BACK TO THE FUTURE: IS TOTAL RETURN INVESTING OLD FASHIONED?

Representing Estate and Trust Beneficiaries and Fiduciaries

July 2, 2004

Terry L. Turnipseed[1]
Syracuse University College of Law

INTRODUCTION

Trusts are tricky animals. Finding the right recipe to make the income beneficiaries and the remaindermen happy is tough, and it has been getting tougher. Trustees must balance two seemingly incompatible goals: the income beneficiaries' desire to maximize income payout versus the remaindermen's desire to maximize the trust corpus.

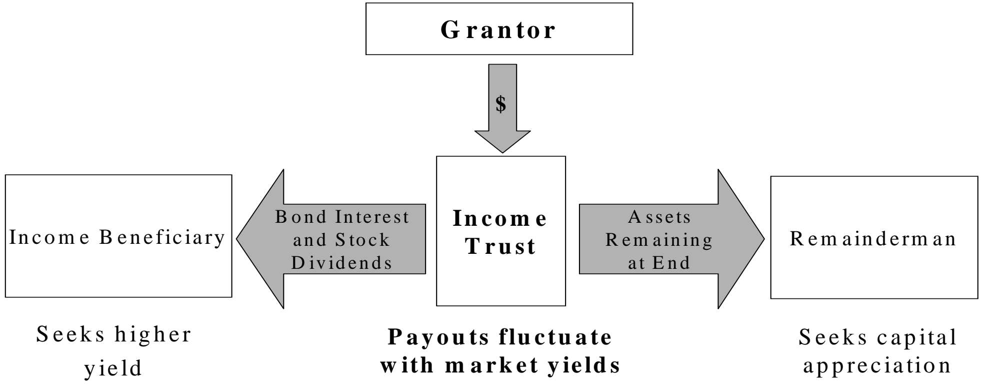
Trust management is most challenging with income-only trusts, historically the most common type of trust prepared. Even though most (though certainly not all) trusts are now drafted to give Trustees power to distribute trust principal to income beneficiaries, there are plenty of big-money income-only trusts still in existence, many exceeding $100,000,000. The current payout in income-only trusts is based on the stock dividends and bond interest earned by the trust's assets. Current beneficiaries, of course, want the asset allocation to be weighted more heavily with income-producing investments – historically bonds[2] – to drive up their annual distributions. This preoccupation with yield is

---

[1] The author would like to thank Alice C. Davenport, Senior Analyst in the Wealth Management Group at Bernstein Investment Research & Management, a unit of Alliance Capital Management L.P. All graphics, historical investment figures and future investment projections are reproduced with permission from Bernstein's presentations *Income Versus Wealth: Finding the Right Balance; Setting Investment Objections;* and *Managing Trusts in an Uncertain World*.

[2] Good Trustees these days will also look for income-producing assets that have better long-term appreciation potential, such as REITs, whose low correlation with both stocks and bonds makes them a good diversifier. Trustees should use REITs only if suitable from an income-tax standpoint, since they usually do not qualify for the reduced tax rate on qualified dividends.

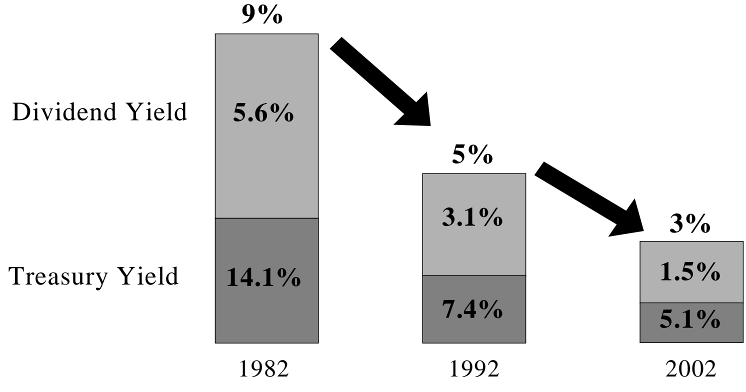
the antithesis of the remaindermen's desire to see trust principal grow, which



would likely require an asset allocation heavily weighted to stocks.

Balancing the desires of income beneficiaries and remaindermen has become even more difficult because yield from stocks and bonds has plummeted in the last twenty or so years. This has seriously reduced the flow of income to beneficiaries, especially after the effects of inflation are taken into account. In 1982, for example, 10-year Treasury bills were yielding 14% and the S&P 500 was yielding 5.5%. A 60/40 stock/bond portfolio, then, had an overall yield of 9% – real money for income beneficiaries. Ten years later in 1992, the same 60/40 mix yielded only 5%. By 2002, a 60/40 mix yielded a paltry 3%. This is an almost 70% reduction in yield in 20 years. Trustees have started to feel the heat from "poverty-stricken" income beneficiaries to alter asset allocations to increase trust portfolio yield.

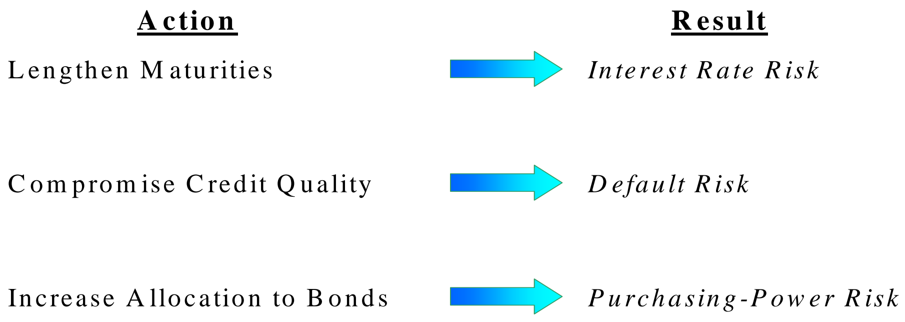
Income from 60/40* Balanced Portfolio



**Calculated using 60% S&P 500 and 40% 10-year Treasuries*

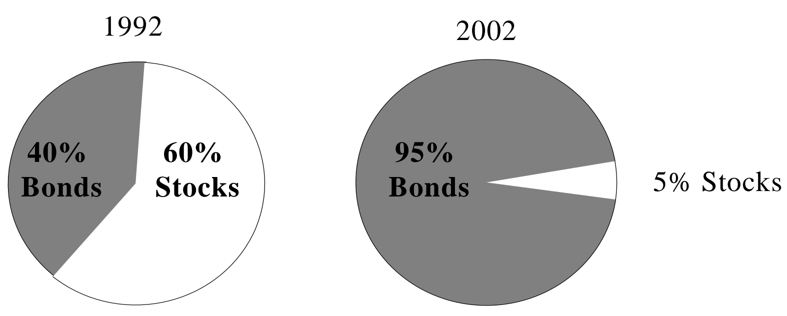
There are ways of going about increasing trust portfolio yield, but each is flawed. The graphic below shows a few examples.

