INTRODUCTION

A. THE INCOME RULE TRUST TRADITION

B. MODERN FINANCIAL THEORY AND UNIFORM LAWS LEAD IN NEW DIRECTIONS

C. NEW FORMS OF TRUSTS INCREASE RETURNS AND HARMONIZE THE PRESENT WITH THE FUTURE

II. CURRENT TRUST DRAFTING Follows OLD RULES, CONTINUES OLD CONFLICTS, AND REDUCES RETURNS

A. THE DUTY OF IMPARTIALITY BETWEEN AN INCOME BENEFICIARY AND REMAINDERMAN

B. BENEFICIARY EXPECTATIONS - BIG AND BIGGER

C. INVESTMENT YIELDS - SMALL AND SMALLER

D. INCOME OR GROWTH - BUT NOT BOTH!

E. WHAT IS "INCOME" - CAPTURING ITS REAL MEANING

III. THE INVESTMENT UNDERPINNINGS

A. TOTAL RETURN INVESTING

B. ASSET ALLOCATION, MODERN PORTFOLIO THEORY, AND DIVERSIFICATION - THE KEYS TO LONG-TERM RETURNS AND RISK MANAGEMENT

IV. CHARITABLE ENDOWMENTS, THE UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT (UMIFA), AND "SPENDING RULES" - THE NONPROFITS LEAD THE WAY!

V. RECENT NATIONAL DEVELOPMENTS IN THE LAW OF TRUSTS

A. RESTATEMENT (THIRD) OF TRUSTS PROMULGATES THE PRUDENT INVESTOR RULE AND INCORPORATES THEORIES OF RISK AND RETURN, TOTAL RETURN INVESTING, AND MODERN PORTFOLIO THEORY

B. THE PRUDENT INVESTOR ACT

C. THE NEW PRINCIPAL AND INCOME ACT: ACCOUNTING ALCHEMY--THE POWER TO ADJUST PRINCIPAL AND INCOME

D. TAXPAYER RELIEF ACT OF 1997--MAKING EQUITIES EVEN STRONGER!

VI. STATE LAWS MODIFY THE NATIONAL TRENDS

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A. THE NEW YORK INITIATIVE STARTS THE STATE LAW ENGINE OF CHANGE .................................................. 44
B. DELAWARE FIRST TO ENACT TOTAL RETURN UNITRUST STATUTE .......... 46
C. MISSOURI SHOWS TRU Grit in FOLLOWING DUAL UNITRUST/POWER TO ADJUST APPROACH ................................................................. 48
D. NEW JERSEY'S "SEMI-SAFE HARBOR" APPROACH ................................................. 49
E. PENNSYVANIA ENTERS THE DISCUSSION WITH A UNITRUST/POWER TO ADJUST STATUTORY PROPOSAL .......................................................... 50
F. MAINE, WASHINGTON, FLORIDA, AND MARYLAND ENACT DUAL POWER TO ADJUST AND UNITRUST CONVERSION STATUTES ....................................... 51
G. SOUTH DAKOTA, IOWA, NEW HAMPSHIRE AND ILLINOIS ENACT UNITRUST ONLY STATUTES .............................................................. 55
H. OHIO ADOPTS THE FIRST TRU SAFE HARBOR .................................................... 58
I. INDIANA ADOPTS A UNITRUST STATUTE TO SUPPLEMENT THE POWER TO ADJUST ............................................................... 61
J. NORTH CAROLINA AND OREGON ADOPT THE POWER TO ADJUST AND THE UNITRUST WHILE COLORADO ADDS THE UNITRUST ........................................ 62
K. ALASKA UPDATES ITS PRINCIPAL AND INCOME LAWS WITH BOTH THE POWER TO ADJUST AND THE UNITRUST ...................... 65
L. TEXAS DOES ITS OWN THING--WITH THE POWER TO ADJUST, AND NO POWER TO CONVERT TO A UNITRUST, BUT A SEPARATE ALTERNATIVE UNITRUST DEFINITION TO HELP UNITRUST DRAFTERS ........................................ 67
M. KENTUCKY AND VIRGINIA ARE ADDED TO THE LIST IN 2004 ..................... 67

VII. DESIGNING A NEW GENERATION OF TRUST VEHICLE ............................................. 71
A. GOALS ..................................................................................................................... 71
B. ALTERNATIVES ........................................................................................................ 72

VIII. CHARACTERISTICS OF THE TOTAL RETURN UNITRUST (TRU) ...................... 74
A. THE TRUSTEE-LIFE BENEFICIARY-REMAINDERMEN PARTNERSHIP ............... 74
B. THE NEED FOR A SMOOTHING RULE .................................................................. 74
C. MEETING EXPECTATIONS ....................................................................................... 78
D. DO WE NEED A FORCE MAJEURE POWER TO CHANGE THE SPENDING RULE? ................................................................................................. 79
E. DRAFTING THE TRU .................................................................................................... 79

IX. THE TOTAL RETURN UNITRUST FORM ................................................................. 81

X. TAX ASPECTS OF THE TRU ..................................................................................... 85
A. QUALIFYING FOR THE MARITAL DEDUCTION-TRADITIONAL ANALYSIS 85
B. STOCK PRUNING, CAPITAL GAINS TAX AND JGTRRA - MAKING MORE INTO EVEN MORE .......................................................................................... 87
C. THE ALLOCATION RULE AND CAPITAL GAINS--WILL THE TRADITIONAL RULE ALLOW A SENSIBLE CONDUIT APPROACH? ............................................. 93
D. TREASURY LEADS THE WAY WITH THEIR PROPOSED REGULATIONS! ......... 95
E. TREASURY GIVES ITS "FINAL" ANSWERS AND LEAVES A FEW QUESTIONS ........................................................................................................... 110
F. DESIRABLE LEGISLATIVE RESPONSES TO THE REGULATIONS ................. 135
G. DRAFTING AND PLANNING ADAPTATIONS TO THE NEW REGULATIONS 151

XI. A TOTAL RETURN UNITRUST COMPUTER MODEL - THE NEED FOR ROAD TESTING - UNDERLYING ASSUMPTIONS ........................................... 155
A. THE NEED TO ROAD TEST THE TOTAL RETURN UNITRUST ............................ 155
B. UNDERLYING ASSUMPTIONS OF THE TOTAL RETURN UNITRUST COMPUTER MODEL ............................................................................................................. 155

XII. ROAD TESTING THE TRU .......................................................................................... 158
A. SELECTING A COMPARISON PERIOD .................................................................... 158
B. COMPARING THE INCOME RULE TRUST TO THE TRU ........................................ 159
C. COMPARING THE TRU WITH THE INDEXED PAYOUT TRUST--A LIMITED
BUT IMPORTANT ALTERNATIVE .......................................................... 170
D. IF INDEXING, LOWER PAYOUT RATE AND SHORTER TERM ARE SAFER. 173
E. USE OF FULLY DISCRETIONARY TRUSTS SHOULD BE EXPANDED .......... 174

XIII. HOW MUCH CAN A TRU TRUST AFFORD TO PAY
OUT AND (PERHAPS) KEEP UP WITH INFLATION? ....................................... 174
A. TAXES, EXPENSES, AND INFLATION-ENEMIES OF THE FAMILY TRUST! 174
B. DISTRIBUTIONS MAINTAIN "REAL" LEVELS AND LAG MARKET VALUES
DUE TO THE SMOOTHING RULE ................................................................ 176
C. TAXES AND EXPENSES INCREASE VOLATILITY ........................................ 176
D. EVEN WITH LOW TURNOVER AND AN ALL-EQUITY PORTFOLIO, 5% IS A
SENSIBLE MAXIMUM FOR LONG-TERM PAYOUT ...................................... 176
E. PAYOUT RATES AND ENDING TRUST VALUES - A SMOOTH
PROGRESSION ............................................................................................... 177
F. HOW MUCH POWER IS THERE IN TOTAL RETURN INVESTING -
REVISITING THE REAL INCOME RULE TRUST ........................................... 179

XIV. HOW DOES TURNOVER AFFECT REAL RETURNS - THE CASE FOR LOW
TURNOVER, TAX EFFICIENCY AND INDEX FUNDS IN TRUST INVESTING...... 182
A. SIGNIFICANT TURNOVER, EVEN AT TODAY'S LOW LONG-TERM CAPITAL
GAINS RATES, IS A MAJOR OBSTACLE ......................................................... 182
B. POWERFUL ARGUMENTS FAVOR INDEXING FOR TRUST PORTFOLIOS... 185

XV. HOW MUCH SLEEPING GOOD (FIXED-INCOME INVESTMENT)
CAN WE AFFORD? .......................................................................................... 190
A. FIXED INCOME AFTER TAXES AND INFLATION-A VANISHING RETURN.. 190
B. HOW MUCH DIVERSIFICATION INTO FIXED INCOME CAN WE AFFORD? 191
C. A CAUTIONARY NOTE ................................................................................ 194

XVI. ESTATE PLANNING WITH TOTAL RETURN TRUSTS ................................. 197
A. TAKE TRU AIM - THE TRU ALLOWS THE ECONOMIC BENEFITS TO BE
DIVIDED IN ACCORDANCE WITH GRANTOR'S TRUST ................................. 197
B. TRU DESIGN BOOSTS TAX PLANNING LEVERAGE TO A WHOLE NEW
LEVEL - PAINLESSLY! ....................................................................................... 199
C. WHAT IS THE RIGHT RATE? ......................................................................... 204
D. ASSET ALLOCATION CRITICALLY AFFECTS SUSTAINABILITY OF THE
TRU RATE - TWICE THE EQUITIES MAY ALLOW TWICE THE PAYOUT! .. 209
E. CHANCES OF PRESERVING THE REAL VALUE OF A TRUST AS A FUNCTION
OF SPENDING AND ASSET ALLOCATION .................................................... 211
F. TOTAL RETURN TRUSTS FILL THE PLANNER'S TOOL CHEST WITH THE
RIGHT TOOLS FOR THE RIGHT JOB .............................................................. 216
G. HOW TO HANDLE THREE TRUST GST PLANS .......................................... 228
H. WHAT TO DO WITH EXISTING TRUSTS .................................................... 238

XVII. VARIATIONS ON A THEME - UNITRUST VARIATIONS -
JERRY HORN'S "GIVE-ME-FIVE" UNITRUST ................................................. 242

XVIII. THE GARLAND AND HERTOG - LEVINE STUDIES - TRU BUSTERS .... 243
A. GARLAND REJECTS INCOME RULE TRUSTS .......................................... 244
B. GARLAND RULE SUGGESTS 100% OF THE STANDARD & POOR'S 500
DIVIDEND YIELD AS THE BEST STANDARD FOR SPENDING FROM A
TRUST ........................................................................................................... 244
C. THE GARLAND RULE IS CONSERVATIVE, BUT UNHELPFUL IN
PRESENT MARKETS ....................................................................................... 244
D. HERTOG AND LEVINE CONCLUDE 5% SPENDING IS TOO HIGH .............. 245
E. HERTOG, LEVINE, AND GARLAND DO NOT TELL US WHAT TO DO IN A
CLIMATE OF VANISHING DIVIDENDS ....................................................... 246
F. RECENT UPDATES TO GARLAND AND LEVINE VIEWS THE TRU
BUSTERS! ....................................................................................................... 246
G. TOTAL CHAOS, MISAPPLYING TOTAL RETURN TRUSTS ....................... 258
H. SIMULATION ANALYSIS BY COLLINS, SAVAGE, AND STAMPFLI..............259

XIX. SO YOU FINALLY HAVE A TOTAL RETURN STATUTE -
    NOW WHAT? EXPLORING THE NEXT STEPS..................................................265
A. WHO NEEDS A TOTAL RETURN TRUST WHEN THERE IS NO TOTAL
    RETURN? WHAT GOOD IS IT IN A BEAR MARKET?.........................................265
B. WHERE WE GO FROM HERE-A DETAILED ANALYSIS IN THE CONTEXT OF
    THE PENNSYLVANIA TOTAL RETURN STATUTE...........................................270

XX. FREQUENTLY ASKED QUESTIONS AND ANSWERS ........................................284
A. ISN'T A FULLY DISCRETIONARY TRUST PREFERABLE TO A TRU
    BECAUSE OF ITS FLEXIBILITY?......................................................................284
B. DOESN'T A FIVE-AND-FIVE POWER ACCOMPLISH THE SAME THING? ....284
C. ARE TRUs A GOOD CHOICE FOR TRUSTS CONTAINING CLOSELY-HELD
    BUSINESS INTERESTS, LLCs OR FLPs? ......................................................285

XXI. MODERN TRUST DESIGN - ONLY THE BEGINNING ....................................285

XXII. APPENDICES ..................................................................................................286
APPENDIX 8 - PENNSYLVANIA STATUTE—THE POWER TO ADJUST AND THE
    POWER TO CONVERT TO A UNITRUST..............................................................286
APPENDIX 9 - QUESTIONS AND ANSWERS CONCERNING THE UNITRUST
    CONVERSION STATUTE....................................................................................297
APPENDIX 10 - DELAWARE UNITRUST STATUTE.................................................300
APPENDIX 11 - SUPPLEMENTAL FORMS ...............................................................307
APPENDIX 12 - STATE BY STATE TABLE - TOTAL RETURN LEGISLATION ....336

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I. INTRODUCTION

A. THE INCOME RULE TRUST TRADITION

During the twentieth century, tremendous changes occurred in the practice of law in the estates and trusts field. The majority of these changes were driven by changes in the tax laws and despite the explosion of "acronym trusts", 1 most trusts remained remarkably unchanged in one important respect. These trusts require the trustee to hold the principal of the trust and to pay the income to the beneficiaries. Clearly, there are plenty of discretionary trusts written for minors and “sprinkle” or “spray” trusts, where the trustee may be given broad discretion to distribute a portion of the income, all of the income, or all of the income and some of the principal. However, it is probably still the case that the majority of trusts written for clients' surviving spouses and children follow a familiar pattern. The documents require the trustee to hold the principal and pay the income, with invasions of principal generally limited to those circumstances that satisfy what Congress has called "ascertainable standards" under §2041(b)(1)(A) of the Internal Revenue Code (Code or I.R.C.), such as use for the beneficiary's "health, education, support, or maintenance." 2 These traditional trusts that tell the trustees to hold the principal and pay the income are subject to a distribution rule based on income and will be referred to in this work as “income rule trusts.”

This practice generally reflected the clients' wishes, since most of them understood (or think they understood) a fundamental difference between the income from property and the property itself. The remonstrance of our forbearers to never spend the principal was good, conservative advice, especially for those who lived during the Great Depression.

But the income rule trust and the concept of “income” itself did not make it through the twentieth century into the twenty-first century unscathed. In the last years of the twentieth century, and the first years of the twenty-first, the concept of income and the design of trusts has undergone remarkable transformation. This is the story of that transformation; the history, the context, the changes, and some speculation on the future.

