds that the co-trustees were also remainder beneficiaries of the trust, an order revoking the letters of trusteeship issued to the co-trustees, and a determination that the
unitrust election could not be made retroactive to January 1, 2002.

Following appeals from the Surrogate’s Court and the Appellate Division, the Court of Appeals held that EPTL §11-2.5(e)(1)(B)(I) did not prohibit a unitrust election by an interested trustee. In an interesting contrast, the court noted that EPTL §11-2.3(b)(5), the power to adjust statute, expressly prohibits a trustee from exercising the power to adjust if the trustee is a beneficiary or if the adjustment would benefit the trustee, directly or indirectly. The court thought it was telling that the legislature included no such prohibition in the simultaneously enacted unitrust provision.

In the absence of an express prohibition, the issue became whether the trustees had discharged their fiduciary obligations. The court reasoned that the co-trustees owed fiduciary duties to Mrs. Heller as an income beneficiary, and also to the daughters as remainder beneficiaries. That the remainder beneficiaries’ interests aligned with the interests of the co-trustees did not relieve the sons of their duties to the remainder beneficiaries. As such, a question of fact as to whether the co-trustees were reasonable in their election of the unitrust provision remained, precluding summary judgment on that issue.

In addition, the Court of Appeals held that, since the New York statute allowed a trustee to specify the effective date of a unitrust election, the co-trustees’ retroactive application of the unitrust election was proper.

**B. Can These Distribution Tools be Utilized Retroactively?**

Note that New York law was changed in August 2008 to make the unitrust option more fully prospective. As a result of the changes, the election date specified by a trustee (without court approval) must now be within the year in which the election is made or the first day of the following year.


In Maryland, the effective date for unitrust conversion must be at least 30 days after notice of conversion. Md. Estates & Trusts Code Ann. §15-502.3(d)(3)-(4).

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2 An election to opt into the unitrust regime can be made without court approval only for trusts created after January 1, 2002, if made within two years. All other trusts require court approval.
Florida has statutory language permitting a trustee to determine the effective date of a unitrust election. However, the Florida statute also provides that the trustee must adopt a written statement providing that “future distributions from the trust will be unitrust amounts.” Fla. Stat. § 738.1041(2)(a).

In Nebraska, the law provides that, in the case of a trust for which a marital deduction has been taken for federal tax purposes, the spouse has the right to compel reconversion of the trust from a total return trust to an income trust. Ne. Revised Statutes §30-3119.01(8)(a).

The determination of whether it is possible to retroactively utilize the power to adjust regime also requires a state-by-state analysis.

In New York, the statute implies that the power to adjust can only be exercised prospectively:

- … the prudent investor standard also authorizes the trustee to adjust between principal and income to the extent the trustee considers advisable to enable the trustee to make appropriate present and future distributions … if the trustee determines…that such an adjustment would be fair and reasonable to all of the beneficiaries… EPTL §11-2.3(b)(5)(A) (Emphasis added.)

In New Jersey, adjustments made with respect to any accounting period must be made within 65 days of the end of that period. N.J. Stat. Ann. §3B:19B-4(a).

In Maryland, an adjustment may not be made before the time within which consent may be given to the trustee, which must be at least 30 days after notice of the adjustment is mailed. Md. Estates & Trusts Code Ann. §15-502.3(b)-(d).

In Nevada, a trustee was permitted to adjust between principal and income for the year preceding its appointment as trustee. The court reasoned that it was permissible to go back to the prior year since the statutory language clearly indicated that the power to adjust may be exercised correctively, after the trustee has an opportunity to review trust data and trustee investment decisions for the immediately preceding year. The court was not asked to go back further than the immediately preceding year. However, if the power to adjust is a corrective power, in the absence of clear statutory direction, query whether

3 Matter of Orpheus Trust, 179 P.3d 562 (Nev. 2008)
it may be possible to look back further in order to be fair and reasonable to all beneficiaries.

C. Can an Income Adjustment Request Invoke an In Terrorem Clause?

In McKenzie v. Vanderpoel, 151 Cal. App. 4th 1442 (2007), an inter vivos trust was created in 1959 to benefit three tiers of beneficiaries, each with a distinct interest. Only the first tier beneficiaries were guaranteed a fixed income payment. Second tier beneficiaries were to receive whatever net income was generated, while principal was reserved for third-tier beneficiaries.