Typical Strategies to Increase Portfolio Yield



The easiest (and thus most popular) way to increase trust portfolio yield is to buy bonds, and then buy more bonds. But even with dramatic increases in the percentage of bonds comprising the trust portfolio, it is clear that a trust portfolio heavily concentrated in bonds will not generate sufficient income for the income beneficiaries over time. Plus, it has a devastating effect for remaindermen. For example: in 1992, a 60/40 portfolio generated a 5% yield. Ten years later in 2002, that same 5% yield would require that the trust portfolio consist of 95% bonds and 5% stocks.

Asset Allocation Necessary to Generate 5% Yield*

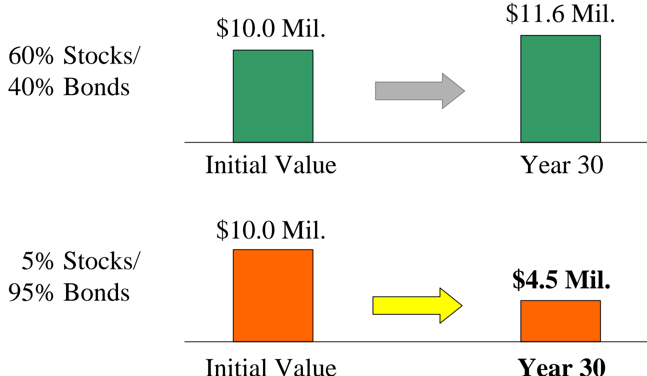


**Stocks represented by the S&P 500 and bonds represented by 10-year Treasuries*

Trustees better hope their malpractice insurance premiums are paid up if they invest in 95% bonds, because the inflation-adjusted remainder would be 55% less than that in a trust portfolio comprised of a 60/40 stock/bond investment mix, a result unacceptable to most remaindermen.[3]

---

[3] Based on the median outcomes at the end of Year 30, assuming an asset allocation of 60% globally diversified equities (35% large-cap U.S. value, 35% large-cap U.S. growth, 25% developed international, 5% emerging markets) and 40% intermediate taxable bonds, or 5% (continued…)



Clearly, the old, familiar paradigm that Trustees once used has been shattered. Something had to be done, and something was done.

PRUDENT INVESTOR RULE

Over the past 16 years, most states have replaced the "prudent person rule" for assessing Trustee investment performance with the "prudent investor rule". I leave the myriad distinctions between the two rules for other articles,[4] but for purposes of this article I will oversimplify by saying that the prudent person rule required (1) Trustees to produce a stream of income adequate for income beneficiaries, (2) the sale of underproductive assets, and (3) an asset-by-asset fiduciary scrutiny. On the other hand, the newer prudent investor rule requires Trustees to invest for total return, regardless of income production, and Trustees are measured by their overall performance and not the performance of any single asset within a trust portfolio. The prudent investor rule is part of the Prudent Investor Act ("Act"), a uniform act promulgated in 1994 and adopted by a majority of states.

Notwithstanding the Act, Trustees are still required to remain impartial vis-à-vis income beneficiaries and remaindermen. If it turns out, for example, that a trust portfolio with 80% or 100% equities is the most appropriate asset allocation for a given trust, there may be little or no income for the income beneficiaries. As a result, a Trustee who fully complies with the prudent investor

---

globally diversified equities and 95% intermediate taxable bonds. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 30 years. Data does not represent any past performance and is not a promise of actual future results. This set of assumptions and disclaimer are relevant to all of the graphics presented in this article.

[4] See, for example, *Dealing with Controversy: A Trustee's Investment Dilemma*, by Jeffrey A. Zaluda of Horwood Marcus & Berk Chtd.

rule's requirement to invest for total return will likely violate the duty to treat all trust beneficiaries impartially. Thus, a Trustee has a substantial incentive **not** to invest for total return.

Absent new tools to implement the prudent investor rule's requirement to invest for total return, it is unlikely that a Trustee can maximize total return while producing a sufficient income stream for the income beneficiaries. Thus, Trustees are left to choose between investing for total return and shortchanging the income beneficiaries, or investing for high income production and shortchanging the remaindermen. In either event, Trustees face the prospect of litigation from either the income beneficiaries or remaindermen.

So what's a Trustee to do?

There are two relatively new methods of implementing the prudent investor rule, each giving Trustees more flexibility in investments and distributions: (1) the Revised Uniform Principal and Income Act ("UPIA") Section 104 Power to Adjust gives Trustees discretion to recharacterize principal as income and vice-versa, annually; and (2) the Unitrust Approach pays out a percentage of assets annually, even if income alone is insufficient to satisfy that percentage amount.

A majority of the states - to date roughly 35 states and the District of Columbia - have adopted the Power to Adjust, while 17 states have adopted legislation authorizing Trustees to opt into a Unitrust regime. Many more states are expected to adopt one or both in the next few years. Appendix A shows the status of state legislation as of April 2004.

SECTION 104 POWER TO ADJUST

The revised UPIA containing the new Section 104 Power to Adjust was enacted in 1997. It allows a Trustee to invest for total return, while at the same time treating all beneficiaries impartially. Section 104 permits equitable adjustments between income and principal if the Trustee is unable to administer a trust impartially between income beneficiaries and remaindermen because the trust only authorizes distributions of income.

Factors Trustees Should Consider (UPIA Section 104(b))

Section 104(b) sets out factors that Trustees should consider in determining whether and to what extent to exercise the Power to Adjust principal to income, as follows:

- nature, purpose, and expected duration of the trust;

- settlor's or testator's intent;
- identity and circumstances of beneficiaries;
- needs for liquidity, regularity of income, preservation and appreciation of capital;
- type of assets held in the trust;
- trust income (as calculated before adjustment);
- whether Trustee has power to invade principal;
- actual and anticipated effects of economic conditions, including effects of inflation and deflation; and
- anticipated tax consequences of adjustment.