B. MODERN FINANCIAL THEORY AND UNIFORM LAWS LEAD IN NEW DIRECTIONS

With the emergence of modern financial theory, total return investing, and the importance of inflation as a significant risk factor, it has become critical that we change the way we view

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1 These trusts include: QTIP Trusts, which are Qualified Terminable Interest Property Trusts, allowed under I.R.C. §2056(b)(7); QDOTs, Qualified Domestic Trusts, allowed by I.R.C. § 2056A for the benefit of a non-citizen spouse; QSSTs, Qualified Subchapter S Trusts, allowed by I.R.C. §1361(d)(1), which are special trusts that are permitted to own subchapter S corporation stock without disqualifying the corporation from subchapter S status; QPRTs, Qualified Personal Residence Trusts, allowed by Treas. Reg. §25.2702-5(c); CRATs, Charitable Remainder Annuity Trusts, allowed by I.R.C. §664(d)(1); CRUTs, Charitable Remainder Unitrusts, allowed by I.R.C. §664(d)(2); CLATs, Charitable Lead Annuity Trusts, allowed under Treas. Reg. §20.2055-2(e)(2); CLUTs, Charitable Lead Unitrusts, allowed under Treas. Reg. §25.2522(c)-3(c)(2)(vii); and ILITs, Irrevocable Life Insurance Trusts, designed to avoid the three-year requirement of I.R.C. §2035 and the "incidents of ownership" rule contained in I.R.C. §2042(2).


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income and principal. For many practitioners, however, the language used in trust drafting remains rooted in the past. Important changes in the law of trusts and in the way estate planners view principal and income were foreshadowed by changes in the way charitable foundations managed their endowment funds as a result of the enactment of the Uniform Management of Institutional Funds Act (UMIFA). This uniform act and the creation of various spending rules that foundations and universities developed for their funds provided food for thought for private trust drafting. This conflict is brought into sharp focus by the trustee's duty of impartiality under the Restatement (Third) of Trusts and the Uniform Prudent Investor Act. Unless the trust instrument indicates to the contrary, the trustee must try to balance impartially the interests of the income beneficiary and the remaindermen. The long term declines in interest rates and the unprecedented drop in dividend yields make it impossible for the trustee to satisfy both the income beneficiary and the remaindermen. With a ten-year U.S. Treasury bond selling at about 4.43%, and the Standard & Poor's (S&P) 500 dividend yield at 1.67% as of July 23, 2004, a trustee cannot structure a portfolio reasonably designed to produce both adequate growth and income. True impartiality will only allow a trustee to disappoint the income and remainder beneficiaries equally.

Asset allocation into stocks, which as we will see is the primary determinant of trust investment return, exacerbates the problem by decreasing accounting income in direct proportion to the percentage of stocks in the portfolio. The typical income rule trust produces conflicts between the interests of the income beneficiary and the remaindermen.

The new Uniform Principal and Income Act is giving trustees in many states the power to adjust returns between income and principal. This will make an important difference for many trusts by expanding the availability of total return investing, which is critical to investment success in both bull and bear markets.

The trust and estate law community should not wait with its feet firmly planted in the sand while the tide of these new developments comes in. Estate planners should be using the best of these concepts today, regardless of whether total return legislation has been adopted in their home state, while giving particular attention to the changes wrought by total return legislation in 43 states plus the District of Columbia, as discussed in detail in Chapter VI. The primary purpose of these materials is to familiarize the reader with these important investment and legal developments and to suggest alternative forms of trust that will give the practitioner

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3 **Uniform Management of Institutional Funds Act, 7A Part II U.L.A. 475 (1999).**
7 Id.
9 Id.
new tools to effect these changes now. The portions of these materials that are grounded in investment theory and history demonstrate the interrelationships between trust drafting and trust investing. In practice, as trusts are currently drafted, the beneficiary's income needs often dictate the asset allocation. Asset allocation, in turn, dictates the long-term returns enjoyed by the trust and its beneficiaries. And as trusts are currently drafted, income needs and prudent asset allocation often point in opposite directions.

C. NEW FORMS OF TRUSTS INCREASE RETURNS AND HARMONIZE THE PRESENT WITH THE FUTURE

Recent studies of trust design in scholarly and professional journals have critically examined the distinctions between principal and income and the impact of total return investing upon optimal trust design.11 Interest in the resulting "total return trust" and specifically the total

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return unitrust (or "TRU") has gone beyond these professional publications into the mainstream financial press.\(^{12}\)

In these materials, we will examine the goals of designing a new generation of trust vehicles and the alternatives to the typical trust, including the fully discretionary trust, the inflation indexed payout trust (indexed payout trust), and the total return unitrust (or "TRU") which may prove itself to be the most commonly helpful vehicle.

We will examine how these forms of trust impact our ability to distribute funds for the current beneficiary and the way in which our methodology affects the relationships between the life beneficiary, trustee and remaindermen. As we will see, the TRU provides a partnership among the life beneficiary, the trustee and the remaindermen that enables impartiality to co-exist with maximization of total return. We will test the TRU and prove its viability even in very difficult markets and discuss the way in which it actually increases returns by allowing a more favorable asset allocation and dollar averaging in bull and bear markets. By contrast, the income rule trust and indexed payout trust will be shown to pay out relatively less in market peaks and, and often, more when the markets are in retreat, thereby decreasing return and increasing risk to the trust portfolio, and, implicitly, to all parties affected by the trust.

II. CURRENT TRUST DRAFTING Follows Old Rules, Continues Old Conflicts, and Reduces Returns

A. THE DUTY OF IMPARTIALITY BETWEEN AN INCOME BENEFICIARY AND REMAINDERMEN

One of the most difficult duties imposed upon a trustee is the duty of impartiality between income and remainder beneficiaries:

The trustee should . . . take into account his obligation to act impartially between income and remainder beneficiaries, and not to make an investment which will favor one at the expense of the other. Thus it might be held to be a breach of duty to place the whole trust fund in low yield government securities in order to secure for the remaindermen the maximum of safety, since the income beneficiaries would obtain a yield much less than could be obtained from other legal investments which would have adequate security. And the making of an investment which had a slightly speculative character in order to acquire for the income beneficiary a higher than normal yield might well be subject to criticism by the remaindermen.13

This statement of the duty of impartiality reflects a view of yield that encompasses only current return and not principal appreciation. This view is expressed in the Restatement (Second) of Trusts, but not the prudent investor rule of the Restatement (Third) of Trusts.14 The balancing of trust interests required by the duty of impartiality is emphasized in the new Restatement and the resulting conflict acknowledged:

The interests of a life income beneficiary, for example, are almost inherently in competition with those of the remainder beneficiaries, especially in light of the risks of inflation; and the different tax circumstances of the various beneficiaries frequently create competing investment preferences. These conflicting fiduciary obligations result in a necessarily flexible and somewhat indefinite duty of impartiality. The duty requires the trustee to balance the competing interests of differently situated beneficiaries in a fair and reasonable manner.15

In concrete terms, the trustee is required to decide between higher yielding fixed-income investments in which neither the income nor the principal is likely to grow over the life of the instrument, or equity securities, such as stocks or equity mutual funds, with lower current yields, but greater long-term returns in income and principal.

Long established practice dictates that the first question to be asked by the trustee with reference to the investment of the funds is "what is the life beneficiary's income need?" More often than not, for both financial and personal reasons, the income beneficiary will want a rather significant amount of current income relative to the size of the principal in the trust. Because

15 RESTATEMENT (THIRD) OF TRUSTS, supra note 5, § 227 cmt. c at 13.
most life income trusts arise at the death of a loved one, the sense of financial loss that the income beneficiary feels is enhanced by their personal loss, as well as the loss of any earned income, pension, or social security rights previously provided by the decedent. As a result of the combination of these factors, both the expectation and the need of the income beneficiaries tend toward the higher end of the yield spectrum. With a long term Treasury bond yielding 5.17% and the Standard & Poor's 500 yielding 1.67%, a current income need of 5% after trustees' fees allocated to income cannot be met, since an all bond portfolio will only yield 4.8% after allocating a minimum of .35% of trustee’s fees against income. Yet, most corporate fiduciaries are reluctant to invest less than one-half of their long-term trust portfolios in equity securities, simply because of the duty of impartiality and the historical truth that fixed-income investments yield dramatically less in total return over long periods of time. With an even mix of stocks and bonds, one is currently able to generate only a net 3.07% return. This amount is often not enough to satisfy the income beneficiary nor is it likely to provide inflation protection for the income beneficiary or the remaindermen.

B. BENEFICIARY EXPECTATIONS - BIG AND BIGGER

Unfortunately, income beneficiaries measure the performance of a trust based upon comparisons of current yield only. Typically, they compare their return with certificates of deposit or other fixed-income investments. Remaindermen, on the other hand, will tend to compare the performance of the trust with a growth oriented portfolio. As a result, both income beneficiaries and remaindermen are often disappointed with the trust. They may conclude that trust funds do not do well, almost as though a trust is, itself, a separate form of investment. Current and remainder beneficiaries have expectations that are divergent and contradictory from the point of view of the trustee. Therefore, their expectations are often not met. This subjective standard, rather than any absolute performance standard, measures the success of the trust in the eyes of the income beneficiary and the remaindermen.

C. INVESTMENT YIELDS - SMALL AND SMALLER

Unfortunately for the trust investor today, dividend yields are very near their all-time low:

\[ \text{If } x = \text{ the fixed income portfolio, } \\
\text{y = the stock portfolio } \\
x + y = 100\% \\
(.0517 x +.0167 y = .0535 \text{ times } 100\% \text{ (minimum of } 35 \text{ basis needed for trustees' fees) } \\
\text{Replace y with } 100\% - x \\
.0517 x + .0167 (100\% - x) = .0535 \\
.0517 x + .0167 -.0167 x = .0535 \\
.035 x = .0368 \\
x = .0368 = 105.14\% \text{ fixed income allocation, which isn’t possible. } \\
.035 \\
\]

\[ (5.17\% + 1.67\%)/2 = 3.42\% \text{ less } .35\% \text{ trustees' income compensation. } \]

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And interest rates have continued their secular decline. Propelled by consistent Federal Reserve policy favoring lower rates, interest rates in 2003 touched their lowest point in forty years:
We are at a difficult point in the history of investment returns which points out very clearly the inadequacies of our methods of determining the normal distribution from a trust.

D. **INCOME OR GROWTH - BUT NOT BOTH!**

In today's market environment, and with the traditional income and principal distinction, the trustee can invest for income or for growth but not for both. A hypothetical $1 million trust invested entirely in the S&P 500 index would have a gross yield of $16,700. If only .35% of the trustees' fees is charged to income, the trustee will have no more than $13,200 to distribute to the income beneficiary. After taxes, even at the current highly favorable long term capital gains tax rate discussed later\(^\text{18}\), our new millionaire beneficiary will have only a bit over $900 a month to spend from our all-equity trust.

And this is probably a best-case scenario in an all-equity trust. Many trustees allocate 50% or more of the trustees' fees to income. And trustees using equity mutual funds will see all of the expenses in the mutual funds allocated to income, reducing gross income in many instances to zero for lower yielding equity mutual funds!

If the trustee were to invest entirely in fixed income, in U.S. Treasuries, the net income might be close to $50,000. But such a portfolio will produce absolutely no growth and a gradual erosion of the purchasing power of the trust principal and income due to inflation. A compromise between the two will be just that - a compromise of both income and growth goals.

It is equally unfortunate that among the different categories of equity investments, this problem virtually excludes trust funds from a sensible participation in high technology stocks and small company growth stocks because those have the very smallest or nonexistent income yields. Trustees who are required to earn "income" were not able to invest in companies such as Cisco Systems, Oracle or Intel whose dividend rates are either nonexistent or inconsequential but whose returns over the last decade powered the markets of the 90’s.\(^\text{19}\) While an absence of these stocks from a portfolio would have been just fine for the years 2000-2002, it is likely that any portfolio that is virtually precluded from investing in the technology sector at any time will be severely disadvantaged in the long term.

Little wonder, then, that trusts and bank trust departments may have an undeserved reputation for producing less satisfactory returns than private investment managers, since private investment managers are measured against gross total return without having to divide the return between the current income beneficiary and the remaindersmen and without being bound to the rule of income. It is the trust document in many cases and not the investment manager that dictates our investment returns.

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\(^\text{18}\) The 15% top rate for qualifying dividends provided by The Jobs and Growth Tax Relief Reconciliation Act of 2003, I.R.C. Section 1(h) is discussed in more detail later.

\(^\text{19}\) Intel now boasts a current yield of .7%, while Cisco Systems and Oracle still have no dividends at all. Albeit with tremendous volatility, they have all greatly outperformed the S & P 500 over the past 10 years. (Cisco by about 1000%). Microsoft used to be in that category, but with its recent $3 per share special dividend and a current 1.1% yield, it doesn’t qualify any more, and probably for the traditional reason that it has more profit (and cash) than growth!
E. WHAT IS "INCOME" - CAPTURING ITS REAL MEANING

This dilemma rather leads one to inquire into the nature of "income" and think about why there is such a concept. In today's world, the distinction between income and principal is highly artificial.20 The root idea behind the income concept is to separate that portion of return as between the fruits of an investment and the investment itself. Historically, it no doubt reaches back into our agrarian past in which one would always have the means of sustaining life if one kept and protected the land. The phrase "never spend the principal" is the financial market's equivalent of "never sell the land."

And this caused no particular problems in the world of financial investments until the late 1950s. Prior to that time, dividend yields on stocks were always greater than the yields on bonds. Few investors today remember that in 1950 the yield on the Standard & Poor's 500 was almost 9% while Intermediate-Term Government Bonds yielded only 1.4%.21 Up to that time, there was merely the dilemma of deciding whether to incur greater risk in exchange for the potential of greater return. The markets and our trust instruments did not put the income and remainder beneficiaries at odds when we used the income rule trust. But for the last 40 years they have, and we in the trust and investing world must wake up and change our ways. The real purpose of these materials is to examine in some depth how we can get back to the original meaning of the term "income" but update it for today's financial markets. What methodology can we use for determining how much can be distributed from a long-term trust and still leave the trustee, the income beneficiary and the remaindermen with a reasonable prospect of preserving the real value of the trust for the benefit of all?

III. THE INVESTMENT UNDERPINNINGS

To understand the problems facing trustees and drafters, and the advantages and disadvantages of potential solutions, one must understand the fundamentals of modern investment theory including:

1. Total return investing; and
2. Asset allocation, modern portfolio theory, and diversification - the keys to long-term returns and risk management.

By examining these concepts, one is better able to see how modern investment approaches have developed and how they fit into a trust and estate practice.