The trust document contained a no contest clause, which stated that no principal or income was to be paid to any beneficiary who “has, directly or indirectly, alone or in cooperation or conjunction with others, contested or sought to impair, object or to invalidate this Declaration of Trust…”

Union Bank of California served as trustee and was given broad discretion, including the discretion to determine principal and income. The trust stated, “Except insofar as the Trustee shall exercise the discretion herein conferred, matters relating to principal and income shall be governed by the provisions of the Principal and Income Law…”

Pursuant to a court order issued in 1992, the trust estate was divided into three equal shares held for the benefit of the second tier beneficiaries. By the end of 2004, plaintiff (a second tier beneficiary) had a separate trust interest valued at over $11 million. Together with the equal shares of the other second tier beneficiaries, the total value of the original trust exceeded $33 million.

Plaintiff contacted the trustee in 2004 and requested an adjustment between principal and income to increase plaintiff’s trust distribution. The trustee sent notice to plaintiff and all trust beneficiaries advising them that it was prepared to transfer $130,210 from principal to income in plaintiff’s trust.

Various beneficiaries objected to the trustee’s proposal, and the trustee elected not to implement the adjustment. Plaintiff filed an application to obtain a judicial determination as to whether a petition to modify her share of the trust by adjusting principal and income (pursuant to the California Principal and Income Act) would violate the trust’s no contest clause. She provided a chart demonstrating that the annual income distributed to her had dropped from over $340,000 to under $265,000 over the previous 4-year period. She requested an annual adjustment equal to 4% of the trust’s principal value.

The Probate Court determined that filing the petition to adjust would be “a contest within the meaning of the no contest clause of the trust” because it would “change the
characterization of the property from principal to income thereby changing the intent of the settlor.”

On appeal, the Court of Appeals of California affirmed the Probate Court’s ruling, holding that since plaintiff’s petition would impair the settlor’s intent that second tier beneficiaries receive only net income, plaintiff’s petition would fall under the scope of the trust’s no contest clause.

The court determined that the California power to adjust did not exempt plaintiff’s adjustment petition from the no-contest clause since the settlor “set out specific provisions tailoring the beneficial interests of each tier of beneficiaries. The general provision providing that the trust be governed by the principal and income law does not override express intent of the trustor that the second tier beneficiaries receive net income only.”

According to the court:

“This proposal is a major change which would impair the terms of the original trust because it would provide more income to plaintiff than allowed by the trust in years when net trust income falls below 4 percent of her trust interest. Further, the principal of the trust, which is to be reserved to the third tier beneficiaries, could be invaded, thus reducing the third tier share in contravention of the terms of the trust.”

Implicit in the court’s determination is the conclusion that an adjustment to an income-only trust would violate a no-contest clause, except if principal payments were also permissible. But if the trustee had the ability to invade principal, the payout to an income beneficiary could be increased without exercising an adjustment power.

Consider that the power to adjust was intended as a mechanism for recharacterizing income in order to administer a trust impartially based on what is fair and reasonable to all beneficiaries, and that payments pursuant to the exercise of the power are not considered principal distributions. Accordingly, query the court’s conclusion that the adjustment proposal was a “major change which would impair the terms of the original trust.”

D. Power to Adjust Litigation

In Estate of Morse, Index No. 83862 (Sur. Ct., Dutchess Cty. 2006), a testamentary trust was established for the benefit of a surviving spouse, with the decedent’s children from a prior marriage as remainder persons.
After the trustee exercised the power to adjust, the remainder beneficiaries brought suit against the trustee, objecting to the adjustment on the grounds that the adjustment favored the interests of the surviving spouse as income beneficiary to the detriment of the remainder beneficiaries.

In response to a petition that was filed for advice and direction, the Surrogates held that the adjustment was an appropriate exercise of the trustee’s power. The Surrogate found that the remainder beneficiaries failed to show any abuse of discretion, bias or arbitrary action, and cited from Section 11-2.3A of New York’s Estates, Powers & Trusts that “[a] court shall not change a fiduciary’s decision to exercise or not exercise an adjustment power unless it determines that the decision was an abuse of the fiduciary’s discretion.”

E. Consider Utilizing Distribution Tools in the Qualified Domestic Trust ("QDOT") Situation:

A QDOT is a trust that can be established for the benefit of a non-US citizen surviving spouse. If properly structured, a QDOT will qualify for the marital deduction, postponing estate tax that would otherwise be due on the death of the first spouse, until the death of the survivor. However, any distribution of principal from a QDOT to the surviving spouse will result in the imposition of an estate tax. Internal Revenue Code ("IRC") §2056A(b).

Consider the result if the power to adjust is exercised by the trustee, or if the trustee opts into the unitrust regime. The IRS regulations make it clear that the exercise of the power to adjust or a conversion to a unitrust will not disqualify the marital deduction nor result in an estate tax. IRC Regs. §§20.2056(b)–5(f)(1) and 20.2056A–5(c)(2).