Trustees' should comply with their fiduciary duty by dusting these factors off and reviewing them every year for every trust to make an affirmative decision whether and to what extent to utilize the Power to Adjust.

Limitations on Power to Adjust (UPIA Section 104(c))

There are some trust situations where a Trustee may not use the Power to Adjust. Under Section 104(c), a Trustee may not make an adjustment that would:

- reduce the income of a marital trust;
- reduce the actuarial value of the income interest in a trust for which a federal gift tax exclusion was taken;
- change the amount payable to a beneficiary as a fixed annuity (*e.g.*, Grantor Retained Annuity Trust or Charitable Lead Annuity Trust) or a fixed fraction of the trust assets (*e.g.*, Grantor Retained UniTrust or Charitable Lead UniTrust);
- reduce any amount permanently set aside for charity;
- create a grantor trust problem (though the Power to Adjust can be exercised by a Co-Trustee where the exercise of that power would not cause a grantor trust problem);

- cause the trust assets to be included in the power holder's estate (though the Power to Adjust can be exercised by a Co-Trustee where the exercise of that power would not cause the assets to be included in the Co-Trustee's estate);

- be made by a Trustee that is beneficiary of the trust (though the Power to Adjust can be exercised by a Co-Trustee where the exercising Co-Trustee is not a beneficiary); or

- benefit the Trustee directly or indirectly (though the Power to Adjust can be exercised by a Co-Trustee that would not benefit by the exercise of the power).

Most of these are not relevant to traditional income-only trusts where the Trustee is an independent party and you are seeking to increase the amount the income beneficiary is receiving. Note that there are ways around some of these limitations, such as having a non-problematic Co-Trustee exercise the power alone, or even petitioning a court.

Releasing the Power to Adjust (UPIA Section 104(e))

Section 104(e) allows a Trustee to release all or part of the Power to Adjust in circumstances where even possessing the power might deprive the trust of a tax benefit or impose a tax burden. For example, if a Trustee's possession of the Power to Adjust would diminish the actuarial value of the income interest in a trust for which the income beneficiary's estate may be eligible to claim a credit for property previously taxed (*e.g.*, in situations where an income beneficiary dies within ten years after the death of the person creating the trust), then the Trustee can release the Power to Adjust and the income interest should be valued traditionally.

Trust Terms That Limit a Power to Adjust (UPIA Section 104(f))

Almost all traditional income-only trusts have language in them that might seem to prohibit the Trustee from utilizing the Power to Adjust. The UPIA drafters did not intend such language to impair the utilization of the Power to Adjust, so the Act specifically states that for trust instruments executed before the adoption of UPIA, Trustees are not forbidden from using the Power to Adjust even if the trust generally prohibits the invasion of principal or the ability to make equitable adjustments.

Further, trust instruments executed after the adoption of the UPIA must

specifically deny the Trustee the Power to Adjust if the settlor intends to prohibit its use. This means that practitioners should discuss the Power to Adjust with every client for whom a trust is prepared to determine whether they want to give the Trustee the option of using a Power to Adjust.

UPIA Protection for Trustees

To what extent are Trustees protected against lawsuits for using a Power to Adjust? Because the Power to Adjust is quite new, Trustees are still trying to determine their liability exposure. The UPIA, especially the newer Section 105, seems to provide a fairly high level of protection for Trustees' decisions relating to the Power to Adjust.

Section 103 provides that a determination in accordance with the UPIA is presumed to be fair and reasonable to all beneficiaries. The UPIA judicial supervision provision, Section 105, was not in the Act as originally promulgated in 1997, but was approved as a new section in 2000. Section 105 provides that a "court may not order a fiduciary to change a decision to exercise or not to exercise a discretionary power conferred by this [Act] unless it determines that a decision was an abuse of the fiduciary's discretion." This "abuse of discretion" standard is a very difficult standard to meet. Section 105 goes further to state that Trustees' decisions are "not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power." The comment to Section 105 calls for Trustees in breach of trust relating to the Power to Adjust to be surcharged only as a "last resort", when it is not possible to remedy the situation by redistributing trust property, including previously distributed property.

UPIA Procedure

The UPIA drafters made the Power to Adjust simple to utilize. Once a state adopts UPIA Section 104, it applies to **all** trusts – period. Whether the trust was created before or after adoption is irrelevant, and the Trustee need not make any kind of election.

Power to Adjust – Possible Shortcomings

What is the downside to utilizing the Power to Adjust? I think there are still some unanswered questions in the minds of Trustees as to just how far they can stretch this seemingly unlimited Power to Adjust between income and principal. Surely a Trustee could not decide one day to characterize 90% of trust principal as income and give it to the income beneficiary. Could that same Trustee recharacterize 50% or 25% of principal as income, or what about 10%? The boundaries, which will be different for each trust, are still not clear. Until

case law begins to define those boundaries, some Trustees may shy away from exercising this powerful discretionary tool for fear of lawsuits by the remaindermen.

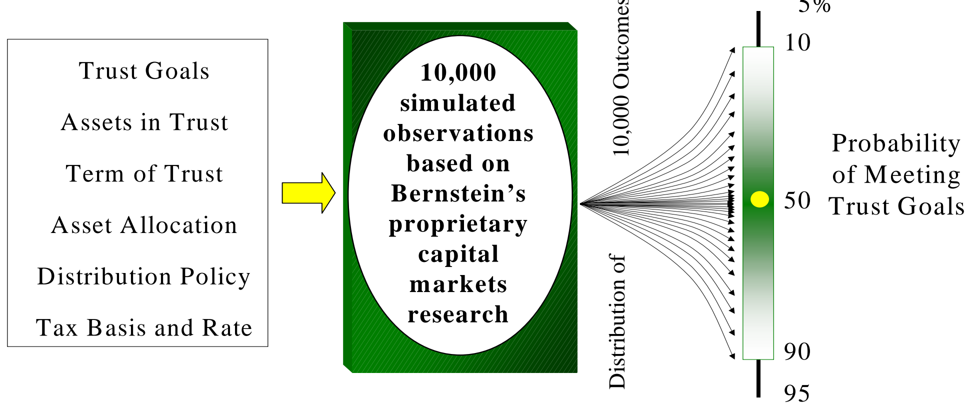
In addition, even after the issuance of the final regulations in January 2004, there are still unanswered questions about the circumstances where the use of a Power to Adjust would be problematic for federal tax purposes. Until the Internal Revenue Service ("Service") issues further guidance defining the boundaries of the Power to Adjust, its use may be more limited than expected. These issues will be discussed in more detail below.