20 The apparent assumption is that the accounting income is the real or excess return (after taxes and inflation), so that if it is consumed, the underlying investment will retain its value. Actually, the accounting income may have either no relationship or an inverse relationship to total return. See HOISINGTON, supra note 11, at 5-6; See also HORN, supra note 11.
A. TOTAL RETURN INVESTING

Simply stated, total return investing is the investing of funds for maximum return, regardless of whether that return is in the form of accounting income or appreciation of principal. The need to preserve both the value of capital and an income stream over long periods has always been a central concern in trust investing. Inflation, however, as a persistent long-term economic and investment factor, has become a critical factor only since the late 1960’s, a long time period now to be sure, but not a long time in the context of the development of the law of trusts, where for example Restatements of the Law may occur only once in every 30 or 40 years.

We can see the great change in the importance of this inflation factor in the graph which follows which shows just how steep the climb has become to scale the inflation mountain.

![Scaling the Inflation Mountain!](image)

If we are going to climb this mountain, our trusts better get into shape! From 1926 to 1940, the economy experienced significant net deflation that started even before the economic downturn in 1929. In contrast, the period from 1941 to 1951 showed significant inflation caused by the Second World War and the Korean conflict, but the postwar era of the 1950s and the first half of the 1960s maintained excellent growth with very little inflation. It was in the latter half
of the 1960s and thereafter, particularly the periods from 1973 to 1975 and 1978 to 1981, that forced investment planners to take inflation seriously. It was during this period of secular inflation that the concept of total return investing was born and flourished. The change in steepness of this mountain is dramatic. In the 43 years from 1926 to 1968, prices doubled, and in the 34 years since then, they have increased more than five times!

Because of inflation, it is no longer sufficient to preserve the same nominal value in a trust. Rather, it is vital that investors strive to maintain the real (i.e., after inflation) value of the principal and of the stream of income it produces. Studies of long-term returns, both in principal value growth and in current income, show that only equity investments that represent an ownership interest in assets and income producing property kept pace with inflation. For this reason, despite their far greater volatility, investments in equity securities and real estate are favored for their growth in principal value and the income streams they produced. A dollar of principal was noted to be just as valuable as a dollar of income, and the recognition that "a dollar is a dollar no matter how it is earned" gave birth to total return investing.

B. ASSET ALLOCATION, MODERN PORTFOLIO THEORY, AND DIVERSIFICATION - THE KEYS TO LONG-TERM RETURNS AND RISK MANAGEMENT

1. Recent History of the Capital Markets

The money management industry has witnessed spectacular growth over the past three decades. Part of this growth can be attributed to legislation such as the Employee Retirement Income Security Act of 1974 (ERISA). Managers and plan sponsors became more sophisticated with respect to managing the assets of retirement plans, their funding policies, and diversification of plan assets. The resulting diversification gave birth to a number of specialty investment firms, and managers and sponsors rushed to improve performance and provide unique investment services.

In the 1980s, 401(k) plans, as the fastest growing segment of retirement plans, led the change from defined benefit and defined contribution trusts to salary reduction plans. Unique to 401(k) plans was the transfer of investment policy responsibility to the individual, which required that numerous investment choices be available. The record-keeping infrastructure of the mutual fund industry and the array of investment alternatives quickly made mutual funds the product of choice of this market.

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22 Id. Compare Table A-20 and A-21 at 262-265 (inflation adjusted returns of Large Company Stocks and Small Company Stocks) with Table A-23 and A-24 at 268-271 (inflation adjusted returns of Long Term Government Bonds and Intermediate Term Government Bonds). The average return after inflation from intermediate term government bonds is slightly under 2.4%, even not taking into account expenses and taxes. After those are taken into account, there is no net return. See text at Section B. 4.

23 An analysis of "stock pruning" demonstrates that a dollar of principal is considerably more valuable than a dollar of income, after taxes. See infra text accompanying notes 246-250.


25 At the same time, retirement plan assets were the fastest growing segment of individuals' net worth, rising from 11.6% of total individual net worth in 1970 to 30.5% by 1989. See THE WORLD ALMANAC AND BOOK OF FACTS 1991, 121 (Mark S. Hoffman ed., 1990) (providing Federal Reserve System data).
The demographic trends in the United States have kept rapid growth in the industry alive as the maturing Baby Boomers pass from the high consumption phase of their life cycles to the high savings and investment phase, which usually arrives after the age of forty-five. Their newfound appetite for investing met with a dramatic proliferation of mutual fund products and financial-planning organizations, which are keen on selling investment services.

Overlaying the industry trends has been almost thirty years of monetary policy that has focused on the ravages of high inflation and created an environment in which financial assets, up until the three year bear market of 2000-2002, have been spectacular winners relative to hard assets such as gold and real estate.

The demand for money management has resulted in more than 22,000 registered investment advisors in the United States as of 1996 and more than 8,000 mutual funds,\(^{26}\) eclipsing even the number of companies listed on the major stock exchanges.

2. Modern Portfolio Theory and Diversification

Central to any analysis of modern investment theory is the concept that a particular investment is valued as a function of its risk and return. An investment's risk is defined as the variability of its total return, including income and principal appreciation or depreciation. The frequency and amplitude of return variation is known as volatility. Generally speaking, the higher the volatility or risk, the higher the return the market will demand, since volatility is a negative to the investor and must be counterbalanced by a higher reward.\(^{27}\)

Volatility can be managed to create lower risk without necessarily lowering the expected return. This is accomplished through diversification, a process that can be employed on many levels.

Consider an investment in one company. Implicit in that investment is a market price that theoretically balances the probable return against the individual company's stock volatility or risk. The volatility of that individual stock reflects a number of levels of risk factors, starting with those risks that would only affect that particular company, or company specific risk.\(^{28}\) For example, to consider risks inherent in the stock of Intel Corporation, one might examine the current leadership, the chain of new product development, or the impact of alleged defects in its newest Pentium processors. A second level of risk might apply primarily to those within the semiconductor industry, a third to the entire technology sector, and a fourth to the U.S. stock market as a whole. If, instead of having one stockholding in Intel, an investor owned nineteen other stocks of various different industries, many of the risks specific to Intel would not apply to the balance of the portfolio.


\(^{27}\) Jonathan R. Macey, AN INTRODUCTION TO MODERN FINANCIAL THEORY 17-18 (2d ed. 1998).

\(^{28}\) Id. at 22-24.
Indeed, if a portfolio included ten stocks in different unrelated industries, all with the same projected risk and return, one might retain the same projected level of return, but decrease the risk because of the effect of diversification. Many of the risks associated with Intel might not be encountered for many or all of the other nine stocks in the portfolio.\textsuperscript{29} Looking at a particular investment as it relates to an entire portfolio and as it may increase return or decrease risk to the portfolio is a function of what is called modern portfolio theory, developed in part as a result of significant mathematical analysis and academic research.

Fiduciary law, on the other hand, has historically focused on each investment, judged by itself, rather than within the context of a portfolio. Was the investment of sufficient quality for use in a fiduciary portfolio? Has specific research been completed on the fundamentals of the company? Could the investment stand the test of prudence? These are all good questions, but investment professionals today do not just examine each investment by itself, they judge each investment in the context of how it affects the risk and return of the portfolio as a whole.

Because investments that individually may be risky can, in combination, actually lower the overall risk of a portfolio, one can increase return or decrease risk without having to pay for it in overall portfolio performance. This is so because many investments show a negative covariance, \textit{i.e.}, when one goes down the other goes up, or at least does not go down. Combining assets that perform differently over time, such as bonds and stocks or diversified individual stocks within a portfolio, actually eliminates much of the company specific risk associated with security selection. However, risk that applies to an entire market, or market risk, remains.\textsuperscript{30}

3. \textit{Asset Allocation as the Key to Long-Term Returns}

In a seminal work on the subject of asset allocation, authors Gary Brinson, Brian Singer, and Gilbert Beebower studied a sample of ninety-one large pension plans.\textsuperscript{31} They concluded that the overwhelming contribution to return performance related to the allocation of assets to particular asset classes and specifically related to the portion of the portfolio allocated to common stocks. In an updated study in 1991, the same authors concluded that 91.5\% of the variation in quarterly return was explained by the investment policy reflecting overall asset allocation of the portfolio with only a relatively few percent attributable to stock selection or active portfolio management.\textsuperscript{32} Therefore, to build a sensible long-term trust investment program, the first and most important question to address is overall asset allocation. If the goal is to keep a fiduciary portfolio in liquid investments, then the primary choices are short-term cash equivalents, bonds, or common stocks. Once that decision is made, the focus can turn to the selection of managers and the products used to implement the long-term strategy.

\textsuperscript{29} A portfolio of ten stocks provides 88.5\% of the possible advantage of diversification. A portfolio of twenty stocks provides 94.2\% of that advantage. \textit{Id.} at 24-25 (citing Richard A. Breely, \textit{An Introduction to Risk and Return from Common Stocks} (1969)).
\textsuperscript{30} Macey, \textit{supra} note 27, at 28.
4. Asset Allocation is Key Because Over Time Stocks Earn More than Other Forms of Financial Investments

The reason that asset allocation is important is that stocks have a significantly higher rate of return over longer periods, making them the asset of choice for the long-term accumulation of wealth. Since 1926, stocks have offered the highest average returns of any major asset class. Large blue-chip companies have offered returns almost twice as high as those of U.S. government bonds and almost three times the return of Treasury Bills. The returns from stocks become even more compelling when we adjust the returns for inflation. As detailed later, the preferential treatment of capital gains over ordinary income tax rates adds substantially to the already great differential between stocks and fixed-income investments, as illustrated in the first chart which follows.

The problem with the higher returns associated with stocks is that they are usually accompanied by higher risk and volatility of the portfolio assets. In any single year, the range of returns from blue-chip stocks is substantial, with the best year since 1926 exceeding a 52% return while the worst year shows a decline of more than 43%. These ranges are illustrated in the second chart which follows:

![Investment Returns and Inflation Chart]

Source Data: Ibbotson Associates

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33 IBBOTSON ASSOCIATES, supra note 21, at 224-225, Table A-1.
Over the long term, however, the case for investing in stocks remains compelling. The likelihood of losing money in stocks declines substantially over ten-year periods and is not much worse than the low ten-year returns from bonds. See bar chart which follows.

Over twenty-year periods, stocks have always provided positive returns\(^{34}\) even through the Depression, recessions, high inflation, wars, and other risks. Stocks are usually the preferred investment and, the longer the time frame, the more likely stocks are to be the best investment. As illustrated by the Holding Periods table below, stocks are always the best bet and betting against them for the long run has been a loser’s game.

\(^{34}\) Id.
Range of 10-Year Returns on Asset Classes

(1926 - 2003)

Large Stocks: 20.1% 10.4%
Government Bonds: 13.1% 5.4%
Treasury Bills: 9.2% 3.7%
Inflation: -2.57%

Percent of Holding Periods as Best Performing Asset Class From 1926 to 2003

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>1 Year Periods (78)</th>
<th>5 Year Periods (74)</th>
<th>10 Year Periods (69)</th>
<th>15 Year Periods (64)</th>
<th>20 Year Periods (59)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Stocks</td>
<td>21%</td>
<td>31%</td>
<td>29%</td>
<td>22%</td>
<td>15%</td>
</tr>
<tr>
<td>Small Stocks</td>
<td>44%</td>
<td>53%</td>
<td>57%</td>
<td>72%</td>
<td>85%</td>
</tr>
<tr>
<td>Corp. Bonds</td>
<td>8%</td>
<td>9%</td>
<td>9%</td>
<td>6%</td>
<td>0%</td>
</tr>
<tr>
<td>Long-term Gov’t Bonds</td>
<td>10%</td>
<td>3%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Intermediate term Gov’t Bonds</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>T-Bills</td>
<td>8%</td>
<td>0%</td>
<td>1%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Inflation</td>
<td>8%</td>
<td>1%</td>
<td>1%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

An even longer term and more interesting study of stock and bond returns can be found as the result of the work of Professor Jeremy J. Siegel, of the Wharton School of the University of Pennsylvania. In his book, *Stocks for the Long Run* Professor Siegel chronicled the nominal and inflation adjusted returns for stocks, bonds, cash and gold since 1802 and found a remarkable consistency of the total real return of stocks. The returns enjoyed during the bull market beginning in 1982 are notably out of scale with the long-term averages. The following

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35 *Id. at 43, Table 2-7.*
tables for stocks and bonds based on Siegel's work can be found in John Bogle's remarkable book *Common Sense on Mutual Funds.* See table which follows:

### Annual Average, Annual Stock Market Returns (1802-1997)

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Total Nominal Return</th>
<th>Consumer Price Inflation</th>
<th>Total Real Return Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1802-1870</td>
<td>7.1</td>
<td>.1</td>
<td>7.0</td>
</tr>
<tr>
<td>1872-1925</td>
<td>7.2</td>
<td>.6</td>
<td>6.6</td>
</tr>
<tr>
<td>1926-1997</td>
<td>10.6</td>
<td>3.1</td>
<td>7.2</td>
</tr>
<tr>
<td>1802-1997</td>
<td>8.4</td>
<td>1.3</td>
<td>7.0</td>
</tr>
<tr>
<td>1982-1997</td>
<td>16.7</td>
<td>3.4</td>
<td>12.8</td>
</tr>
</tbody>
</table>

The 2000-2002 bear market has corrected the recent "excess return" as stock market returns are reverting towards their longer term averages. Bond market real returns are actually considerably less consistent than stock returns:

### Average Annual Bond Market Returns - Long-Term Government Bonds (1802-1997)

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Total Nominal Return</th>
<th>Consumer Price Inflation</th>
<th>Total Real Return Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1802-1870</td>
<td>4.9</td>
<td>.1</td>
<td>4.8</td>
</tr>
<tr>
<td>1872-1925</td>
<td>4.3</td>
<td>.6</td>
<td>3.7</td>
</tr>
<tr>
<td>1926-1997</td>
<td>5.2</td>
<td>3.1</td>
<td>2.0</td>
</tr>
<tr>
<td>1802-1997</td>
<td>4.8</td>
<td>1.3</td>
<td>3.5</td>
</tr>
<tr>
<td>1982-1997</td>
<td>13.4</td>
<td>3.4</td>
<td>9.6</td>
</tr>
</tbody>
</table>

While real returns on stocks have been very consistent over very long periods, approaching a lifetime, there is plenty of volatility in the short run. Over these shorter but highly significant time frames, the volatility of the stock market must be weighed against its superior returns.

The tradeoff between risk and return is sometimes called the efficient frontier that displays the effects of asset class blending. A portfolio of 100% bonds (0% stocks) provides a low level of nominal return with a moderate amount of risk. As the riskier asset, common stock, is added to an all-bond portfolio, the return increases. Initially the portfolio risk is not increased by adding some stocks because stocks and bonds often perform differently, actually reducing the volatility of the portfolio. The lowest volatility portfolio of stocks and bonds actually has about 15% stocks and 85% bonds, not 100% bonds. As one moves further up the efficient frontier, returns increase along with the risk of the returns in the portfolio. The key decision is...

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determining where to position portfolios along the curve. What is the optimal asset allocation? That decision determines over 90% of the expected portfolio return over time. See Efficient Frontier graph which follows.