Consequently, to the extent that the adjusted income payout exceeds the trust’s yield, the excess is redefined as income and should have no estate tax consequence. For example, if a QDOT’s yield is 2% and a trustee in Delaware opts into the Delaware unitrust regime, selecting a 5% payout, the 3% payout in excess of the trust’s yield is considered income for both trust accounting and tax purposes.

3. Tax Consequences are Critical

As a trustee, it is important to consider not only the gross amount to be distributed to the beneficiaries, but also the net amount the beneficiaries will receive, once tax consequences have been considered. Indeed, the Prudent Investor statutes typically require a trustee to consider the expected tax consequences of distributions of income and principal. In addition, anticipated tax consequences are generally included in the list of factors to be considered by a trustee in making a determination to utilize the power to adjust or unitrust regimes.
The actual amounts received by the beneficiaries can be significantly impacted by decisions a trustee makes: how the trust funds are to be invested and how the capital gains taxes are to be allocated.

A. Investment Issues:

If a trustee is dealing with a flexible power to adjust or unitrust regime (where the amount to be distributed to the income beneficiary can be adjusted depending on all the facts and circumstances), the investment strategy for the trust, with its attendant tax consequences, can be factored into the analysis of an appropriate payout to the income beneficiary. If, however, a trustee is locked into a fixed payout to the income beneficiary (as with the fixed 4% unitrust payout in New York), the trustee is not able to manipulate the amount the beneficiary is to receive to reflect the tax burden.

Consider the following in the context of a unitrust arrangement governed by New York law: If, for example, the yield on taxable bonds is greater than the yield on tax exempt bonds, the remainder persons would surely prefer the bond portfolio to be invested in taxable bonds: if the yield is higher, the trustee will have to dip into principal less to make the guaranteed 4% payout. The fact that the income beneficiary will be taxable on the yield might not be of concern to the remainder persons.

On the other hand, the income beneficiary would surely prefer to see the bond portfolio invested in tax exempt bonds: she would get the tax benefit from the investment in tax exempt instruments. To the extent that the lower yielding tax-exempt bonds (and other trust income and dividends) produced less than 4%, the shortfall necessary to satisfy the 4% guaranteed unitrust payment would be made up with a tax-free distribution of principal (assuming gains are taxed to the trust).

B. Capital Gains Tax Issues:

Under IRC Reg. §1.643(a)–3(a), capital gains are ordinarily taxed to the trust (remainder persons). However, capital gains may be includable in distributable net income and passed out to an income beneficiary if, pursuant to the terms of the governing instrument and local law or pursuant to a reasonable and impartial exercise of discretion, gains are:

Reg. §1.643(a)–3(b) (1) Allocated to income;

(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 to a beneficiary.

Accordingly, with respect to the exercise of the power to adjust, it appears that the trustee has the flexibility to tax capital gains to the income beneficiaries in some years, and to the trust in others, as long as that determination is made reasonably and impartially. Consider, however, whether a trustee is operating with a flexible power to adjust regime (where the amount to be distributed to the income beneficiary can be adjusted depending on all the facts and circumstances). If so, even if gains are consistently taxed to the trust, for example, the allocation of the capital gains taxes is one of the factors that the trustee can consider in determining an appropriate tax-adjusted income payout to the income beneficiary.

In contrast to the apparent flexibility afforded to the trustee in the power to adjust regime, the IRS regulations make clear that, if using a unitrust regime, the discretionary power to allocate capital gains to income must be exercised consistently. IRC Reg. §1.643(a)-3(e), Examples 12-14.

In other words, a trustee is locked into allocating capital gains the same way that the allocation is made in the first year of the unitrust regime. Of course, given only one choice, the income beneficiaries would probably elect to have gains taxed to the trust and the remainder persons would probably elect to have gains taxed to the income beneficiary. In a flexible unitrust regime (where the unitrust payout amount can be adjusted depending on all the facts and circumstances), the allocation of the capital gains taxes is one of the factors the trustee can consider in determining the appropriate unitrust amount. However, if the unitrust is fixed in amount (as it is in New York at 4%), one or the other set of beneficiaries will be unhappy with the tax allocation.

**What is a Trustee to do?**

A trustee should consider all the facts, make a reasonable determination under the circumstances, and document the identification of these issues and their resolution.

**4. When There Are No Guidelines, How is a Trustee to Determine an Appropriate Payout?**

Once having determined to make an adjustment, however, the statutes are typically silent regarding an appropriate amount of an adjustment. How is a trustee to determine an appropriate payout in the absence of any guidance? Even in those states in which a permissible adjusted income payout range or unitrust payout range is provided, how is a
trustee to determine where (within the permissible range) a payout determination should fall?