What is the Correct Distribution Policy?

That is the big question, is it not? Trustees that decide to utilize the Power to Adjust must decide what amount, either in dollar terms or as a percentage of trust assets, to distribute annually to the income beneficiaries. Since the widespread adoption of Section 104 of the UPIA, top executives of the biggest trust companies in the country, as well as practitioners with whom I have spoken, all say the same thing: "This is great, but where do I draw the line?"

If you are trying to decide the appropriate distribution as a practitioner at a firm with few Trusts & Estates resources or you are in solo practice, there are not that many off-the-shelf resources available. The best of these practitioners will use Excel models, prepare a few projections and hope for the best. The less-than-the-best generally just pick a number and cross their fingers.

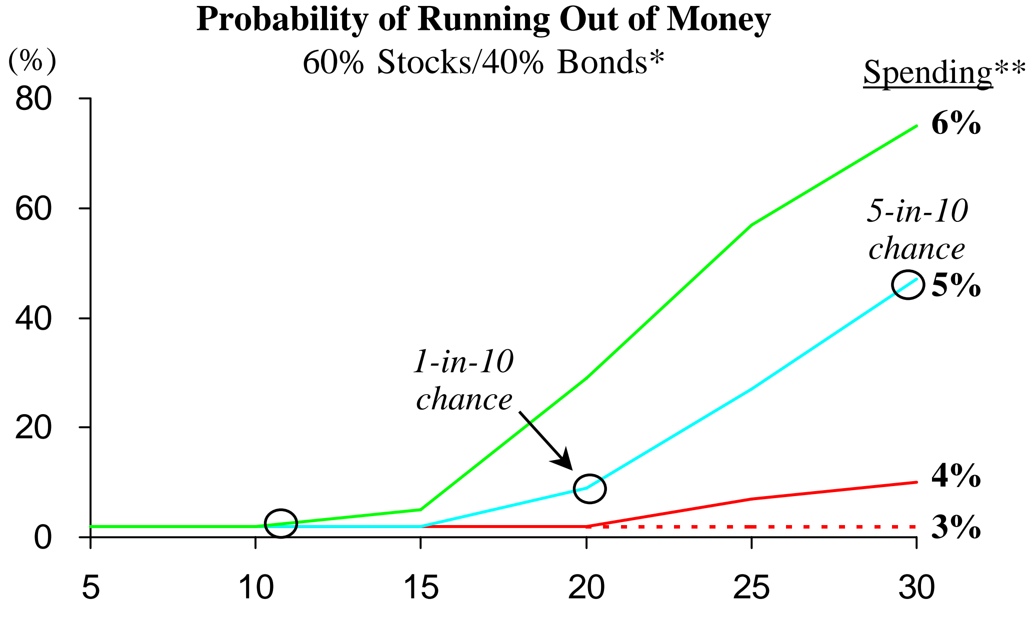
Companies with large trust shops can do better, and most do. Most have developed software models that try to estimate what the correct payout should be for a particular trust. Some models are fairly crude and seem to mostly rely on human judgment, while some are amazingly complex and sophisticated. One of the most sophisticated is the Bernstein Wealth Forecasting modeling software.



From one given set of assumptions, the Bernstein model runs 10,000 possible scenario outcomes, weights them according to probability and spits out a probability distribution of outcomes.

Here is one series of examples that helps explain this process. In each case, the model is looking at the question "what level of distributions are sustainable over the long term".[5] Here, the amount spent is expressed in terms of a percentage of the trust's beginning assets; this should not be confused with unitrust-type distributions.

Spending policies cannot be evaluated in a vacuum; they should be judged in terms of how well they help meet particular goals. There are several ways to think about goals when it comes to distributions from a trust or spending one's own pool of assets. One way is to project the probability of running out of money, as in the graph below. For a trust with income beneficiaries and remaindermen, reducing the trust principal to zero (or anything close) is clearly unacceptable. Remainder beneficiaries will want to see that this chance is *de minimis*, as the 3% distribution rate is, for any possible trust term.



---

[5] Represents globally diversified balanced portfolio: 21% U.S. Growth stocks, 21% U.S. Value stocks, 15% Developed International stocks, 3% Emerging Market stocks and 40% Intermediate Municipal bonds. Spending in the first year is calculated as a percentage of initial assets; after the first year, spending is assumed to grow with inflation. Spending represents after-tax net spending from a taxable portfolio. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 30 years. Data does not represent any past performance and is not a promise of actual future results.

The expected term of the trust is also important, *i.e.*, how quickly are the remaindermen likely to get their money? If you look at the graph above to the 4%, 5% and 6% distribution lines, there is a point after which the chance of running out of money starts to rise to the point of unacceptability. For 6%, after 10 years; for 5%, after 15 years; and for 4%, after 20 years. Of course, the younger the income beneficiaries are, the smaller the distributions must be. Trustees should quantify these concepts for all beneficiaries.

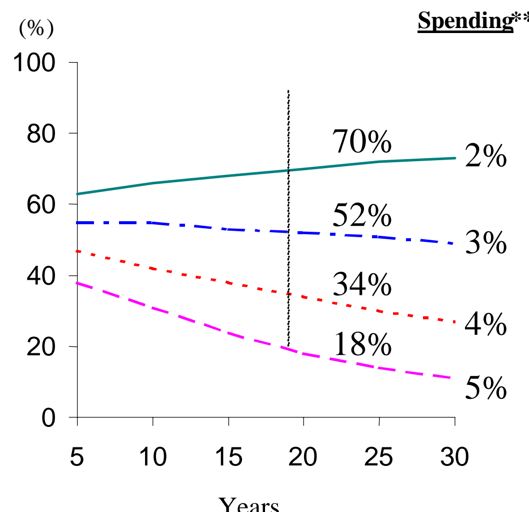
While analyzing the odds of running out of trust assets is interesting, the key choice a Trustee must make is whether the Trustee is going to try to maintain nominal trust asset value or inflation-adjusted asset value. The latter goal clearly results in lower distributions, as the graphs below show.

For example, a 4% distribution rate of a portfolio consisting of 60/40 stocks and bonds has a 61% chance of maintaining nominal trust asset value after 20 years. If the goal is to maintain inflation-adjusted asset levels, however, the same portfolio with a 4% distribution rate only has a 34% chance of meeting its goal – a figure not likely to bring smiles to the remaindermen's faces.