While adding bonds to an all-equity portfolio reduces risk, it is done at a substantial cost if the conservative portfolio is maintained over the long run. We shall examine that cost in many ways in these materials.

Diversification can also be accomplished by utilizing international securities. International equities are not fully correlated with the U.S. stock market, yet their historical rate of return has been just as high. Therefore, adding international equities diversifies, and lowers risk. The bull market of the 1990’s in the U.S. equity market erased the foreign market's prior edge in long-term total return. Further, the interconnectedness of the world's markets is clearly increasing, perhaps reducing to some degree the value of this diversification at least in the highly developed foreign markets. Indeed, during the period 2001-2002, real diversification in equities was increasingly hard to come by. The EAFE index from January 1, 2001 through September 20, 2001 with a minus 30.79% performance led the S & P 500’s decline of minus 25.63% through the same period. While there was value in international diversification in 2002 and 2003, the

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38 Id. See also, Stanley T. Klinefelter, The Care and Feeding of Trustees, AN. C. OF TR. & EST. COUNS. AN. MTG. Ex. A. The material illustrates that from 1980 through 1995, a blend of large and small capitalization equities, international equities, and fixed income should have produced better returns and fewer risks than simply blending fixed income and large capitalization stocks alone.

39 The highly developed markets have clearly become more correlated with the U.S. Markets in the last decade. The emerging markets still retain a considerable independence from the U.S., though the variation in returns in recent years has often been in the wrong direction. Stephen B. Wilcox and Mikko B. Huumonen, International
five year period ending June 30, 2004 showed an average total return for the S & P 500 Index of -2.20%, while the EAFE Index for the same period showed an average annual return of .13%.40

Another way to reduce risk in a domestic stock portfolio is to invest in different segments of the market such as value, growth, small, mid-capitalization, and large capitalization securities. Diversification has many faces.

Clearly the conclusion to be drawn from the data is that for a long-term investor or a long-term trust, the volatility of the stock market over the short term is a risk worth taking. No other liquid asset offers the nominal or absolute return derived from stocks. When inflation adjusted or "real" rates of return and the tax advantages of the stock investing are factored in, stocks clearly become the wealth-building asset of choice. The dividend history of stocks also gives the investor an increasing stream of cash returns not available from fixed-interest investments such as bonds or Treasury Bills. Only during periods when inflation and interest rates are high or during a severe bear market does a switch to fixed-income securities and cash equivalents seem to lead to higher cash returns. Even during periods, such as the 1970s, when this was so, such a result was paradoxical, since the inflated values of underlying assets and income streams should logically have been reflected in better stock market returns. This is particularly true if the value of the company’s assets is an important element in it’s pricing, as opposed to earnings or growth in earnings, or if the company’s product itself is a commodity, such as oil, or timber.

In building an investment portfolio, patience is needed to endure the inevitable market corrections. Discipline is required for the plan to be carried out in the interest of building wealth. Most of all, careful asset allocation is essential for long-term investment success.

The analysis of risk, return, and asset allocation, which are critical to successful long-term investment, is limited in a trust context by the language of the trust document. If all the income, and only income, is to be distributed to a life beneficiary whose need is greater than the current dividend yield from stocks, then asset allocation takes a back seat to the trust provisions that drive the trustees' decisions.

5. **In the Real World of Trusts, Only Stocks Earn Real Returns After Taxes, Expenses and Inflation**

The higher returns earned by equities in the long term are clearly critical to a long-term investment strategy. But in the real world of private trusts, they are even more crucial because of the real world obstacles which the private trust must overcome-specifically taxes, expenses and inflation. Let's look again at the following bar chart which summarizes the long-term returns along with inflation from 1926 for stocks, bonds, and cash, proxies for which are the S&P 500, the Intermediate Government Index and U.S. Treasury Bills:

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40 *See* the online performance data for I Shares by Barclays’ Global Investor Services available at www.ishares.com.

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When we take out, however, the long-term impact of income taxes through our computer model described later and subtract for 1% trustees' fees, our chart looks considerably different:

Source Data: Ibbotson Associates
And when we take away the impact of inflation as well, the results are truly striking.

Source: Ibbotson Associates and Author's Computer Model
The combination of taxes, expenses and inflation utterly defeats the long term returns of short term and intermediate term bonds. They have no real net return in the context of a private taxable trust. This stark reality will be viewed from a number of vantage points throughout the course of these materials, but its importance cannot be overstated. If the long-term returns on bonds and cash equivalents are eliminated by taxes, expenses and inflation, then we should use them as we must to decrease volatility to an acceptable level, but use them sparingly in a long-term trust if we intend to preserve its value.

6. In the Real World of Trusts—Is it Really that Bad?

One is tempted to question whether in the real world of trusts, the actual results are really as problematic as described above. It may be instructive at this point to take a quick look at a real trust and real data, as opposed to a theoretical trust with theoretical values. We will examine the data applicable to a real trust of which the author is a co-trustee. This trust was one in which the settlor, a family friend of the author, had insisted that the trust be an income only trust for the benefit of her brother, with whom she had reconciled shortly prior to her death. Her point of view was that she wanted to help him during his lifetime, but did not want to build up his estate. Hence she insisted that no principal distributions be made under any circumstances. Now this wasn’t really wise even at the time the trust was drafted, in 1983, but she was insistent, and with dividend yields at about 5% and interest rates on bonds over 10%, her insistence did not pose an immediate problem.

After the settlor’s death in 1987, the trustees were faced with an elderly beneficiary with a significant need and desire for current income. With no ability to distribute principal under any circumstances, the trustees were forced to compromise between the competing demands for income with the need to try to maintain or build value for the remainder beneficiaries. The response was typical: a 50% equity/50% bond portfolio. Specifically, the trust was invested in a laddered portfolio of Treasuries and highly rated municipal bonds, and in blue chip type stocks with a proven history of dividend increases. Now this didn’t fully address the investment goals of either the current beneficiary or the remaindermen. Rather, it was aimed at impartially responding to the needs of both. However, as the following chart illustrates, neither the income beneficiary, nor the remaindeman, would have their needs addressed optimally.
The bars show the year ending market values of the trust, and the lines show the actual net income available to distribute to the current beneficiary. As one can see, the income beneficiary’s share showed a nominal decrease in income over the entire 14-year period, despite the greatest bull stock market in history, and despite rebalancing the portfolio on a number of occasions to try to increase the available income. On a real basis, the results are dramatically worse, with a 41.4% decline in spendable income from 1987. The volatility of the income distribution is also noteworthy, and is the result of the very volatile nature of interest rates throughout the period. Conservatism in the structure of the laddered bond portfolio probably added to the volatility, in that the average maturity was in the intermediate range for the government bonds in the portfolio, but there is no doubt that the nature of the investments made were virtually dictated, not by the concepts of risk and return so much as the concept of income need and dividend yield. Stocks with low or no dividend yield were not potential candidates for this portfolio, regardless of their prospects, because of the rule of income. As a result, the principal growth, while significant, was not nearly as great as for a more broadly diversified portfolio.

The frustration the author felt with this particular portfolio was a significant factor in influencing the ensuing eight years of work in researching, designing, testing and refining the uses for the Total Return Unitrust. We shall revisit this trust a little later on to see how it might have performed had the TRU been available and utilized during the same period.
The management of endowment funds, particularly for colleges and universities, began to change in the mid-1960s. Like conservative private investors, these educational institutions followed the traditional legal rules for trusts to determine how much of their endowments to spend. Institutions would spend precisely that income that came in the form of interest, dividends, rents, or royalties. By the mid-1960s, the concept of total return investing began to erode the assumptions concerning spending and investment.  

Colleges and universities in many jurisdictions are free from the traditional restraints of income and principal allocation when dealing with endowment because of the local enactment of the Uniform Management of Institutional Funds Acts (UMIFA). This Act was promulgated by the National Conference of Commissioners on Uniform State Laws in 1972 as a result of concern that endowments were not generating the maximum return. This concern was brought into focus in the late 1960s and early 1970s by a series of Ford Foundation Reports, two known as the Barker Reports and two by Carry and Bright.

The specific thrust of the Ford Foundation Report was that colleges and foundations were investing too conservatively. The institutions were giving up capital gain returns because of mistaken definitions of prudence and a desire not to lock up capital gain in perpetuity in endowments. In other words, the spend-income-only rule was leading to unfortunate investment decisions. The UMIFA solution was to give universities the power to invest under a more liberal prudent person rule and to allow colleges to use either the traditional principal and income rule or a total return standard when making annual spending decisions.

History shows that, during some periods of time, the income return might be a very small proportion of the total return. Examples of such periods include the time from 1956 to 1968 and 1986 to 2000. On the other hand, very high yield bonds in the early 1980s were over-productive of income. High inflation expectations were built into their rates of interest, so spending based on accounting income often unfairly allocated return, and even worse, led to poor investment results simply because of the need to generate current income.

Indeed, in an economy in which there is consistent inflation, spending all of the income from bonds substantially erodes the purchasing power of principal. And trustee's fees only add to that erosion. The concept of "income" in the context of bonds is fundamentally flawed because it fails to account for inflation.

41 DOBRIS, supra note 4, at 50 (analyzing the change in investing attitudes prevalent in the 1960s).
42 Id. at 51-52.
43 IBBOTSON ASSOCIATES, supra note 21, Compare Table A-2, at 226-227 with Table A-1 at 224-225.
The investment goals for endowment spending have substantial similarities with the goals of private trusts. Endowments seek a stable flow of real income and either to maintain the purchasing power or to increase the real value of the endowment. The role of most spending policies is to limit spending to no more than the real return, that is, the accounting income plus the increase in value over time as adjusted by inflation. Limiting distributions to the real return preserves the value of the underlying endowment fund. While this result is probably the goal of most spending policies at universities, universities pursue this outcome in different ways.

Many institutions use traditional income accounting rules. Many others have turned to a combination of total return investing coupled with a percentage payout of the endowment value, essentially creating a form of unitrust. The difficulty with a unitrust payout is that there is likely to be too much fluctuation in the payout. This is particularly important within the context of university budgets, which are highly inflexible and ill-suited to absorb significant swings in endowment income on a year-to-year basis. As a result, most schools have adopted some type of smoothing rule. Some simply increase spending every year on the basis that inflation demands it. Perhaps the simplest of these smoothing rules is to provide for a unitrust payout over rolling averages of three to five years of unitrust values. The use of a unitrust payout based upon a percentage likely to be no more than the real return provides a sensible theoretical base for endowment spending. A number of prestigious universities use moving averages to smooth their endowment income. The payout tends to average between 4% and 6%.

Analyses of the payout methods of endowments as of 1989 show that almost 40% of the foundations still cling to the income rule regarding payout, while approximately 30% of the foundations base their payout decisions on overall investment objectives and performance. The larger foundations tend to have more sophisticated and more complicated rules. Yale University uses a smoothing rule that incorporates a target percentage of current market value and a spending component from the previous year's expenditures.

As these materials demonstrate, the artificial distinctions between income and principal are losing ground in the charitable foundation area, as well as in the law of private trusts.

44 Real income is income adjusted for inflation.
45 Id. at 62 n.45.
46 Id. at 56-61.
47 These schools include Brown University, Bryn Mawr College, Bucknell University, California Institute of Technology, Georgetown University, University of Michigan, University of Minnesota, Mount Holyoke College, University of Pennsylvania, Radcliffe College, Columbia University, Tulane University, Vanderbilt University, College of William and Mary, and many others. Id. at 62 n.45.
48 LESTER M. SOLOMON & KENNETH P. VOYTECK, MANAGING FOUNDATION ASSETS: AN ANALYSIS OF FOUNDATION INVESTMENT AND PAYOUT PROCEDURES AND PERFORMANCE 48 (1989). With the low current dividend and interest payouts today, this percentage clinging to an income rule has surely decreased significantly.
49 DOBRIS, supra note 4, at 65 n.60.
V. RECENT NATIONAL DEVELOPMENTS IN THE LAW OF TRUSTS

A. RESTATEMENT (THIRD) OF TRUSTS PROMULGATES THE PRUDENT INVESTOR RULE AND INCORPORATES THEORIES OF RISK AND RETURN, TOTAL RETURN INVESTING, AND MODERN PORTFOLIO THEORY

The Restatement (Third) of Trusts first stated the prudent investor rule in its modern form as follows:

§227. General Standard of Prudent Investment

The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.

(a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trust has a duty to diversify the investments of the trustee unless, under the circumstances, it is prudent not to do so.

(c) In addition, the trustee must:

   (1) conform to fundamental fiduciary duties of loyalty (§170) and impartiality (§183);

   (2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§171); and

   (3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§188).

(d) The trustee's duties under this section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute.50

The prudent investor rule represents a significant departure from prior law in a number of respects. First, the law had been that each individual investment is judged separately, not on a portfolio basis. Second, the duty to diversify is clearly stated. While this has long been accepted

as good practice, it has not been black letter law nationwide. Third, delegation of investment and other functions is permitted as long as the decision to delegate and the selection and supervision of agents is done reasonably. Finally, cost control is required, no doubt a reflection of the efficient markets\(^{51}\) theory, which argues against the expenditure of additional funds to attempt to increase returns by timing or selectivity in investing.

One of the foundations of the requirement of diversification is the theory that in an efficient market each stock has the same expected return for a given level of risk, even though they will not in fact have the same rate of return. However, increasing the number of individual stocks reduces the volatility of the entire portfolio. When the volatility of the entire portfolio is reduced, there is a reduction in the overall risk without changing the probable average return of the portfolio. In this respect, the risk of having too small a number of individual investments of a particular kind is considered to be uncompensated risk, as opposed to the compensated risk of a particular market where risk and return tend to be directly related to one another. The higher the risk, the higher the return the market will demand in pricing the investment.\(^{52}\)

The commentary to Restatement §227 points toward the total return trust:

In short, only when beneficial rights do not turn on a distinction between income and principal is the trustee allowed to focus on total return . . . without regard to the income component of that return. In other trust situations there exists a fiduciary duty to make the trust estate productive of trust accounting income. The trustee then has a duty to consider two aspects of the productivity question. First, what is an appropriate level or range of income productivity for the particular trust? As noted above, this is a matter for interpretation and fiduciary judgment . . . Second, how should that productivity objective be incorporated into an overall portfolio strategy? In resolving the latter question the trustee is not governed by the productivity standard in the selection and retention of each individual investment. The standard applies to the portfolio as a whole.\(^{53}\)

The matter of "interpretation and fiduciary judgment" is made much more difficult in the typical trust document which fails to state the economic and human goals and preferences of the settlor of the trust.

B. THE PRUDENT INVESTOR ACT

Carrying forward the concepts introduced with the Restatement (Third) of Trust, the Uniform Prudent Investor Act was adopted by the National Conference of Commissioners on Uniform State Laws on August 5, 1994, and approved by the American Bar Association on February 14, 1995. Incorporating modern portfolio theory into the Uniform Prudent Investor Act abrogates all categorical restrictions on types of investments. The trustee can invest "in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets

\(^{51}\) An efficient market is one in which all relevant information and factors are known and considered in the marketplace so that price is always a fair reflection of risk and return. See Macey, supra note 27, at 38.