Consider that the baseline fundamental duty of a trustee is to keep pace with inflation. Accordingly, a logical starting point may be to calculate the amount of income a beneficiary might expect to receive in a portfolio designed only to keep pace with inflation. From that starting point, the payout amount might be adjusted upwards or downwards depending on a consideration of the factors listed in the various state statutes.

A smoothing mechanism might also be considered even if not mandated by statute, to account for market volatility.

5. **Strategies to Minimize Trustee Liability**

It is important to heed the fact that no decision a trustee makes can be made on auto-pilot. It is the responsibility of a trustee to make reasonable, reasoned decisions, based on a consideration of all the facts and circumstances, including a determination about whether to exercise the power to adjust, or opt into the unitrust regime. Documenting the process is critical. The guidance of trusted professional advisors can also minimize fiduciary risk.

A. **Consider all the Facts and Circumstances**

Deciding on a course of action after consideration of all the facts and circumstances can help protect a trustee from liability, as **Merrill Lynch Trust Company v. Campbell**, 2009 Del. Ch. LEXIS 160 (2009) illustrates. In 1996, Mary Campbell was persuaded by a financial advisor of a brokerage firm to place her concentrated holding in Exxon shares (which represented most of her life savings) into a charitable remainder unitrust. The trust agreement provided for a ten percent annual payout to Mrs. Campbell for life, then to her husband if he survived her, and upon the death of the second spouse, payments would be allocated among the couple’s three children. Upon the death of the last of the three children, the trust would terminate, and the remainder would be allocated in equal shares among various designated charities.

Merrill Lynch Trust Company was designated trustee of the trust. At the time of formation, the trust’s market value was approximately $840,000. The expected duration of the trust was between forty-eight and fifty-one years.

Shortly after the trust was created, Mrs. Campbell’s financial needs increased, due in large part to her husband’s declining health. Mrs. Campbell informed her financial advisor that the annual trust distribution was insufficient, and that she needed access to additional funds.
Mrs. Campbell’s request was communicated to Merrill Lynch, as a result of which Merrill Lynch altered the investment strategy of the trust from “Growth & Income” to “Growth”. The “Growth” designation prescribed a more risky investment strategy and targeted an equity mix of 90% of the trust’s assets. Mrs. Campbell was entirely unaware that her request for additional income would alter the investment strategy of the trust, and expose the trust assets to greater risk.

In February 1997, Mrs. Campbell received a letter informing her of the change of investment strategy, which she signed on the advice of the financial advisor. Due to the new investment strategy, which coincided with broad declines in the stock market, the trust steadily decreased in value. By the end of 2002, the trust was valued at $356,000.

The severe loss of capital in the trust resulted in proportionately reduced payouts to Mrs. Campbell. Upon investigation, Mrs. Campbell discovered that the new investment strategy had led to the trust’s declining value.

Following an unsuccessful arbitration proceeding, Mrs. Campbell attempted to replace Merrill Lynch as trustee. Merrill Lynch refused to allow the replacement, unless Mrs. Campbell released Merrill Lynch and its affiliates from liability. Mrs. Campbell refused to do so.

Merrill Lynch then brought an action against Mrs. Campbell, her children as successor beneficiaries, and the charities as remainder persons, seeking approval of its investment methods since the creation of the trust, and a declaratory judgment that its administration of the trust and investment strategies were lawful and appropriate.

Mrs. Campbell brought a counterclaim against Merrill Lynch. She claimed that she was induced to enter into the trust agreement by misleading misrepresentations and omissions – but that claim was held to be time-barred. She also challenged, among other matters, the investment strategy. She argued that investing for an individual of advanced age requires a significant component of fixed income investments, instead of the 90-100% equity strategy implemented.

The court examined the prudent investor standard to which the trustee was subject and noted that the very terms of the trust agreement, and its obligations, shape the contours of the prudent investor’s responsibilities:

“A trustee will not be liable to a beneficiary for following a specific investment strategy to the extent that the trustee acted in reasonable reliance on the terms of the trust. The conduct of a trustee in administering the trust is not to be determined a violation of any fiduciary duty based on hindsight knowledge of subsequently developed facts and circumstances.”