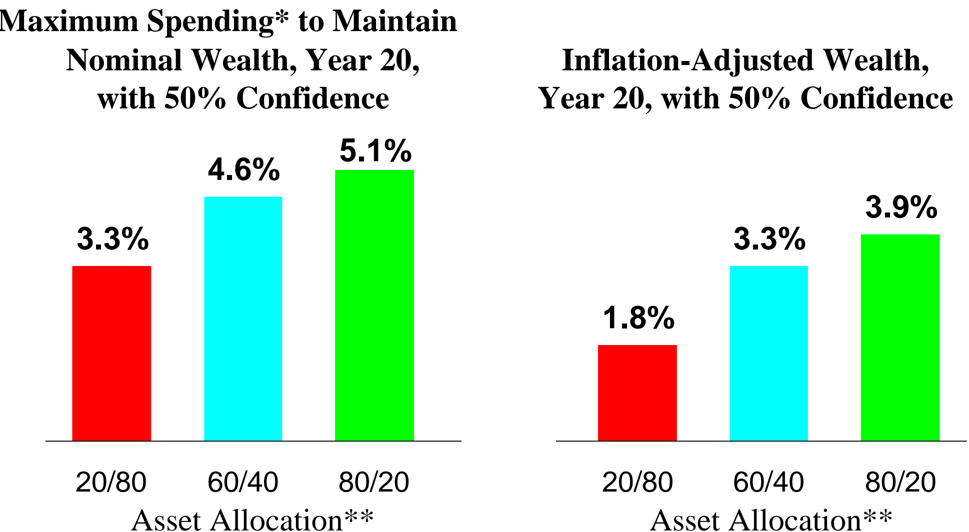
Probability of Maintaining Nominal Wealth
60% Stocks/40% Bonds*

(%)
Spending**
100
80
60
40
20
0
96%
84%
61%
36%
2%
3%
4%
5%
5 10 15 20 25 30
Years

Probability of Maintaining Inflation-Adjusted Wealth
60% Stocks/40% Bonds



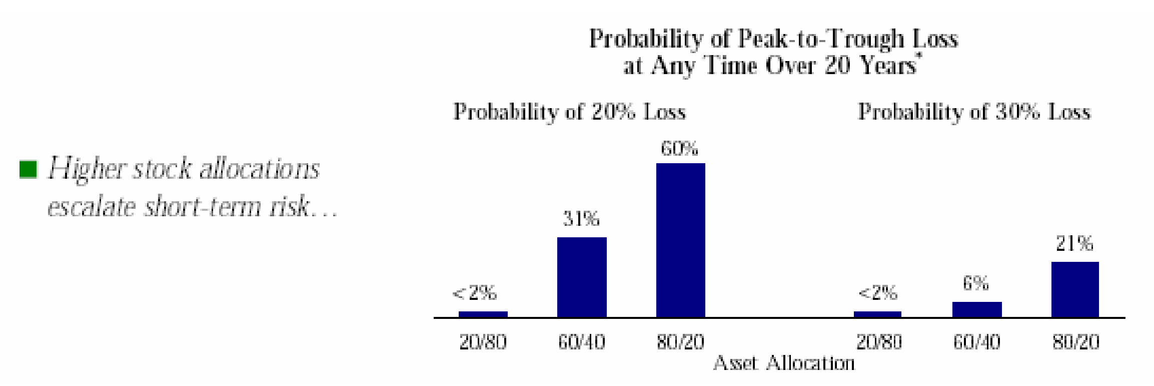
As seen in the bar charts below, asset allocation also plays a role.



A Trustee could distribute 3.9% for 20 years with an 80/20 stock to bond ratio and have a 50% confidence level of maintaining a constant inflation-adjusted asset pool for the remaindermen. If the stock to bond ratio were inverted to 20/80, that same Trustee could only distribute out 1.8%.

In summary, if Trustees uses the Power to Adjust or the Unitrust concept, the income beneficiaries and remaindermen should have the same investment goal – total return – which makes the Trustees' life significantly easier.

The final component of the Trustees' decision is risk: how risk averse are the beneficiaries? Trustees with significant portfolios in the last bear market have war stories about distraught beneficiaries constantly contacting them. Generally, it is the remaindermen that are most concerned about bear markets because they see their financial legacy disappearing as income beneficiaries continue on in their accustomed standard of living.



As most financial advisors preach, stocks should be the preferred investment class if, as they should be, Trustees are investing for the long haul. But reducing the chance of the 20% and 30% peak-to-trough losses can greatly reduce Trustees' stress levels. As the bar charts above indicate, asset allocation determines risk. Should Trustees really be worried about this statistic? In my opinion, asset allocations should be set for the expected duration of the trust, which is normally a long term. History shows that for longer-term trusts, this means portfolio investments of 80%+ stocks.

So, instead of income beneficiaries and remaindermen fighting with Trustees over stock to bond ratios in asset allocations, the new topics for discussion should be threefold: (1) whether the goal is to maintain nominal or inflation-adjusted wealth; (2) what confidence level for maintaining wealth to pick; and (3) what the beneficiaries' level of risk tolerance is to bear markets. These are the new issues. Without cutting edge tools like the Bernstein or similar models, Trustees are really making these decisions in a vacuum.

UNITRUST APPROACH

Like the Power to Adjust, the Unitrust approach allows a Trustee to invest for total return (as required by the prudent investor rule), while at the same time treating all beneficiaries impartially. Unitrusts differ from income trusts in that the annual payouts are based on a specified percentage of the trust's value each year rather than the portfolio's yield. As a result of this important distinction, the interests of the income beneficiaries and the remaindermen are better aligned – meaning *both* parties benefit from capital appreciation, which (like the Power to Adjust) reduces tensions. Of course, it also means the payouts will fluctuate with the value of the trust assets.

There is no model Unitrust statute, so statute terms vary dramatically from state to state. Below are some key points.

- Some states, like Maryland[6] and New York[7], require a specific distribution percentage, *e.g.*, 3 or 4 percent. Some states, such as Delaware[8], give the Trustee discretion to distribute within a range, *e.g.*, 3 to 5 percent.

- When determining a given year's distribution payout, most states have

[6] Md. Code Ann. Est & Trusts § 15-502.1 (2002).

[7] N.Y. Est. Powers & Trusts § 11-2.4 (2002).