\(^{52}\) Restatement (Third) of Trusts §227 cmts. e-h (1990).

\(^{53}\) Id. at §227 cmt. i (some special duties of trustees).
the other requirements of prudent investing."\(^{54}\) Section 2 of the Act also states a number of circumstances that the trustee must consider in investing and managing trust assets:

1. general economic conditions;
2. the possible effect of inflation or deflation;
3. the expected tax consequences of investment decisions or strategies;
4. the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely-held enterprises, tangible and intangible personal property, and real property;
5. the expected total return from income and the appreciation of capital;
6. other resources of the beneficiaries;
7. needs for liquidity, regularity of income, and preservation or appreciation of capital; and
8. an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.\(^{55}\)

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

If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.\(^{56}\)

This duty of impartiality implies a shift away from the general favoring of the life income beneficiary, often what the testator might prefer, in favor of an evenhanded duty between the current and remainder beneficiaries. This is likely to increase the burden on the trustee of the conventional income rule trust in selecting investments. The Prudent Investor Act or a variation of it has been adopted in some form in the District of Columbia and 41 states.\(^{57}\)

C. THE NEW PRINCIPAL AND INCOME ACT: ACCOUNTING ALCHEMY--THE POWER TO ADJUST PRINCIPAL AND INCOME

A third version of a Uniform Principal and Income Act was approved by the National Conference of Commissioners on Uniform State Laws in July 1997, and approved by the American Bar Association in January of 1998. The primary purposes of this newest revision, reflecting six years of labor, is to update the prior Principal and Income Acts, i.e., to recognize new forms of investments, to reflect the modern portfolio theory of investing, and to allow fiduciaries the means for making the best investment decisions parallel with the prudent investor rules in the Restatement (Third) of Trusts and in the Uniform Prudent Investor Act.\(^{58}\)

\(^{54}\) PRUDENT INVESTOR ACT, supra note 6 (prefatory note).
\(^{55}\) Id. at 22.
\(^{56}\) Id. at 28.
\(^{58}\) UNIF. PRINCIPAL AND INCOME ACT, supra note 10 (prefatory note).
The Uniform Principal and Income Act reflects acceptance of total return investing and gives the trustee the power to reallocate or adjust returns between income and principal under certain circumstances. It has been adopted in the District of Columbia and 37 states and is under consideration in at least 1 other.\textsuperscript{59}

Section 104 of the Act, titled "Trustee's Power to Adjust," addresses the tension between the duty of impartiality and the duty to give due regard to the interests of both the income and remainder beneficiaries.\textsuperscript{60} The critical language of Section 104 reads as follows:

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

Section 103 of the Act provides that:

(a) In allocating receipts and disbursements to or between principal and income, and in any matter within the scope of [Articles] 2 and 3, a fiduciary:

(1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];

(2) may administer a trust or estate by the exercise of a discretionary power of administration given the fiduciary by the terms of the trust or the will even if the fiduciary exercises that power in a manner different from a provision of this [Act];

\textsuperscript{59}Alabama, Alaska (with a unitrust alternative), Arizona, Arkansas, California, Colorado (with a unitrust alternative), Connecticut, District of Columbia, Florida (with a unitrust alternative), Hawaii, Idaho, Indiana (with a unitrust alternative), Iowa (without section 104, but with a unitrust alternative), Kansas, Maine (with a unitrust alternative), Maryland (with a unitrust alternative), Michigan, Minnesota (adopted only the power to adjust), Missouri (with a unitrust alternative), Montana, Nebraska, Nevada, New Jersey (with a unitrust safe harbor), New Mexico, New York (with a unitrust alternative), North Carolina (with a unitrust alternative), North Dakota (without section 104), Ohio (with a unitrust safe harbor), Oklahoma, Oregon (with a Unitrust alternative), Pennsylvania (with a unitrust alternative), South Carolina, Tennessee, Texas (with an alternative unitrust definition of income), Utah, Virginia (with a unitrust also), Washington (with a unitrust alternative), West Virginia, and Wyoming. \textit{See} website at following address:  http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-upia.asp. In addition, Minnesota adopted just the power to adjust (Minnesota Statutes Section 501B.705), Kentucky has adopted a version of section 104 with a unitrust alternative (KRS 386.454) and Louisiana has adopted a version of sections 104-105 without adoption of the rest of the Act. \textit{See} La. Acts 520 (to be codified at La. Rev. Stat. Ann. Secs. 9-2158 to –2163 (effective Jan. 1, 2002). \textit{See} Appendix 11 to these materials for details and references to these acts in table form. For a now somewhat dated survey of total return legislation, \textit{See} WELCH, \textit{Progress of Total Return Legislation}, \textit{supra} n. 11.

\textsuperscript{60} \textit{UNIFORM PRINCIPAL AND INCOME ACT, supra} note 10.
(3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

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

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

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

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

The Uniform Act also strives to preserve the critical tax benefits of the marital deduction and the annual gift tax exclusion on a gift of an income interest. These benefits still rest upon the distinctions between income and principal.

Further, the trustee may need protection from the power if the power might make the trustee or the grantor subject to the grantor trust rules; or worse, if the power might cause a federal estate tax inclusion in the estate of either the trustee or one who has a removal and appointment power for the trustee. Hence, these situations are excluded as well.

61 Id.
62 See id. § 104(c)(1), (2). See Section X.D. and X.E. discussing the Proposed Regulations and the Final Regulations under Section 643 and related sections which unseat these distinctions for states which allow for the power to adjust and/or a unitrust alternative.
63 Id. §104(c)(5), (6).
Section 104 of the revised Uniform Principal and Income Act would deny this power to a trustee who is an interested party to such an adjustment, whether the trustee is a beneficiary or otherwise. If the trustee is interested or the use of the adjustment power would result in an inadvertent tax result, Section 104 would deny this power to the interested trustee, but would allow a disinterested co-trustee\textsuperscript{64} to exercise the power if this approach would eliminate the difficulty.

Finally, the Uniform Act would allow the trustee with a tax concern to release all or part of the power provided by proposed Section 104, either permanently or for a specified period, including a period measured by the life of an individual.\textsuperscript{65}

The terms of proposed Section 104 do not automatically apply to every trust retroactively, but this power of equitable adjustment would apply "unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment."\textsuperscript{66} It is unlikely that many existing trusts would have such clear language, and hence retroactive applicability will be almost universal.

The comments and examples following new Section 104 make clear that it is a power given in response to the evolution of the prudent investor rule and the Uniform Prudent Investor Act requirements of impartiality between beneficiaries in the context of total return investing. Examples 1 and 3 illustrate the particular importance of the ability of a trustee to compensate for a decrease in accounting income caused by an increase in the proportion of trust assets allocated to stocks in response to the prudent investor rule.\textsuperscript{67} Another example makes clear that during a period of high inflation with high interest rates, a portion of the interest may be considered to be a return of capital and added to principal.\textsuperscript{68} The purpose of the provision is clear enough:

The purpose of Section 104 is to enable a trustee to select investments based on the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest and dividends. Section 104 provides a power to adjust total return between principal and income in the limited circumstances specified after applying the terms of the trust and the provisions in other sections of this Act. It

\textsuperscript{64} Id. §104(d).
\textsuperscript{65} Id. §104(e). Whether the power to release will give greater or lesser comfort to a trustee remains to be seen. If the trustee continues to retain some interest in the trust which might make the release a transfer with a retained interest, that trustee would not be able to effectively release a power of appointment considered to be general if the trustee is trying to avoid death tax includability. See Rev. Rul. 86-39, 1986-1 C.B. 301. For this reason, a disclaimer qualified under I.R.C. §2518 might be needed within nine months of the creation of the power. See I.R.C. §2518 (1997). Hopefully, the tax protective provisions contained in the Uniform Act relative to death tax includability will be respected by the Service. The Service has taken a dim view of provisions drafted by a taxpayer who conditioned the lapse of a right of withdrawal on such lapse not resulting in federal gift tax. Tech. Adv. Mem. 89-01-004 (Jan. 1, 1989), \textit{citing Commissioner v. Proctor}, 142 F.2d 824 (4th Cir. 1944), \textit{cert. denied}, 323 U.S. 756 (1944). Surely, the Service would treat a local law, particularly one derived from a uniform law, more kindly than it did the taxpayer's drafting in the technical advice memoranda.

\textsuperscript{66} UNIF. PRINCIPAL AND INCOME ACT, supra note 10, §104(f).
\textsuperscript{67} Id. §104 exs. 1 & 3.
\textsuperscript{68} Id. §104 ex. 2.

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sets forth a default rule that a settlor can expressly set aside in the terms of the trust.\footnote{See id. §104 cmt.}

As with seemingly everything in the trusts and estates field, the evolution of this section to allow an equitable adjustment between principal and income reflects a number of changes as a result of tax concerns.\footnote{Some (including the author) might say that we have been overly preoccupied with the tax aspects of trust design, and not enough with the needs of our clients. See, e.g., HOISINGTON, supra note 11, at 5-3.} Hopefully, the specific examples agreed upon will give enough specific guidance to make this provision of real benefit to trustees. If a trustee does not know how to use Section 104, it will not be used.

A power to adjust from principal to income and from income to principal should be very useful in a number of situations in which the trustees otherwise are restricted by the terms of the trust document.

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

This grant of an open-ended power may also be uncomfortable for many trustees who will not know when or how to use it.

Let us take a concrete example that is not specifically addressed in the comments to Section 104 and see how it applies. Let us assume that we had a trust that directs the trustee to hold the principal and pay the income to the beneficiary with no discretionary powers to distribute principal. Let us assume further that the trust had been invested entirely in equities, so that the overall investment performance had been very good, but the income return as of the present time is relatively small. We then are informed as trustee that the current beneficiary's need for income has dramatically increased because of health care issues. Let us assume we have a $1 million trust and it is invested entirely in equities with the characteristics of the S&P 500. This means that we would have current income distributable of about $13,200 after some portion of the trustees' fees is allocated to income. We are then faced with a need for a much higher level of income, as, for example, $50,000 a year. The traditional way to address the problem would be to try to readjust the asset allocation to produce the accounting income necessary. This would necessarily involve sale of all of the equity securities with resultant capital gains tax taking away perhaps 15% of the portfolio. Even reinvestment entirely in fixed-income investments would not solve our problem, even in the short term. The $1,000,000 in the trust could become $850,000 after we pay the capital gains taxes requiring a net reinvestment yield of 5.89% after trustees' fees. Before the capital gains tax bite, we only needed 5%. And of
course in the long term the result would likely be even worse for both the current and remainder beneficiaries.

Would Section 104 help us out here? First, we would look at the terms of the trust and administer the trust in accordance with its provisions using any discretionary powers. Since we have none, we would have to make a finding that distribution of the net dividend income was such that the trustee is unable to administer the trust or estate impartially based on what is fair and reasonable to all of the beneficiaries. If we could tell from the instrument that the current beneficiary was to be favored, we would not have to be completely impartial. Certainly one can make the case that distributing only the net dividend income from an all-equity portfolio is not fair and reasonable to the current beneficiary at today's yields and total return. But would it allow us to adjust the net income from 1% to 5%? That is what we would need to do in order to satisfy the beneficiary's need.\textsuperscript{71} The factors listed in Section 104 (b) are similar to those in the Prudent Investor Act:

\begin{itemize}
\item[(b)] In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee shall consider all factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:
\begin{itemize}
\item[(1)] the nature, purpose, and expected duration of the trust;
\item[(2)] the intent of the settlor;
\item[(3)] the identity and circumstances of the beneficiaries;
\item[(4)] the needs for liquidity, regularity of income, and preservation and appreciation of capital;
\item[(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;
\item[(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;
\end{itemize}
\end{itemize}

\textsuperscript{71} James Gamble, Co-Reporter of the UPAIA, was asked about this hypothetical at the 1999 ACTEC Fall meeting in Boston. His response was that Section 104 could stretch this far if the need were there. While he did not expand on the answer, the rationale might be that a trustee would otherwise be forced to convert to an almost all bond portfolio and it is the income from that portfolio which might be used as a benchmark in this case because of the extreme need of the beneficiary.
whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

(8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

(9) the anticipated tax consequences of an adjustment.

Only (4) above uses the word “need” and then it is coupled with other words, the import of which is not all that clear to this author—“needs for liquidity, regularity of income [How about the amount?], and preservation and appreciation of capital.” In short, while the need of the beneficiary should be an important factor in investing, administering and distributing any trust, the statutory support for need as a key criteria in the power to adjust is not evident. Example 3 under Section 104 illustrates the point that even if there is no financial need, the power to adjust may be appropriately used to maintain impartiality between the income beneficiary and the remainderman in light of the investment portfolio.

Example (3) – T is the trustee of a trust that requires the income to be paid to the settlor’s sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. E’s income from her social security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit T to invade principal to provide for E’s health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce very little dividend income. Even though it is not necessary to invade principal to maintain E’s accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

So that lack of an income need does not take away an income beneficiary’s right to “income.” But what if E’s needs to maintain her standard of living required a substantial amount of income from the trust? The comments under Section 104 don’t really answer that question, and the only inference, contained in Example 3 would argue that it is irrelevant.

We should keep in mind, however, that Section 104 was not specifically designed to satisfy the beneficiary's need, but rather to avoid the conflict between acting as a prudent investor with due regard for both the current and remainder beneficiaries and following the old income and principal rules. The second paragraph of the comment under Section 104 makes it clear that the intent is not to enable a trustee to increase the beneficial interest of the income beneficiary:

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Section 104 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio’s total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule.

Our examination of Section 104 and its comments fails to reveal a basis by which a beneficiary’s need for a level of distribution is given weight in determining an adjustment to income. Nor in more general terms do we observe any clear standard offered by Section 104 as to how much of an adjustment the trustee might make or how one would measure it. One might hypothesize such standards, based perhaps on historical real returns or even year by year inflation adjusted returns, but we do not find it in Section 104 of the Act.

Since the adoption of the Uniform Principal and Income Act, a new section, Section 105, has also been added to deal with the judicial control of discretionary powers under the Act, and particularly the discretionary powers given under Section 104(a). This section attempts to codify what the authors consider to be the normal rules governing a fiduciary's exercise of discretion.\textsuperscript{72}

\textbf{SECTION 105. JUDICIAL CONTROL OF DISCRETIONARY POWERS.}

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

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

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

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

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

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

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

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

(d) Upon [petition] by the fiduciary, the court having jurisdiction over the trust or estate shall determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary power conferred by this [Act] will result in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income and remainder beneficiaries will be affected by the proposed exercise or nonexercise of the power, a beneficiary

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Section 105 provides that the primary remedy for an abuse of discretion would be to simply reverse the adjustment in the case of Section 104 if the court found that the trustee had abused its discretion. Section 105(c)(3) provides that if the court cannot otherwise make whole the trust, the beneficiaries, or both as a result of the trustee's abuse of discretion, the court may impose personal liability on the fiduciary. Section 105(d) provides that the trustee can petition the court to determine whether a proposed exercise or non-exercise of a discretionary power would result in an abuse of discretion, but such a process is unlikely to be used in the ordinary situation where the cost and time delays inherent in court action would normally be unattractive.