(Emphasis added.)
The Delaware Court of Chancery noted that the trust anticipated no less than ten beneficiaries, imposing upon the trustee a duty of impartiality to administer the trust in a manner designed to deliver reasonable income payments, while preserving the trust’s corpus. Expert witness testimony attested to the fact that, preserving the trust’s corpus for its 50-year expected duration with a 10% annual payment, was an “onerous challenge”. The court found that Merrill Lynch chose the equity mix based on its understanding of preserving the trust principal for its long anticipated life, given the annual 10% payout obligation. Judging the trustee’s actions in light of the circumstances at the time, and not with the benefit of hindsight, the court held that:

“…considering the duties owed to each anticipated beneficiary and the unique coalescence of competing mandates…[the trustee’s] decision to invest the Trust’s assets heavily in equities [was] reasonable.”

Although the record concerning the process the trustee employed to raise the equity level following Campbell’s request for increased payouts was “thin”, the record was found to amply document the trustee’s standard practices. The court found that there was no reason to suspect that the standard practices were not followed and that, the documentation that there was, supported a finding that the trustee employed a deliberative process, including trust committee review.

At the end of the day, the decision was driven by the fact that the trust agreement set a nearly “unreachable standard”. The trustee had few, if any, good options when setting the investment course for the trust. Based on all the evidence, it chose a course that was most likely to result in satisfaction of its obligations – delivery of a large payout to income beneficiaries for fifty years and preservation of the trust corpus for the benefit of the remaindermen.

Contrast the decision in the Campbell case to that in Western Reserve v. David Graben, 233 S.W.3d 360, Rehearing denied by, 2007 Tex.App. LEXIS 6648. In Graben, an investment advisor and his employer were sued by two clients who alleged negligence and breach of fiduciary duties in the purchase and supervision of variable annuities.

When the clients initially approached the investment advisor looking to invest their retirement funds, they listed their investment objectives as long-term growth, income, and short-term growth. However, during their initial meeting with the advisor and at various other points over the course of the relationship, both clients expressed concerns about the loss of their retirement funds.

In 1999, the advisor placed each client’s initial investment into equities, and received substantial commissions for the investment.

In 2000, the stock market began to fall. Both clients approached the advisor to raise
concerns about the losses to their annuities, and suggested selling the annuities to preserve their initial investments. The advisor recommended that both clients stay invested until the market recovered to avoid locking in their losses and avoid the imposition of penalties and the generation of new commissions.

Both clients followed the suggestions of the advisor and did not sell. The market continued to decline between 2000-2004, and the clients sustained further losses on their investments. After terminating their relationships with the advisor, both clients brought suit against the advisor for negligence and breach of fiduciary duty.

A Texas jury awarded both clients damages, punitive damages, and attorneys’ fees, and ordered disgorgement of commissions received by the advisor.

The Texas Court of Appeals held that the evidence was sufficient to support the jury’s finding of breach of fiduciary duty, but overturned the jury’s finding of fraud, punitive damages, and entitlement to attorneys’ fees.

The Court found that the advisor had assumed the role of financial advisor to two clients who were unsophisticated investors, and thus transactions between advisor and client were not arms’ length business transactions. By assuming the role of advisor, a fiduciary relationship was established between advisor and client.

The Court upheld the finding of breach of fiduciary duty, holding that “because the clients were at retirement age and needed current income from their investments, almost all financial advisors would have recommended the clients’ money to be invested more in the bond market rather than in equity funds due to the reduced risk of loss that bond funds provided.”

B. Proper Documentation is Critical

It is critical that an attorney or other individual acting as trustee not only fulfill all the responsibilities imposed under the Prudent Investor Rule, but also that the trustee document that s/he has done so. In determining whether to utilize the power to adjust or unitrust regimes, documentation can also play a critical role.

In Re Charles G. Dumont, 791 N.Y.S.2d 868 (2004), rev’d in part, 809 N.Y.S.2d 360 (App. Div. 4th Dep’t 2006), appeal denied, 813 N.Y.S.2d 689 (App. Div. 4th Dep’t 2006), appeal denied, appeal dismissed, 855 N.E.2d 1167 (2006), reargument denied, 860 N.E.2d 993 (2006), involved a concentrated stock holding in a trust. The trust was funded almost entirely with Eastman Kodak stock. The corporate trustee maintained the nearly exclusive concentration in Kodak stock for almost half a century, despite precipitous drops in the stock’s value. In the course of his determination to surcharge the trustee nearly $21 million dollars for failure to diversify, the Surrogate noted that, during
a period of time in question, there were no copies of correspondence, no copies of trust
review forms, no internal memoranda regarding the trust’s terms and no documentation
whatsoever as to the investment strategy of the trust or the performance of Eastman Kodak.

Although the Surrogate’s determination to surcharge the trustee for failure to diversify
was overturned on appeal, it is telling to heed the Surrogate’s finding that the complete
lack of documentation alone was a breach of trust.