[8] Del. Code Ann, tit. 12, § 3527 (2002).

a multi-year smoothing rule that averages the trust asset values in the few years prior to the given year's distribution. The Service's 2004 regulations explicitly blessed the use of these smoothing rules.

- Most states require a court order to get a trust back out of Unitrust mode, an aspect of Unitrust that most Trustees dislike.

- In Unitrusts, Trustees lose their distribution discretion, in contrast to utilizing the Power to Adjust where Trustees actually gain new discretionary power.

- Many Trustees believe the most common 4% statutory payout rate is too high in this investment return environment. Most are using the Power to Adjust to distribute out around 3.25% to 3.5%.

Discretionary, Not Mandatory, Income Distributions

One interesting and little-discussed situation arises where income distribution is *discretionary* and not mandatory, and no principal distributions are allowed. We currently represent the four income beneficiaries of a $100M+ trust where Trustees have total discretion to give them anywhere from nothing up to the full income amount each year. What if the Trustees of this Trust decided to convert to the Unitrust model in a state that set the Unitrust percentage at, for example, 4%?

Likely, the proper interpretation is that such an arrangement would give Trustees discretion to distribute *up to* the 4% Unitrust amount, but not require the Trustee to distribute the full Unitrust amount, even if income beneficiaries so demand. Trustees would seem to have a safe harbor for distributions up to the Unitrust amount. This might encourage higher current distributions because Trustees would know that remaindermen would be unlikely to prevail in a lawsuit if the Trustee is making distributions equal to or less than the Unitrust amount.

Unitrust Model Inappropriate

Conversion to Unitrust works well in a wide variety of common income-only trust situations, but may not work in a few types of trusts. For instance, conversion might be inappropriate for spendthrift trusts where there is some concern about creditors. Conversion to Unitrust might allow creditors to reach the Unitrust payout. Conversion to Unitrust also seems inappropriate for trusts funded primarily with real property or closely held businesses (because costly annual valuations would be required and a mandatory payout might require a partial liquidation of the business) and most generation-skipping trusts (because distributions would be required to go to non-skip persons, which would result in

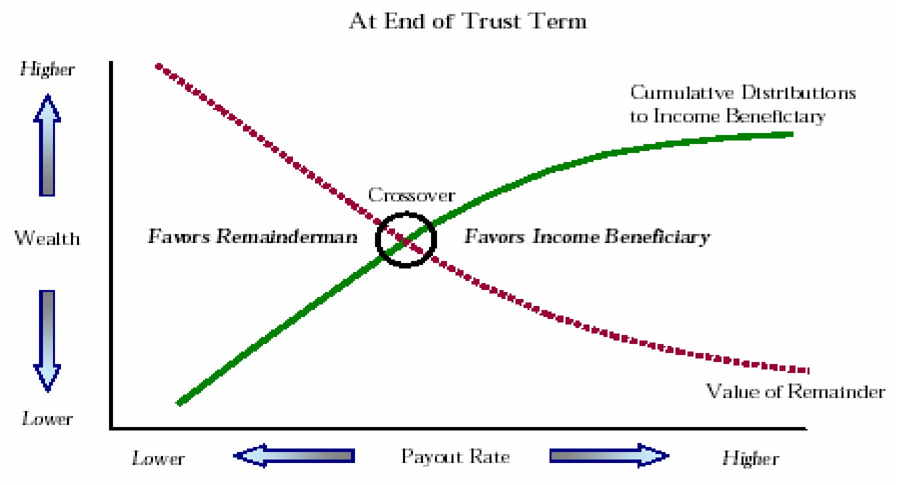
an inefficient use of GST-protected trust assets).

Incorporating Unitrust Language Into Trust Agreements

What effect might the Unitrust option have on document preparation? Regardless of whether clients are in a jurisdiction with statutory Unitrust provisions, attorneys should discuss the Unitrust concept with settlors. If trust governing law **is not** a statutory Unitrust jurisdiction, then settlors can take advantage of the Unitrust concept by incorporating it into the trust agreement. A settlor may set the Unitrust rate in a trust agreement. Regardless of whether a Settlor is in a statutory Unitrust jurisdiction or not, a Settlor is always free to lay out the terms of her own Unitrust structure and/or opt out of any statutory framework, if any.

If governing law **is** a statutory Unitrust jurisdiction, then clients that **do not** wish to leave the Trustee with the option of converting to Unitrust should specifically disallow its use. Similar to the Section 104 Power to Adjust, most Unitrust statutes do not permit existing trust language to prevent conversion to Unitrust. Trust terms, therefore, should specifically indicate that the Settlor intends to deny the Trustee the power to convert to Unitrust. Anything short of such a statement is probably ineffective in preventing the conversion to Unitrust.

The key question (as in the Power to Adjust) is where to set the long-term Unitrust rate. Here again, new modeling techniques, like the Bernstein model below, have been developed to aid in setting the payout rate. The client should consider not only how much he or she wants to go to the income beneficiaries in absolute terms, based on the size of the trust, but also how different Unitrust rates will share the trust's overall wealth among the beneficiaries in different proportions. As the following graph illustrates, it is possible to determine what Unitrust rate will result in equal sharing of wealth among the beneficiaries for a given trust term.



If something other than equal sharing is the goal, this too can be quantified.

FINAL REGULATIONS

In response to the increasing utilization of the Unitrust approach and the Power to Adjust, the Service issued final regulations in early 2004 addressing certain federal tax issues.[9]

Only Reasonable Allocations are Acceptable

The regulations provide that "allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a *reasonable apportionment* between the income and remainder beneficiaries of the total return of the trust for the year." What's "reasonable"? The regulations provide a safe harbor: if state law authorizes an income beneficiary to receive an annual Unitrust amount of *between 3% and 5% (inclusive)*, the allocation is reasonable. For example, Maryland and New York statutes contain 4% Unitrust provisions that fit squarely into this definition, as does the Delaware 3% to 5% discretionary Unitrust range.

The regulations also provide that "a state statute that permits the Trustee to make adjustments between income and principal to fulfill the Trustee's duty of impartiality", *i.e.*, to utilize the Power to Adjust, is "*generally*" a reasonable allocation of the trust's total return. By using the term *generally*, the Service may be creating a bias, or safe harbor, vis-à-vis a statutory Unitrust provision compared to the Section 104 Power to Adjust. The proposed regulations clearly provide that any Unitrust distribution between 3% and 5% is *per se* reasonable.