In addition to providing some guidance as to the interrelationship between the trustee’s exercise of discretion and the oversight of courts, the comments under Section 105 attempt to provide further insight into the process of the trustee’s decision making in exercising the power to adjust. In this attempt, the exercise of the power to adjust is sometimes described as similar to the traditional duty to determine asset allocation between stocks and fixed income securities. This notion is specifically inserted in the comments to Section 105:

In seeking the proper balance between the interests of the beneficiaries in matters involving principal and income, a trustee's traditional approach has been to determine the settlor's objectives from the terms of the trust, gather the information needed to ascertain the financial circumstances of the beneficiaries, determine the extent to which the settlor's objectives can be achieved with the resources available in the trust, and then allocate the trust's assets between stocks and fixed-income securities in a way that will produce a particular level or range of income for the income beneficiary. The key element in this process has been to determine the appropriate level or range of income for the income beneficiary, and that will continue to be the key element in deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a). If it becomes necessary for a court to determine whether an abuse of the discretionary power to adjust between principal and income has occurred, the criteria should be the same as those that courts have used in the past to determine whether a trustee has abused its discretion in allocating the trust's assets between stocks and fixed-income securities.

This explanatory comment which seeks to trace the thought process for the power to adjust to the asset allocation decision in the traditional income and principal trust arguably brings in the need of the beneficiary (“financial circumstances of the beneficiaries”), since the need of the current beneficiary for income is traditionally a threshold question in the process of determining the issue of asset allocation in a trust—so much so that it often contradicted or even overrode the duty of the trustee to invest prudently and sensibly for total return.

The breadth of discretion afforded by the power to adjust is nudged yet wider by the wording as the comment under Section 105 continues:

who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion.” UNIF. PRINCIPAL AND INCOME ACT Sec. 105, 7B U.L.A. (2000).
A fiduciary has broad latitude in choosing the methods and criteria to use in deciding whether and to what extent to exercise the power to adjust in order to achieve impartiality between income beneficiaries and remainder beneficiaries or the degree of partiality for one or the other that is provided for by the terms of the trust or the will. For example, in deciding what the appropriate level or range of income should be for the income beneficiary and whether to exercise the power, a trustee may use the methods employed prior to the adoption of the 1997 Act in deciding how to allocate trust assets between stocks and fixed-income securities; or may consider the amount that would be distributed each year based on a percentage of the portfolio’s value at the beginning or end of an accounting period, or the average portfolio value for several accounting periods, in a manner similar to a unitrust, and may select a percentage that the trustee believes is appropriate for this purpose and use the same percentage or different percentages in subsequent years. The trustee may also use hypothetical portfolios of marketable securities to determine an appropriate level or range of income within which a distribution might fall. (emphasis inserted)\(^3\)

The foregoing comment suggests that there are several different methods by which one can approach the power to adjust.

1. **The “traditional” method.** The first method for determining an appropriate adjustment is to use the traditional method by which a trustee with a financial asset portfolio would decide upon an asset allocation between stocks and bonds. That “method” is described in the preceding paragraph of the comment. The trustee would try to determine the “appropriate level or range of income for the income beneficiary” by determining the settlor's objectives from the terms of the trust, gathering the information needed to ascertain the financial circumstances of the beneficiaries, determining the extent to which the settlor's objectives can be achieved with the resources available in the trust, and then allocating the trust's assets between stocks and fixed-income securities in a way that will produce a particular level or range of income for the income beneficiary. Presumably, once the appropriate level or range of income for the income beneficiary is ascertained in the traditional way, the trustee would go about investing the trust prudently without regard to what portion of the prospective return from the trust is from income and what portion of the prospective return of the trust is from capital appreciation. The factors to be considered in the investment process would be those stated in the Prudent Investor Rule and which are incorporated into Section 104; specifically taking into account the duration of the trust, the need to produce liquidity for distributions at the “appropriate level of income”, the risk tolerance of the trust and its beneficiaries, the economic conditions and the effects of inflation and deflation, as well as the tax effects of a proposed adjustment, but not taking into account the portion of the return which is likely to be the result of the distribution of interest and dividends. So if the primary objective of the trust from the terms of the trust was the satisfaction of the income needs of the income beneficiary, the needs of that beneficiary would be very relevant to determining an “appropriate level or range of income.” And gathering the information needed to ascertain the financial circumstances of the beneficiaries continues us down that trail. Unfortunately, determining the settlor’s intent from the terms of the trust is often very difficult,

\(^3\) **UNIF. PRINCIPAL AND INCOME ACT Sec. 105, 7B U.L.A. cmt (2000).**

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because the settlor’s intent on this all important issue is frequently (if not typically) not expressed.

2. **The hypothetical portfolios of marketable securities approach.** A second method, mentioned last, is that of using “hypothetical portfolios of marketable securities to determine an appropriate level or range of income”. It may or may not be a truly different approach. Presumably, the approach referred to would be to determine the level of income that would be produced by an asset allocation that might be selected by a traditional asset allocation process. That is, by determining the objectives of the settlor and the financial circumstances of the beneficiaries and then selecting a level or range of income that appears appropriate given a hypothetical portfolio of stocks and bonds. Hence if the objectives of the trust appeared to require an impartiality between the income beneficiary and the remainder beneficiary, and if the financial circumstances of the income beneficiary might lead the trustee towards producing as much income as possible given the duty of impartiality, the trustee might conclude that under a traditional approach to asset allocation, a 50% stock and 50% bond portfolio was warranted, and the income distribution would be based upon a hypothetical 50/50 portfolio. At the present time, that might be a return of 3%. The portfolio might then be invested any way the trustee concluded was prudent—which might well be 80% in stocks and 20% in bonds. To finish the process, the income from the 80% stock portfolio (likely about 2%) would be increased by adjusting 1% in principal cash to income cash. This hypothetical portfolios notion sounds very much like the “traditional approach” noted above. But why tie our new notion of income to an otherwise failed analysis? As we will see later on, the amount of net accounting income generated by a given asset allocation has little to do with how much one can spend from a portfolio and still have a reasonable prospect of preserving the real value of the trust portfolio. Indeed, insofar as one can afford to pay out more from a portfolio composed mostly of equities, one would not judge the appropriate income level of the portfolio by its accounting income, but by statistical and financial analysis of how much one expects to be able to distribute and the method of determining the distribution while still preserving its value over time.

3. **The third method, emphasized above, could be described as a “flexible unitrust method.”** It is suggested by this author that while there is no hard data on the manner in which the power to adjust is being employed, that this third method is the one utilized by almost all of the trustees using the power to adjust. Speaking about the payout in any way other than as a percentage of the value of the portfolio is likely to be too confusing for most trustees and beneficiaries. Even if you were to use the “hypothetical portfolios” approach, the description to the beneficiary is likely to be phrased in terms of a percentage of the value of the trust. Further, the use of a “flexible” unitrust method takes away the one strong objection of those who disfavor the unitrust—and that is its inflexibility. Of course flexibility is a two edged sword. Inflexibility produces predictability just as flexibility produces uncertainty. Whether this flexibility will be viewed as a good thing will depend in large part upon who holds the flexibility in her hand and how much she (the trustee) is to be trusted. Does she earn her name?

But the most important question—that of the choice of rate of payout, is not really addressed; the comment simply says the trustee “may select a percentage that the trustee believes is appropriate for this purpose and use the same percentage or different percentages in subsequent years”. What rate is “appropriate” for this purpose? This author would suggest that a
rate which is appropriate is one which is reasonably designed to leave the principal with the same real value after inflation as it had at the time the rate is selected, if the object is to replicate the original meaning of “income”. Or phrased differently, if the settlor’s intent is true impartiality between the current and future beneficiaries, it would be appropriate to grow the income and the principal at exactly the rate of inflation, after expenses and taxes. On the other hand, if the intent of the settlor is to grow the value of the trust, the payout level should be appropriate to a growth goal. And that is exactly what is done in the analyses performed later in Section XIII of these materials. Note, however, that the level of income distributed by this method is essentially quite different from that which would be the result of the traditional or hypothetical portfolios analysis. If one were to posit a 50/50 portfolio, the income today might be 3%, but the level of payout which will support an impartial distribution of income (that is, intended to preserve but not grow real value) would be different depending upon the actual asset allocation, and the higher the level of asset allocation into equities, the larger the payout the trust could afford, as we will see later on in these materials.

And what about the power to pay out “the same percentage or different percentages in subsequent years”? If the market value of the portfolio went down, would the trustee be justified in raising the percentage? Or should she lower it to preserve the value of the trust in the face of a declining market value? We will see the way a unitrust deals with these issues in an inflexible methodical way, but the comment simply gives the trustee the power to act flexibly. The trustee is on her own as to how to use it!

The Comment to Section 105 goes on to address some fine points about the power to adjust, such as whether the adjustment can be made prospectively, and whether the adjustment process must be revisited every year:

An adjustment may be made prospectively at the beginning of an accounting period, based on a projected return or range of returns for a trust’s portfolio, or retrospectively after the fiduciary knows the total realized or unrealized return for the period; and instead of an annual adjustment, the trustee may distribute a fixed dollar amount for several years, in a manner similar to an annuity, and may change the fixed dollar amount periodically. No inference of abuse is to be drawn if a fiduciary uses different methods or criteria for the same trust from time to time, or uses different methods or criteria for different trusts for the same accounting period.

If a trustee is comfortable relying upon the comment at its face value, this would allow a trustee to set a payout or a rate of payout for several (or even many) years, and only revisit it from time to time, rather than going through an annual analysis of the fairness of a particular payout, which is more than likely going to be an unproductive process, and which may be counterproductive from the long term investment strategy and the best interests of the trust.
D. TAXPAYER RELIEF ACT OF 1997--MAKING EQUITIES EVEN STRONGER!

Amidst burgeoning stock market gains and declining dividend and interest yields, the Taxpayer Relief Act of 1997 (TRA '97)\(^74\) provided additional incentive for total return equity investors. With the top rate for capital gains taxes at 20% rather than 28%, the case for total return investing and the desire to maximize after-tax returns to the trust pressed investors strongly towards growth where the majority of return could be tax deferred and eventually taxed at only one-half the rate of ordinary income at its top bracket. This trend in the tax law has continued and even accelerated in the 21st Century with even greater tax relief for qualified dividends and long term capital gains, as discussed in Section X. B.

VI. STATE LAWS MODIFY THE NATIONAL TRENDS

A. THE NEW YORK INITIATIVE STARTS THE STATE LAW ENGINE OF CHANGE

As discussed previously, the real problem is that our traditional definition of income doesn't work anymore in the context of stocks and bonds. New York was the first state to take up the task of a serious analysis of the "income" problem and propose a change. While it was the fourth state to enact unitrust friendly legislation on September 4, 2001,\(^75\) the work of its legislative committees produced much of the early initiative and progress in legislative analysis.

With the issuance of its fifth report dated May 11, 1999, New York's Statewide Legislative Advisory Committee proposed the adoption of a version of the Revised Uniform Principal and Income Act for existing trusts, including Section 104 discussed above.\(^76\) Perhaps even more significantly, the Committee proposed a new default standard for future trusts which redefines accounting income for new trusts and estates as a 4% unitrust interest, including the three-year smoothing rule suggested in this author's prior articles and as discussed in the following section of these materials.\(^77\) New York's unique approach would allow the drafter to opt into the new default rule or into Section 104. The Report recommended this section be placed in the Prudent Investor Act rather than the Uniform Principal and Income Act because it grows out of investment principles and from New York's provision that the trustee ought to invest in such a way as to provide an "appropriate benefit currently distributable."\(^78\) While the Committee recommended the adoption of the Revised Uniform Principal and Income Act along with Section 104, it clearly concluded that the principal and income standard was fundamentally flawed:

Section 104 of the Revised Uniform Act provides an adjustment power as between principal and income based on a trustee's determination that the

\(^{75}\) The final Bill was passed by the New York Assembly on June 18th, and by the Senate on June 19th, but was not delivered to the Governor until August 23, 2001. http://assembly.state.ny.us/leg/?bn=A09050.
\(^{76}\) STATE OF NEW YORK, EPTL-SCPA LEGISLATIVE ADVISORY COMMITTEE, Proposed Changes to the Definition of Trust Accounting Income, to Redefine Appropriate Benefit Currently Distributable, May 11, 1999 (on file with author).
\(^{77}\) Id. Exhibit 1, at 6-12.
\(^{78}\) Id. Exhibit 2(A), at 1.
application of the Act would otherwise fail to provide an appropriate benefit. Thus, the Act itself recognizes that it may be flawed in achieving its intended purpose. Its final application depends on a trustee's judgment as to what would be impartial. Alternatively, it would be possible to have a principal and income act which abandoned mechanical definitions of income and gave the trustee power to allocate to income whatever was considered impartial. Neither the Revised Uniform Act nor such an alternative approach, ultimately provide an adequate standard for trustees of future trusts to apply. In the Committee's view, the law should be rewritten to face the real issue more directly and to provide more guidance to trustees in defining appropriate benefit currently distributable. 79

The report concluded that income was an unsatisfactory measure for what the trustees should distribute because it is inherently arbitrary, manipulable and contrary to contemporary investment understanding. It is often arbitrary because some types of receipts lack an inherent division between income and principal and thus the Uniform Act is required to adopt an arbitrary standard, as they do for receipts for oil and gas and timber production and the sales of derivative products.

The level of income is manipulable because it depends on investment choice. One company may pay profits as dividends to shareholders and another company may retain its profits, increasing stock value. 80

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Longer term bonds have an "inflation premium" built into the interest they must pay to attract purchasers. To distribute this premium entirely to a current beneficiary sacrifices the long term purchasing power of principal. 81

The Committee concluded that the rule of income is contrary to modern investment understanding in which non-trust investors clearly seek total return.