In order to demonstrate compliance with the Prudent Investor Rule, it is essential that a
trustee document investment objectives, investment process, review and monitoring of
the trust portfolio, and maintain records of all meetings, correspondence and other
communications with the trust beneficiaries. Specifically, an Investment Policy
Statement should be in place for the trust, the purpose of which is to define investment
goals and the parameters of the investment strategy designed to achieve those goals.

Utilization of a total return regime can be an important tool in enabling a trustee to
achieve investment goals pursuant to prudent investor principles. The process by which
the trustee determines to use a total return regime, the factors a trustee considers and the
methodology for computing an adjusted payout should also be carefully documented.
Records of correspondence and other communications with beneficiaries should be
maintained. It is critical to have policies and procedures in place. Indeed, consider the
Campbell case where, despite the fact that the records of the trustee were “thin” regarding
process for the case at hand, the record was found to amply document the trustee’s
standard practices.

Trustees might also consider accounting and obtaining releases to foreclose potentially
open-ended liability. Matter Of Judicial Settlement Of The Account Of HSBC Bank,
2010 NY Slip Op 1099 (2010), illustrates the importance of a trustee’s obtaining releases
from beneficiaries, even pursuant to an informal accounting. Jesse Littleton created a
trust, naming himself and his wife as income beneficiaries. Upon their deaths, one fourth
of the assets continued in trust for their son. Upon the son’s death, the trust assets
continued in trust for the benefit of the petitioners, son’s wife and children. The
predecessor of HSBC Bank U.S.A. was named trustee.

The trust contained a retention clause stating that the trustee had “absolute discretion” to
retain “any stocks, bonds or other securities…including securities of Corning Glass
Works and any successor or affiliate thereof.” In addition, the clause exonerated the
trustee from liability, stating that the trustee “shall not be or be held responsible for any
loss or depreciation that may occur in the value [of those securities]…” Corning Glass
stock constituted more than 80% of the trust assets.
Upon settlement of the trust, an informal accounting containing the trust’s complete transaction history was sent to petitioners’ attorney along with a receipt and release agreement. The accounting disclosed significant declines in the value of Corning Glass stock. Petitioners signed their respective releases, which provided that HSBC was forever absolved from all liability for the handling of trust assets.

Three years later, petitioners commenced a proceeding to set aside the releases, claiming breach of fiduciary duty.

The New York Appellate Division affirmed the Surrogate’s decision to dismiss the breach of fiduciary duty claim. The court found that HSBC fulfilled its fiduciary duty by providing petitioners with a full accounting of the trust to which they failed to object, and executed releases waiving their rights against HSBC.

…Particularly if the Strict Privity Rule is Relaxed

In New York, documentation of legal advice has been considerably elevated in importance in light of a recently decided case in the New York Court of Appeals.

In Estate of Saul Schneider v. Finmann, 2010 NY Slip Op 05281 (2010), decided on June 17, 2010, the Court of Appeals held that sufficient privity existed between the personal representative of an estate and the estate planning attorney for the personal representative to maintain a malpractice claim against the attorney on the estate’s behalf.

In the Schneider case, the decedent’s estate commenced a malpractice action against the decedent’s estate planning attorney, alleging that the attorney negligently advised the decedent to transfer, or failed to advise decedent not to transfer, an insurance policy into his own name. The result was that the insurance policy proceeds were includable in the decedent’s estate.

The New York Supreme Court granted defendant’s motion to dismiss the complaint for failure to state a cause of action. The Appellate Division affirmed, holding that, in New York, absent fraud, strict privity is required to maintain a claim against an attorney for profession negligence.

The Court of Appeals reversed, holding that privity, or a relationship approaching privity, exists between the personal representative of an estate and the estate planning attorney. According to the court, the strict privity rule leaves the estate with no recourse against an attorney who planned the estate negligently, and the estate essentially “stands in the shoes of a decedent,” giving the estate capacity to maintain the malpractice action.
The Court stipulated, however, that strict privity should remain a bar against malpractice suits by estate beneficiaries or other third parties, absent fraud or other special circumstances.

Bear in mind, however, that a permissible malpractice action against an estate planning attorney is presumably subject to general statute of limitations rules.

Under New York Civil Practice Law and Rules ("CPLR") Section 214(6), legal malpractice actions have a three-year statute of limitations. Pursuant to New York’s Estates Powers and Trusts Law Section 11-3.2(b), a cause of action for injury is not lost because of the death of the person in whose favor the cause of action existed. Note also that, under CPLR §210(a), the statute of limitations for a malpractice action can be extended to the greater of (1) one year after the death of the decedent, or (2) the remaining statutory period.