Allocations Cannot Depart Fundamentally From Tradition

The regulations threaten that "trust provisions that depart fundamentally from traditional principles of income and principal will *generally* not be recognized." Practitioners should be wary of trust language that is radical compared to older allocation concepts until there is further guidance from case law.

---

[9] 69 Fed. Reg. 12 (January 2, 2004).

Utilizing These New Concepts Will Not Affect Most Techniques

The regulations state that Qualified Terminable Interest Property and other marital deduction trusts, Qualified Domestic Trusts (both discussed in more detail below), and generation skipping transfer tax grandfathered trusts may be either converted to Unitrust or allowed to utilize a Power to Adjust without negative federal tax implications.

Further, unlike the proposed regulations, the final regulations make clear that that there will be no gift tax or possible taxable sale or exchange upon a switch from a principal and income regime to a Unitrust regime or vice-versa. The regulations caution, though, that a switch not authorized by state statute even if valid under state law - for example by way of a judicial decision or non-judicial settlement - could constitute a recognition event and/or result in a taxable gift.

Allocation of Capital Gains

The regulations revised then-existing regulations to provide flexibility with respect to the allocation to DNI of any capital gains associated with principal distributions. Capital gains will now be included in DNI to the extent they are, pursuant to the terms of the governing instrument and applicable local law or pursuant to a "reasonable and impartial" exercise of discretion by the fiduciary, allocated to

- income,
- corpus but treated consistently by the Trustee as part of the distribution to the beneficiary on the trust's books, records and tax returns, or
- corpus but
  - actually distributed to the beneficiary or
  - utilized by the fiduciary to determine the amount to be distributed to the beneficiary.

Again, the pesky words "reasonable and impartial" are used, which decreases the certainty associated with this language.

Unlike the proposed regulations, the final regulations do not require that a Power to Adjust allocation be exercised consistently, though the Explanation notes that, once again, such an allocation has to be exercised "reasonably and impartially". [Expect case law to sort out a lot of these instances where the Service uses words like "generally", "reasonable" and "impartial".] The Service does provide 14 examples that delineate a fiduciary's discretion in allocating capital gains to or excluding capital gains from DNI, thereby determining whether the beneficiary or the trust should bear the capital gains burden.

This section will undoubtedly spawn several planning opportunities such as passing the tax burden to a surviving spouse in a reverse QTIP trust situation to maximize the value of this GST-protected interest left for descendants.

Marital Deduction Trusts

The Code requires that a trust must pay out all of its income to a surviving spouse in order to qualify for the marital deduction. The use of the Power to Adjust or Unitrust in a marital trust setting has been one of the real driving forces behind the states pushing the Service to adopt these regulations.

The regulations state that the all-income requirement will be met in a marital trust if the spouse's entitlement to income is determined by a state law that provides for a "reasonable apportionment" between the income and remainder beneficiaries of the total return of the trust. The regulations included the same *per se* acceptable safe harbor for a Unitrust amount between 3% and 5%, inclusive. Note once again the "reasonable" language for use of the Power to Adjust and the bright-line safe harbor for use of the Unitrust concept.

One planning technique can be derived from the acceptance in the regulations of the use of Power to Adjust or Unitrust in QDOTs set up for non-citizen spouses. Practitioners should keep an eye out for opportunities to flow more non-taxable QDOT assets out to a non-citizen spouse by converting the QDOT from a traditional income trust to Unitrust or a regime where the Power to Adjust is utilized. [Remember that "income" is not hit with a transfer tax when distributed to a non-citizen spouse while "principal" is taxed.]

Effective Dates

The regulations generally are effective for taxable years of estates and trusts ending after January 2, 2004. The Explanation makes it clear, in addition, that taxpayers may rely upon the regulations for any taxable years with respect to which there is a state statute applicable to an estate or trust that grants the Trustee a Power to Adjust or provides for a Unitrust regime. For example, trusts

governed by a state Unitrust statute effective on March 1, 2002, may gain the benefit of the regulations for taxable years back to that date.

Some Issues Left Unresolved by the Regulations

The regulations do not address the following potentially problematic, complex issues (that are beyond the scope of this paper):

- charitable deduction limitations;
- private foundations; and
- foreign trusts.[10]

If utilizing a Unitrust approach, advisors should be aware of the complex, collateral effect this will have for valuation purposes in certain instances, including the valuation of:

- partially complete gifts under section 2512;
- interests in trusts under section 7520;
- 5% reversionary interests of grantor trusts under section 673; and
- beneficial interests in trust with respect to the attribution rules under sections 267, 318, and 4946.[11]

UNITRUST V. POWER TO ADJUST – WHICH IS BETTER?

If a jurisdiction has both statutory Unitrust and Power to Adjust provisions, which should a Trustee choose?

Reasons to Utilize Statutory Unitrust Provisions

- If Trustees are concerned about potential liability to remaindermen, Trustees might prefer Unitrust because it provides a safe harbor for distributions up to the percentage allowable, *e.g.*, in Maryland and New York, 4%. Statutory Unitrust provisions that allow distributions only between 3% and 5% (inclusive) are *per se* accepted for federal tax purposes. When describing fiduciaries' duties when utilizing the

---

[10] For further information on these more complex issues, I recommend Laura Howell-Smith's article entitled *How Prop. Regs. On the Definition of Income Affect Total Return Trusts*, in the July 2001 issue of *Estate Planning*.

[11] *Id.*

Power to Adjust, the Service's regulations use the term "reasonable and impartial" in almost every instance. Until case law and PLR-type guidance begins to define the definitional boundaries of "reasonable and impartial", fiduciaries may well be hesitant about wholeheartedly embracing the Power to Adjust.

- Unitrust simplifies trust administration and eliminates some complexity in the Trustees' investment decisions.

- From an income beneficiary's viewpoint, 4% looks pretty good in today's market environment. Forcing conversion would keep a steady, reasonably high, predictable flow of assets coming to income beneficiaries. It would also remove all discretion and personal politics associated with Trustees' discretion to decide distributions. Income beneficiaries will be particularly keen to convert when the remaindermen are not their children, such as when the income beneficiary was the second wife of the grantor.

Reasons to Utilize UPIA Section 104 Power to Adjust Provisions

- Trustees can make distributions below or above the Unitrust amount if they so choose.