The proposal allowed both existing trusts and future trusts the ability to opt in or out of either a unitrust or a revised Uniform Principal and Income Act regimen including the flexibility of Section 104. As originally recommended, existing trusts would have been governed by the new UPAIA with Section 104, but with the option of electing the unitrust approach. Future trusts would have been within the unitrust regimen with the option to change back to the UPAIA with Section 104. 82 As a result of suggestions and comments by the New York Bankers' Association, the New York State Bar Association Trusts and Estates Law Section and others, the unitrust regimen was made an option for both existing trusts and future trusts with the UPAIA and Section 104 as the default in both cases. 83

79 Id. Exhibit 1, at 3.
80 Id. Exhibit 1, at 3.
81 Id. Exhibit 1, at 4.
82 Id. Exhibit 2(C). For a summary of the workings of the New York statute, See HIRSCHSON, supra n. 11.
83 STATE OF NEW YORK, EPTL-SCPA LEGISLATIVE ADVISORY COMMITTEE, Proposed Changes to the Definition of Trust Accounting Income, to Redefine Appropriate Benefit Currently Distributable, Supplement to Fifth Report, May 26, 2000 (on file with author). Concerns were expressed by several affected groups, including the Association

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These changes will encourage trustees to address these issues and decide which course appears most suitable for their specific trust. The determination of what is to be distributed is so central to the purpose of a trust that the thought and effort of the trustees in the process is well worth the effort. The truly unique nature of this legislation, based as it was upon an extensive study over a five-year period, is that each trust would be given a choice. It could continue with the familiar income and principal regimen but with the unfamiliar Section 104 power to adjust. Or it can adopt the non-charitable private unitrust approach which in concept has been around for a good while, but which has drawn much attention only in recent years. Only time plus the freedom to choose will allow trustees to test out this new landscape and see how well these alternatives work in practice.

Importantly, this New York Committee requested the IRS by letter dated December 30, 1999 to address the tax implications of these prospective changes in the state law definition of income particularly with reference to the marital deduction. This request for guidance along with several other issues raised by the author’s articles was answered in the Proposed Regulations discussed in Section X.D. of these materials. The final version of the New York Statute relied upon these Proposed Regulations and did not provide for the payment of income or the unitrust amount, whichever is the greater, for marital trusts.

B. DELAWARE FIRST TO ENACT TOTAL RETURN UNITRUST STATUTE!

On June 21, 2001, Delaware became the first state in the country to enact a statute expressly allowing trustees of income trusts to convert their regime to one employing the Total Return Unitrust concept. While both New York, which passed its statute the day before, and Missouri, which passed its statute at the end of May were ready to put their laws into effect, Delaware's Governor had the quickest pen.

Delaware's Unitrust Statute allows a trustee to convert an income trust to a unitrust or a unitrust to an income trust, by giving proper notice to the current and remainder beneficiaries. If no one objects within a 60 day period after the notice, the change can be made with no court involvement. Even if there are no disinterested trustees, the statute provides a mechanism to appoint a disinterested person to make the decision about the conversion, so that court involvement should only rarely be necessary (famous last words perhaps).

of the Bar of the City of New York, as to which regimen should be used as the default standard, some preferring the UPAIA and Section 104. Concerns were also expressed as to the use of the unitrust regimen during the estate administration prior to funding of a trust. This was viewed by some as unduly complicated and was also eliminated in the final version.

84 Wolf 2, supra n. 11 at 153 (ordering rule for capital gains as a part of DNI); Wolf Miami, Part II, supra n. 11 at I-C-47–I-C-48; Wolf Miami, Part II, supra n. 11 at I-C-90 (effect of modification of income rule trust to unitrust on GST grandfathering).

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

86 12 Del. Code §3527 (b)(2).

87 12 Del. Code §3527 (c).

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A unique feature of the Delaware statute is that the trustee has a choice to set the rate between 3 and 5% (the range for which was probably taken from the range specifically noted to be acceptable in the Proposed Regulations as discussed in Section X.D. infra).

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

1. the intentions of the trustor, as reflected in the governing instrument,
2. general economic conditions,
3. projected current earnings and appreciation for the trust, and
4. projected inflation and its impact on the trust.\(^{88}\)

The trustee has discretion to determine the effective date of the conversion, the timing of distributions, and the valuation dates or the averages of valuations dates as are deemed appropriate.\(^{89}\)

The Delaware law specifically grants the trustee the power to allocate short and long term capital gains to income for purposes of determining DNI.\(^{90}\) As discussed later in connection with the Proposed and Final Regulations, this is important because it may both lower the total tax burden and makes a higher payout rate prudent. Delaware’s unitrust statute gives the trustee significant flexibility in administering their new total return unitrusts, particularly the flexibility of choosing a unitrust rate between 3% and 5%. This is favorable, provided that the trustees do not mind making some important choices in the process.

A key difference between the Delaware legislation and that of New York and Missouri is that Delaware does not include the option of the power to adjust, although consideration has been given to adding the power to adjust as well. Delaware’s flexible total return unitrust statute is intended to be available to virtually all trusts, even those moved to Delaware as the legislative note indicates helpfully (hint!).

Following the adoption of the Final Regulations as discussed in Section X. E. of these materials, Delaware was also the first to adopt a fine tuning of their unitrust statute in light of the wording of the Final Regulations.\(^{91}\)

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\(^{88}\) 12 Del. Code §3527 (f).
\(^{89}\) 12 Del. Code §3527 (i).
\(^{90}\) 12 Del. Code §3527 (h)(2).
\(^{91}\) Senate Bill 388, amended various subsections of 12 Del. Code §3527 and was signed by the Governor on June 24, 2004. See [http://www.legis.state.de.us/Legislature.nsf/fsLIS?openframeset&Frame=Main&Src=/LIS/LIS142.NSF/0](http://www.legis.state.de.us/Legislature.nsf/fsLIS?openframeset&Frame=Main&Src=/LIS/LIS142.NSF/0)
C. MISSOURI SHOWS TRU GRIT IN FOLLOWING DUAL UNITRUST/POWER TO ADJUST APPROACH.

Missouri, like New York, enacted a statute with both the unitrust and the power to adjust and was the second state to enact unitrust legislation on July 7, 2001. The power to adjust and the unitrust sections are protected by short statutes of limitations, so that after a two year period from the action of an adjustment or three years after a unitrust conversion, the action becomes incontestable. The unitrust portion of the statute provides for the three year smoothing rule as recommended in this and the author’s prior articles.

The unitrust statute can apply to any trust referring to the new statute created after August 28, 2001, and to any irrevocable trust created before that date, if the trustee elects to have the section apply, but the election requires notice to all qualified beneficiaries of the trust and the settlor, if living, and is written so that the conversion would not go into effect until two years later—August 28, 2003. This two-year delay would have been distinctly less helpful to trustees desiring change and who do not opt for using the power to adjust in the meantime. Perhaps even less helpful is the fact that for trusts becoming irrevocable prior to August 28, 2001, the conversion period has now expired, because of the conversion date of August 28, 2003, and the fact that 60 days advance notice must be given. Effectively, then, the statute applies only to trusts for which conversion has already been initiated and to new trusts which indicate an intent that the new statute was to apply to them.

One of the more interesting (and potentially problematic) aspects of the otherwise thoughtfully drafted Missouri statute is that the unitrust percentage must be at least 3%, but it has no upper limit. Nor is there any ordering provision or express power in the trustee to allocate short and long-term capital gain to the unitrust amount. This is important in that without such an ordering provision or a consistently applied trustees’ practice, a given rate will have the effect of a higher stated rate compared to a state law with an ordering provision.

The lack of any stated cap or limit on the unitrust rate could have encouraged some pretty unreasonable demands of Missouri's trustees, since in the eyes of your average beneficiary, 5% or even 10% may not sound like an unreasonable request for the unitrust rate. Perhaps it is no coincidence that under the Missouri statute, only the trustee is specifically empowered to make the conversion, and choose the rate. Perhaps fortunately in this regard, the years in which the statute has been available have been bear market years, which would tend to dampen the arguments for higher and higher payout rates. On the other hand, having a “window” period during a severe bear market most likely dampened any action whatever on the part of many trustees, and it is unfortunate that the ability to convert is now not available in Missouri, except perhaps by court petition.

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92 http://www.house.state.mo.us/bills01/bills01/hb241.htm
93 RSMo 469.409.
94 RSMo 469.411.5. (3).
95 RSMo 469.411.1. (1)-(2).
96 RSMo 469.411.5.
97 RSMo 469.411.1. (1).
D. NEW JERSEY’S “SEMI-SAFE HARBOR” APPROACH

Unlike Delaware, New York, and Missouri, New Jersey’s approach to allow a unitrust methodology was to grant the trustee a partial safe harbor for the use of the power to adjust under its new Uniform Principal and Income Act. The applicable language is terse:

A decision by a trustee to increase the distribution to the income beneficiary or beneficiaries in any accounting period to an amount not in excess of four percent, or to decrease that period’s distributions to not less than six percent, of the net fair market value of the trust assets on the first business day of that accounting period shall be presumed to be fair and reasonable to all of the beneficiaries. Any adjustment by a trustee between income and principal with respect to any accounting period shall be made during that accounting period or within 65 days after the end of that period. (Emphasis added)

Note that all that the statute does is create a presumption that the adjustment is fair and reasonable to all of the beneficiaries. In effect, it gives guidance as to a range of adjustments upward to four percent, or downward to six percent, which is thought to be prima facie reasonable. The adjustment is not a true safe harbor, because it is only presumed to be fair and reasonable. It is not conclusively presumed to be fair and reasonable. For this reason the author considers the statute to be a “semi-safe harbor” approach. Of course the high-end safe harbor allowing a trustee to adjust income downward to not less than 6% appears irrelevant for the moment. Unfortunately too, if one were to invest 100% in bonds today (or better yet, in March of 2000) it is unlikely that any adjustment would be forthcoming, since the income from an all bond portfolio is unlikely to be in excess of 6%. And a trustee may not feel safe adjusting between 4% and 6% because adjustments within that range lack the statutory presumption of reasonableness.

Thus by giving guidance that it is reasonable for a trustee to adjust income up to 4% or down to 6%, the provision is likely to have the effect of discouraging adjustments of income which would otherwise be between 4% and 6%, perhaps on the theory that 4% to 6% is a reasonable range for income from a trust. Unfortunately, if the portfolio is largely or completely in bonds, an income in that range may leave no return at all for the remainder beneficiary, causing the trustee to fail to fulfill its duty of impartiality under those circumstances.

From a tax point of view this approach may be less favorable also. It is not clear that this approach will attract the same imprimatur from the Proposed and Final Regulations as the separate statutory regimes as discussed later. Clearly it should qualify as “income” as an exercise of the power to adjust, though 6% is above the range mentioned in the Proposed Regulations. But what will the New Jersey statute do for trusts which are originally drafted as unitrusts? Will a 5% unitrust intended as a marital trust qualify for the marital deduction, without paying out the income if greater than the 5%? That seems unlikely. And what about a conversion from an income rule trust to a unitrust--is that O.K. for GST purposes? These questions do not have as clear answers as they do in states that have used the dual approach, making the power to adjust and the unitrust both expressly available.

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99 Id.
While a safe harbor approach sounds reasonable, it is well for states considering such an approach to consider carefully all of the effects of a semi hybrid approach. In a sense, a safe harbor approach may take away the best characteristics of both the power to adjust and the unitrust. It would detract from the flexibility of the power to adjust, and would detract from the predictability of the unitrust, and will attract less certain benefits for future trusts drafted as unitrusts.

For a safe harbor approach that would give the trustee the maximum possible level of comfort, see the discussion of the Ohio statute in Subsection H below.

E. PENNSYLVANIA ENTERS THE DISCUSSION WITH A UNITRUST/POWER TO ADJUST STATUTORY PROPOSAL.

On the same day that Delaware's total return unitrust statute became law, Pennsylvania's introduced its own Senate Bill 1014 (perhaps numbered wistfully to help take our minds off of the scheduled loss of our beloved step-up some years down the road). Pennsylvania's Bill, like New York, adopted a default rate of 4%, but references specifically the right to adopt a different rate by Court action (although most of the actions and decisions contemplated under the Pennsylvania Bill would not require Court Action).

The Pennsylvania Bill, which was signed into law almost a year later on May 15, 2002 gives the trustee the ability to choose between the power to adjust and a statutory unitrust, in which case the power to adjust is expressly waived. The power to adjust and the unitrust statute are intended to be very broadly available in the Pennsylvania proposal, as the requirement that the trustee be acting as a prudent investor, contained in the uniform act was omitted as being unduly restrictive. Tax sensitive situations are excluded from the application of either of the two approaches, and in case of doubt, the power to adjust or the power to convert to a unitrust may be released, either permanently or for a specified period of time.

Pennsylvania’s statutory unitrust option allows the trustee to convert an existing trust to a 4% unitrust by a simple notification process. If no objections were raised, the conversion would be complete. The relevant portion of the statute covering unitrust conversions is attached as Appendix 8 to these materials. In concept, the Pennsylvania statute is similar to the one adopted in New York, with the exception that a less detailed approach is used, with more discretion given to the trustee to make decisions concerning many of the conventions and rules affecting the administration of the trust, such as the effective date of the conversion, the frequency of distributions during the calendar year, the selection of valuation dates, the treatment for a short year, treatment of personal use property, and other less critical matters. Pennsylvania’s proposal puts no time limits on the conversion, and would allow the trustee with court approval to select a payout percentage other than 4%, to provide a distribution of net

100 20 Pa.C.S. §8101 et seq.
101 See id. Section 8104(a) and Section 8105(a). For a full pdf of the final version of the Bill which was enacted go to the following URL site: http://www2.legis.state.pa.us/WU01/LI/BT/2001/0/SB1014P1431.pdf.
102 See also, Joint State Government Commission, Advisory Committee on Decedents’ Estates Laws Recommendations to Legislative Task Force, May 4, 2001 at 22-29 (on file with author).
103 20 Pa.C.S. §8105(e).
income (as if the trust were not a unitrust) in excess of the unitrust distribution if such
distribution were necessary to preserve a tax benefit, to adopt a smoothing period other than 3
years, or to reconvert from a unitrust.\textsuperscript{104} This tax sensitive provision to require the distribution of
net income with court approval, if larger than the unitrust amount, is important and is different
from some of the other statutes, such as New York, in which the “net income” requirement is not
mentioned in connection with marital trusts or in connection with the preservation of GST
grandfathering. This net income requirement will generally not be required going forward since
the Final Regulations, discussed in Section X. E., have been issued and are in effect.

Importantly, the Pennsylvania statute reflects the ordering rule set forth in the author’s
forms that is favorably treated by the Proposed and Final Regulations.\textsuperscript{105} This means that the 4%
payout should carry out with it short term capital gains and then long term capital gains to the
extent needed to comprise the full unitrust payout. For this reason, the 4% Pennsylvania payout
may be considered to be more conservative than the New York statute allowing the same rate,
and closer to the 3% rate set as a minimum for Missouri, because the New York and Missouri
statutes do not contain an ordering rule. Depending upon the cost basis of the trust investments,
and the degree of turnover in the portfolio, a 4% unitrust distribution would be the equivalent to
a 3.3% (for a low basis portfolio) to 3.75% (for a high basis portfolio) distribution in which the
capital gains taxes were entirely paid by the trust because capital gains were excluded from
DNI.\textsuperscript{106} The Pennsylvania statute incorporates most of the language from the Uniform Act’s
Section 105 into its Section 8106, which sets forth the standard of review as abuse of discretion,
and generally directs the remedy towards reversal of the prior action by the trustee, such as a
higher distribution if the distribution were too low, or future withholding from distribution if the
prior distribution were too high, only referring to surcharge if none of the other remedies are
sufficient.\textsuperscript{107}

Pennsylvania’s statute has been the one most frequently used as a model by other states
in drafting their own total return statutes with Delaware a close second.