In addition, the statute of limitations period could possibly be extended under the doctrine of continuous representation. Pursuant to this doctrine, the statute of limitations is tolled for a legal malpractice action until the end of an ongoing representation which pertains directly to the matter in which the attorney committed the malpractice.

C. Trusted Professional Advisors Can Help Facilitate Compliance With the Law

One important step a trustee can take to minimize fiduciary risk is to hire trusted professional advisors who are cognizant of the responsibilities imposed on fiduciaries, and have expertise in fulfilling those responsibilities. Professional advisors also have expertise in utilizing the tools available to fiduciaries (including the distribution tools of the power to adjust and unitrust regimes), and can navigate the complex issues associated with their use.

When friends or family members are appointed as trustees, oftentimes they are simply unaware of the full scope of their duties and powers. In Mary and Emanuel Rosenfeld Foundation Trust, 2006 Phila. Ct. Com. Pl. LEXIS 394, in part and rev’d in part, remanded, without opinion, 953 A.2d 849 (2008), is a classic example.

Emanuel Rosenfeld, the founder of Pep Boys, established a charitable trust in 1952, which was funded entirely with Pep Boys stock. The trust document named Mr. Rosenfeld’s son Lester, his daughter Rita, Lester’s son Robert, and Wachovia bank as trustees.

During the mid-1990s, both Rita and Wachovia repeatedly expressed concern that the charitable trust was funded entirely with Pep Boys stock, and communicated to the other trustees that they were interested in diversifying the trust assets. Lester, who had worked for Pep Boys since 1952 and served as a board member, refused to address Rita’s
concerns about the trust and blatantly ignored letters sent by Wachovia stressing the need for diversification. Robert’s involvement in trust issues at this time was passive and disinterested.

Wachovia actively monitored the trust’s investments during the lifetime of the trust, and pointed out in its letters to the co-trustees that the value of Pep Boys stock was steadily declining between 1997 and 2000.

When Lester and Robert finally agreed to sell some of the Pep Boys stock in 2001, the stock had already declined significantly in value.

In 2002, Rita filed a lawsuit against Lester, Robert, and Wachovia for breach of fiduciary duty, based on the failure to diversify the trust. Summary judgment was later granted to Wachovia, based on Wachovia’s consistent monitoring and review of the trust assets, and the letters sent by Wachovia urging diversification.

The court found that Lester’s obdurate refusal to diversify resulted from his conflict over his relationship with the company, which he put before the interests of the charitable remaindermen. According to the court, Lester’s son had a cavalierly negligent attitude towards his fiduciary responsibility and was motivated by concerns over how his personal fortunes would be adversely effected if he deviated from his father’s position.

The court noted that neither Lester nor Robert fully appreciated their fiduciary responsibilities – a finding which is clear from the following excerpt from Lester’s deposition testimony:

Q: Do you consider yourself a trustee of the foundation to have any duties to beneficiaries of the foundation, and by beneficiaries, I mean the charities that will be receiving…

A: No

Q: …distribution?

A: No.

Q: You have no duty to the beneficiaries?

A: No. I have no commitment to them, they’re very appreciative of what we give them and I’m grateful for the fact that we’re able to do it.

Q: Now, I understand from your testimony that it didn’t matter what the bank was recommending
as to putting the proceeds into, you were against
diversification per se, correct?

A: Yes.

The Court rejected the claim that no losses could be assessed since the trust was worth more than its inception value. Instead, the Court looked to damages based on what the trust assets would have earned, but for the breach, and surcharged Lester and Robert nearly $600,000. They were also surcharged in the amount of the legal fees incurred by Wachovia and the charitable beneficiary—an additional $425,000.

Giving some comfort to those trustees who do determine to hire a professional investment advisor is the case of O’Neill v. O’Neill, 169 Ohio App. 3d 852 (2006). In 1998, Patrick O’Neill became the principal beneficiary of a trust established by his grandfather. The individual trustee of the trust was O’Neill’s uncle. Under the terms of the trust, O’Neill was to receive all the trust principal on his 40th birthday, in 2001.

In 1999, the uncle delegated the investment duties of the trust to Merrill Lynch. At that time, the trust was valued at approximately $327,000. Merrill Lynch invested heavily in technology stocks, and in less than one year, the trust portfolio’s value increased to over $600,000. In early 2000, the technology market crashed, and on the date of O’Neill’s 40th birthday, the trust assets were valued at approximately $37,000.

In 2003, O’Neill brought suit against his uncle under the Prudent Investor Act for breach of fiduciary duty in delegating the investment duties for the trust to Merrill Lynch. The uncle’s motion for summary judgment was granted.