- For mandatory income trusts, Trustees have more flexibility to adjust annual distributions to react to market conditions, beneficiary needs, etc. Right now, all of the large trust companies (to my knowledge) believe 4% is too high a distribution rate.

- Trustees cannot easily opt in and out of most statutory Unitrust provisions, but can easily vary their utilization of the Power to Adjust from year to year.

Final Thoughts

The decision on whether to use the Power to Adjust or Unitrust basically comes down to a tradeoff between the simplicity, predictability and safe harbor aspects of the Unitrust conversion balanced against the flexibility of the Power to Adjust. Unitrust is currently disfavored (indeed I have yet to meet a Trustee that wants to convert any trust to a statutory Unitrust model) because Trustees believe the 4% distribution rate is too high, and it removes a lot of Trustees' discretion.

But two factors – the favorable distribution rate and the removal of Trustee discretion – might make Unitrust very attractive to many income beneficiaries. In many states, income beneficiaries have the right, unilaterally, to petition a court to force a change to Unitrust, with a rebuttable presumption in favor of Unitrust that a Trustee must overcome. Right now, not many income beneficiaries are aware of their rights, but as more become aware, Trustees could be forced to convert in increasing numbers. As time goes on, case law will develop defining Trustees' duties to inform beneficiaries of their rights to compel Unitrust conversion. This is a very sensitive topic right now with most Trustees.

CONCLUSION

Whether you are a Trustee or a planner, these new tools create an entirely new regime that all practitioners must get acquainted with now. Failing to think about and discuss these new tools with clients could have negative implications for your practice ranging from a loss of potential revenue from developing a new line of business to a chance of a future malpractice claim. The new tools are complex and take time to explain to clients, but practitioners should exert the effort to learn about the Power to Adjust and Unitrust techniques, explain the options to clients, and quantify for clients the implications of choosing either technique. If implemented properly, utilizing these new tools can make taming the trust animal significantly easier – Trustees, income beneficiaries and remaindermen will all be better for it.

Appendix A: Total Return Legislation (as of 4-15-04)

Code: A=Power to adjust between income and principal
U=Unitrust conversion only
B=Both power to adjust and unitrust conversion
P=Legislation pending

Jurisdiction	Code	UPIA (1994)	UPAIA (1997)	Power to adjust	Unitrust Conversion	Notes
Alabama	A		Yes	Yes		
Alaska	B	Yes	Yes	Yes	Yes 4%; (3-yr smoothing starting in year 4)	Enacted 7/16/03; effective 9/1/03
Arizona	A	Yes	Yes	Yes		
Arkansas	A	Yes	Yes	Yes		
California	A	Yes	Yes	Yes		Unitrust conversion law failed in 1999
Colorado	A	Yes	Yes	Yes		
Connecticut	A	Yes	Yes	Yes		
Delaware	U				Yes 3-5%; Tax ordering	Effective 6-21-01
D.C.	A	Yes	Yes	Yes		UPIA effective 3-26-1999
Florida	B		Yes	Yes	Yes 3-5% or ½ Jan. §7520 (min 3, max 5)	Enacted 2002, effective 1-1-03
Georgia						
Hawaii	A	Yes	Yes	Yes		
Idaho	A	Yes	Yes	Yes		
Illinois	U	Yes *			Yes 4% default; 3-5% if all agree	*Similar; UPIA is based partly on Illinois law; Unitrust effec. 8-22-02
Indiana	A	Yes	Yes	Yes		Enacted 2002, effective 1-1-03
Iowa	U	Yes	Yes		Yes 4% default; 3-5% with court approval	Effective 4-5-02
Kansas	A	Yes	Yes	Yes		
Kentucky						
Louisiana	A			Yes*		*Can adjust to below 5% or to above 5% only with court order
Maine	B	Yes	Yes	Yes	Yes 4%; 3-yr smoothing	Effective 1-1-03
Maryland	U	Similar to UPIA	Yes	No	Yes 4%; 3-yr smoothing	Effective 10-1-02
Massachusetts	P	Yes	Intro 03			HB740/SB962; House Judiciary Comm.

Michigan		Yes	Intro 03			HB5307; House 2nd reading
Minnesota	A	Yes		Yes		
Mississippi						
Missouri	B	Yes	Yes	Yes	Yes 3% min; no max	Effective 8-28-01
Montana	A	Yes	Yes	Yes		Enacted 4/25/03
Nebraska	A	Yes	Yes	Yes		
Nevada	A	Yes	Yes	Yes		Enacted 6/9/03
New Hampshire		Yes			Yes 5%; 3-yr smoothing	Effective 1-1-03
New Jersey	A	Yes	Yes	Yes *		*Adjusting up to 4% or down to 6% presumed reasonable
New Mexico	A	Yes	Yes	Yes		
New York	B	Similar to UPIA	Yes	Yes	Yes 4%, 3-yr smoothing	Effective 1-1-02
North Carolina	B	Yes	Yes	Yes	Yes 3-5%; smoothing up to 3 yrs	Enacted 6/23/03
North Dakota	A	Yes	Yes	Yes		
Ohio	A	Yes	Yes	Yes*		*Safe harbor for adjusting up to 4%
Oklahoma	A	Yes	Yes	Yes		
Oregon	B	Yes	Yes	Yes	Yes 4%, tax ordering, 3-year smoothing	Enacted 6/10/03; effective 1-1-04
Pennsylvania	B	Yes	Yes	Yes	Yes 4%; 3-yr smoothing	Effective 7-15-02
Rhode Island		Yes	Failed 02	Failed 02		
South Carolina	A	Yes	Yes	Yes		
South Dakota	U				Yes 3% min; no max	Effective 2-27-02
Tennessee	A	Yes	Yes	Yes		
Texas	A	Yes	Yes	Yes	New trusts (no conversion) 3-5%; tax order; smooth any # yrs	Enacted 6/20/03; effective 1/1/04
Utah	A	Yes	Yes			Enacted 3/23/04
Vermont		Yes	Failed 02	Failed 02		
Virginia	A	Yes	Yes	Yes		
Virgin Islands			Intro 03/04			25-0059; passed Finance Committee
Washington	B	Yes	Yes	Yes	Yes 4%; 3-yr smoothing	Effective 1-1-03
West Virginia	A	Yes	Yes	Yes		
Wisconsin		Yes	Failed 02	Failed 02		UPIA passed legislature in 2004; to governor for signing
Wyoming	A	Yes	Yes	Yes		