On appeal, the Ohio Court of Appeals noted that, pursuant to the Ohio Uniform Prudent Investor Act, a trustee may delegate investment and management functions, using reasonable care, skill and caution: 1) selecting an agent; 2) establishing the scope and terms of the delegation consistent with the purpose and terms of the trust; and 3) periodically reviewing the agent’s actions in order to monitor the agent’s performance with the terms of the delegation.

The Court of Appeals upheld the lower court’s ruling. The question before the court was: How much reviewing and monitoring is required by the trustee to satisfy the mandate of the Prudent Investor Act? In this case, the uncle received and reviewed periodic statements for the trust (although he testified he did not scrutinize them), some of which were prepared by Merrill Lynch and some of which were prepared by an accountant. He received performance reports and confirmation of trades. The uncle also periodically met with Merrill Lynch concerning the trust.
The court did not find it necessary that the uncle be “heavily involved” in the duties delegated in order to comply with the Prudent Investor Act. The court determined that the actions of the uncle constituted sufficient evidence that he did not “fall asleep at the wheel.”

In addition, the court noted that portfolio losses due to the crash of the technology market were very common at the time, and it was not unusual for an investor to stay the course in that particular market after sustaining heavy losses.

Finally, the court noted that some responsibility for the trust losses fell to O’Neill, who collaborated with Merrill Lynch in deciding to make the technology stock trades.

Individuals often wish to appoint friends or family members as trustees: and with good reason. Family members and friends are generally trusted, loved and have a deep knowledge and connection with the family. However, many individual trustees who agree to act as fiduciary might not fully appreciate the scope of their role (including the availability of total return distribution tools and the myriad of complex issues which must be addressed in determining to utilize those tools), and the potential liabilities to which they may be subject if fiduciary obligations are breached. Trusted professional advisors with expertise in the area can counsel the individual trustee regarding the fiduciary role, including utilizing distribution tools to facilitate achievement of goals.
Power to Adjust and Unitrust Regimes: A State-By-State Analysis
<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Statutory Reference</th>
<th>Power to Adjust</th>
<th>Unitrust</th>
<th>Effective Date</th>
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<tbody>
<tr>
<td>Alabama</td>
<td>Ala. Code 19-3A-101 to 19-3A-605</td>
<td>Yes</td>
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<td>California</td>
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<td>Yes (4% default 3%-5% with consent)</td>
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<td>Florida</td>
<td>Fla. Stat. Ann. 738.101 to 738.804</td>
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<td>Massachusetts</td>
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<td>Michigan</td>
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<td>South Carolina</td>
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<td>Statutory Reference</td>
<td>Power to Adjust</td>
<td>Unitrust</td>
<td>Effective Date</td>
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<td>Tennessee</td>
<td>Tenn. Code Ann. 35-6-101 to 35-6-602</td>
<td>Yes</td>
<td>Yes (3-5%)</td>
<td>7/1/00 (PTA) and 7/1/10 (U)</td>
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<td>Texas</td>
<td>Tex. Prop. Code Ann. 116.001 to 116.206</td>
<td>Yes</td>
<td>Yes (3-5%)</td>
<td>1/1/04</td>
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<td>Utah</td>
<td>Utah Code Ann. 22-3-101 to 22-3-603</td>
<td>Yes</td>
<td>No</td>
<td>5/3/04</td>
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<td>Vermont</td>
<td>14A V.S.A. 907 to 908</td>
<td>No</td>
<td>Yes (3-5%)</td>
<td>2/1/11</td>
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<td>Virginia</td>
<td>VA Code. Ann. 55-277.1 to 55-277.33</td>
<td>Yes</td>
<td>Yes (3-5%)</td>
<td>1/1/00</td>
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<td>Washington</td>
<td>Wash. Code Rev. 11.104A.001 to 11.104A.905</td>
<td>Yes</td>
<td>Yes (4%)</td>
<td>1/1/03</td>
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<td>West Virginia</td>
<td>W. Va. Code 44B-1-101 to 44B-6-606</td>
<td>Yes</td>
<td>Yes (3-5%)</td>
<td>7/1/00</td>
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<td>Wisconsin</td>
<td>Wis. Stat. 701.20</td>
<td>Yes</td>
<td>Yes (3-5%)</td>
<td>5/17/05</td>
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<td>Wyoming</td>
<td>Wyo. Stat. Ann. 2-3-801 to 2-3-917</td>
<td>Yes</td>
<td>Yes (3-5%)</td>
<td>7/1/01 (PTA) and 7/1/07 (U)</td>
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