\section{F. MAINE, WASHINGTON, FLORIDA, AND MARYLAND ENACT DUAL POWER
TO ADJUST AND UNITRUST CONVERSION STATUTES}

During 2002, four states in addition to Pennsylvania have enacted total return statutes that
provide both the power to adjust and a unitrust conversion statute—Maine,\textsuperscript{108} Washington,\textsuperscript{109}
Florida\textsuperscript{110} and Maryland,\textsuperscript{111} following the lead of New York, Pennsylvania and Missouri in this

\textsuperscript{104} See id. §8105(g).
\textsuperscript{105} See id. §8105(f)(2).
\textsuperscript{106} Based upon the author’s extensive computer modeling of such scenarios. There are too many variables to
succinctly state all of the differences, but the variables include the asset allocation between stocks and bonds, the
current accounting income of that asset allocation as compared to the unitrust amount, the turnover in the portfolio,
and the cost basis of the investments in the portfolio. To take a simple example, a 4% unitrust payout with a 2%
portfolio yield comprised of taxable interest and dividends would after 1% trustee’s fees be able to distribute 3%
capital gains per year to the beneficiary. At a 20% tax rate, this equals 60 basis points (6/10ths of 1%).
\textsuperscript{107} See 20 Pa.C.S. §8106.
\textsuperscript{108} MRSA §§7-701 et seq.
\textsuperscript{109} RCW §§11.104 et seq.
\textsuperscript{110} FRS §§738.101 et seq.
\textsuperscript{111} Md. Est. & Trusts §§15-501 et seq.
regard. And in this author’s opinion, having both the power to adjust and the unitrust provides the richest set of alternatives to the great variety of trusts, trust assets, and trust beneficiaries that may need help investing prudently and distributing fairly.

Maine followed the Pennsylvania statutory language rather closely. The unitrust percentage is set at 4% unless a different rate is set by the court,\textsuperscript{112} with a three year averaging convention,\textsuperscript{113} and the ordering rule distributing ordinary income, short term capital gains, long term capital gains, and then principal of the trust in that order.\textsuperscript{114} It leaves a number of the finer points to the discretion of the trustee, such as the effective date of the conversion, the provisions that define the proration process for a short year, the frequency of the unitrust distributions during the year and the effect of other payments from or contributions to the trust on the trust’s valuation, whether to value the trust annually or more frequently, the valuation dates to use, how frequently to value non-liquid assets, and whether to omit from the valuation property used by the beneficiary such as residential real estate or tangible personal property.\textsuperscript{115}

Generally, the actions required for the power to adjust and the unitrust may be taken without court action, but to select a different rate other than 4%, to provide for the distribution of net income if more than the unitrust amount, to average the valuation over a period other than 3 years, or to reconvert the unitrust to an income trust and revive the power to adjust, requires court action.\textsuperscript{116} The power to adjust provisions generally track the Uniform Act, and both provisions exclude situations deemed to be inappropriate; such as where the power to adjust or the power to convert might contravene the express intent of the settler; or where they might cause a tax benefit to be lost, such as where a charitable or marital deduction has been taken, or where the trustee having these powers might cause the trustee to be considered the owner of the trust for income or federal estate tax purposes.\textsuperscript{117} Maine followed the provisions in the Uniform Act to exclude charitable trusts from the unitrust conversion unless both the income and principal is set aside for charity.\textsuperscript{118} This is probably not optimal, since it will exclude some partially charitable trusts from conversion where there was no charitable deduction taken, such as where a portion, but not all, of the trust remainder passes to charity. The Pennsylvania act limits the application of that provision to exclude trusts where the charitable deduction has been taken. This appears to be an overbroad provision in the Uniform Act which will be unhelpful to the relatively small portion of trusts within that category.

The state of Washington followed the provisions of the Pennsylvania statute with reference to the unitrust provisions even more closely than did Maine, so a partially charitable remainder would not eliminate the power to convert to a unitrust.\textsuperscript{119} Their power to adjust provisions have several interesting differences from the Uniform Act. First, a personal representative with nonintervention powers may have the power to adjust, if the personal

\textsuperscript{112}MRSA §7-705(d), (g).
\textsuperscript{113}See id. §7-705(g).
\textsuperscript{114}See id. §7-705(f)(2).
\textsuperscript{115}See id. §7-705(e).
\textsuperscript{116}See id. §7-705(g).
\textsuperscript{117}See id. §7-704(c), 7-705(i).
\textsuperscript{118}See id. §7-705(i)(2).
\textsuperscript{119}See RCW §106(l)(1).
representative is investing and managing the assets of the estate as a prudent investor.\textsuperscript{120} Unless a beneficiary has requested the fiduciary to make an adjustment, there is no duty on the fiduciary to do so, though they would have the power to do so.\textsuperscript{121} The statutes across the country differ significantly in how much protection they offer a trustee with reference to the exercise of the power to adjust and the conversion to a unitrust, though this issue has obviously been an important legislative consideration everywhere such legislation has been enacted.

While Florida followed the trend of providing both the power to adjust and the unitrust remedy, its provisions have some significant differences from the legislation elsewhere. One of the significant differences is that with respect to the power to adjust, there is significantly more detail and process involved in its implementation than elsewhere. The effective date of the legislation is January 1, 2003, but before an adjustment power can be exercised for a trust already in existence as of the effective date, the trustee must first give to all reasonably ascertainable current beneficiaries and all reasonably ascertainable remainder beneficiaries a notice with detailed information about the power to adjust and the fact that it can be blocked by a supermajority of the beneficiaries (2/3\textsuperscript{rd}) who object to its exercise.\textsuperscript{122} If the power to adjust is blocked by a supermajority of the beneficiaries, it cannot be exercised without court approval for a period of one year, following which the process could repeat itself!\textsuperscript{123} This procedure, imposed to address retroactively concerns, seems like a lot of process to implement a remedy whose primary advantage is its flexibility. Once the notification is given, however, assuming a supermajority does not object, then the flexibility should be real enough. The detailed provisions in the statute as to the contents of the notice before the application of the power to adjust do not indicate the way in which the power to adjust might be exercised, making one wonder how a beneficiary might react to such a power necessarily outlined in the abstract.\textsuperscript{124} There are provisions in the Florida Act to protect the trustee in the event of a good faith mistake in the notification process and there is no implied duty to make an adjustment.\textsuperscript{125}

The total return unitrust provisions of the Florida statute are also a blend of several of the other statutes, but with a Florida twist. Generally, a trustee may, without court approval, convert an income trust to a unitrust, convert a unitrust to an income trust, or change the percentage used to calculate the unitrust amount, or the method to determine the fair market value of the trust by a notification process.\textsuperscript{126} This portion of the statute, together with the right in the trustee to select a rate from 3-5\%, seems to have been borrowed from the Delaware statute discussed previously.\textsuperscript{127} But Florida added its own twist by allowing an alternative unitrust method whereby the rate would be the applicable Section 7520 rate divided by two, but in all events not less than 3\% nor more than 5\%.\textsuperscript{128} This provision sounds sensible but may not be the best

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\item[120] See \textit{id.} §104(e).
\item[121] See \textit{id.} §104(lh).
\item[122] See \textit{FRS} §738.104(a), (8)(a).
\item[123] See \textit{id.} §738.104(8)(e)2.
\item[124] See \textit{id.} §738.104(9) The trustee may include general information about the fiduciary obligations with reference to the power to adjust, but it is not clear how understandable this may be to the average beneficiary.
\item[125] See \textit{id.} §738.104(8)(e)1 (as to notice) and §738.104(7) as to no implied duty to adjust.
\item[126] See \textit{id.} §738.1041(2).
\item[127] See text at nn. 85-89.
\item[128] See \textit{FRS} §738.1041(2)(b)2. Our thanks to Bruce Stone of Miami, who provided helpful comments, and pointed out that this floating rate provision was intended to allow a trustee who was also a beneficiary to select the floating rate rather than having to appoint a disinterested party to select the rate between 3\% and 5\%.
\end{thebibliography}

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alternative, because the higher Section 7520 rate does not imply a higher “real” return, because
the higher interest rates are a general indication of higher inflation, and if our intent over the long
term is to distribute on a regular basis that “real” return, one half of the Section 7520 rate is
unlikely to fill the bill. What it would do is blend the unitrust method with the income rule in our
old style trusts, so the volatility of the distributions will be increased by making the distributions
more interest sensitive. If this were used in a high inflation, high interest rate bear market like the
1970’s, it would increase the payout when the markets went down, thus dampening the down
market for the beneficiary, but hurting the portfolio by distributing more when the markets are
low. If it were implemented in our recent bear market, with low interest rates and low market
values, it would exacerbate the decline in the beneficiary’s income. For example, the December
2004 7520 rate was 4%, so one half of that rate would have been 2%, a rate that would make
many income beneficiaries very unhappy, particularly after three years of a bear market.

The statute simply states that the trustee may determine the “method to be used in
determining the fair market value of the trust”. 129 The statute provides that the unitrust amount
may not be less than the net income of the trust where the marital deduction has been taken or
where the generation-skipping transfer tax does not apply by reason of any effective date or
transition rule, but it contains a proviso that the section will not apply if it is not necessary to
qualify for the marital deduction or to preserve the GST grandfathering. 130 An ordering rule is
included, and the trustee protected for good faith action or inaction. 131 A majority in interest of
the beneficiaries may petition the trustee to convert to a unitrust, and if the trustee fails to do so
within 6 months of the request, then the beneficiaries have standing to file a petition with the
court to convert the trust. 132

The most puzzling section of the legislation is the proviso that if the trust is one “with
respect to which a trustee currently possesses the power to adjust under s. 738.104” the trust may
not be converted to a unitrust. 133 It seems sensible that the trustee ought not exercise both the
power to adjust and the power to convert to a unitrust at the same time, but if this means that the
unitrust is only an alternative if the trustee is blocked from use of the power to adjust by a
supermajority of the beneficiaries, or by the fact that the trustee is an interested trustee, it would
seem to take away the trustee’s ability to choose the most appropriate approach for a particular
trust. If so, the choice of remedy is taking a back seat to a statutory preference for the power to
adjust.

Maryland’s statute followed much of the Pennsylvania model, but has some important
differences. For a trustee to convert the trust to a unitrust, the trustee must receive a written
request from a beneficiary. 134 This means that the trustee will not feel any pressure to consider
the conversion in the absence of a demand for it by the beneficiaries. In general the situations in
which court approval is required are the same as the Pennsylvania statute, with the exception that
the trustee can reconvert to an income trust with the same process that they converted to a
unitrust. One area where Maryland improved upon the Pennsylvania model is in defining the

129 See FRS §738.1041(2)(b)1.c.
130 See id. §738.1041(5).
131 See id. §738.1041(10).
132 See id. §738.1041(11).
133 See id. §738.1041(12)(e).
134 See id.
persons who should receive notice or changes under the unitrust provisions or the power to adjust, which they define as a “qualified beneficiary”. A qualified beneficiary is one who:

(1) Is a distributee or permissible distributee of the income or principal of the trust estate;

(2) Would be a distributee or permissible distributee of the income or principal of the trust estate if the interest of the distributes described in item (1) of this paragraph terminated on the date that notice is given by the trustee; or

(3) Would be a distributee or permissible distributee of the income or principal of the trust estate if the trust were to terminate on the date that notice is given by the trustee, and no powers of appointment were exercised.  

They also deal directly with the fact that if one of the individuals is a minor, the notice goes to the natural guardian, or if a disabled person, the guardian. Maryland was the first state to utilize the Uniform Trust Act definition of “qualified beneficiary” to better refine the notification process.

While the Florida statute seemed to favor the power to adjust approach to the problem, the Maryland statute tends to guide the trustee more towards the unitrust approach. Like the unitrust conversion, the power to adjust may be used only if the trustee receives a request from a beneficiary to exercise the power, but the trustee must also determine that a conversion of the trust to a unitrust is an inappropriate method of complying with the duty of impartiality. The trustee must then comply with the notice requirements like a unitrust conversion, or petition the court for its review of the proposed adjustment. Without a court approval, the power to adjust may not be exercised to increase the net income to above 4% measured as of the first day of the accounting period, or to decrease it below 4%.

It is interesting to observe the legislative frameworks in the several states that have enacted both the unitrust and the power to adjust, which despite their general structural similarities, seem to reflect significantly different attitudes towards the two approaches.

G. SOUTH DAKOTA, IOWA, NEW HAMPSHIRE AND ILLINOIS ENACT UNITRUST ONLY STATUTES

South Dakota, Iowa, New Hampshire and Illinois enacted unitrust only statutes in 2002, without an accompanying power to adjust.

135 See id.
136 See id.
137 See id.
138 See id. §15-502.2(A)(6).
139 See id. §15-502.2(C).
140 See SDC §55-15-1 et seq.
141 See Iowa Code §637-101 et seq.
142 See Iowa Code §637-101 et seq.
143 See Iowa Code §637-101 et seq.
South Dakota was the first to act, and its statute allows a trustee to convert a trust to a unitrust, reconvert a unitrust to an income rule trust, or change the percentage used to calculate the unitrust amount or the method used to determine the unitrust amounts by adopting a written policy to that effect and notifying the trustee, if living, the current beneficiaries and the remainder beneficiaries, provided that there is one legally competent person in each class, and no one objects within 60 days of the notice.\textsuperscript{144} South Dakota appears to have borrowed Delaware’s provisions concerning the appointment of a disinterested party if all trustees are interested under the Act.\textsuperscript{145}

The provisions concerning the calculation of the unitrust amount appear to raise a few questions, at least to this author. While it appears that the trustee would have a choice as to rate, it is not clear that the statute grants that authority:

The percentage that may be elected in determining the unitrust amount shall be a reasonable current return from the trust, taking into account the intentions of the trustor of the trust as expressed in the governing instrument, the needs of the beneficiaries, general economic conditions, projected current earnings and appreciation for the trust, and projected inflation and its impact on the trust. \textit{However, if such percentage is three percent or greater, or if no percentage is specified, then the percentage shall be three percent.}\textsuperscript{146} (emphasis inserted)

It is simply not clear how a percentage over 3\% could be elected.

The unitrust calculation excludes personal use property\textsuperscript{147} and the unitrust amount will not be less than the net income of the trust for a marital trust or a GST grandfathered trust.\textsuperscript{148} An ordering rule is expressly authorized.\textsuperscript{149} The trustee is protected against attack for any action taken or not taken, provided that it was done in good faith.\textsuperscript{150} And the statute expressly provides the strongest possible statement that there is no duty to take any action under the chapter, and no trustee will be liable for not considering whether to take any action or for choosing not to take any such action.\textsuperscript{151}

Iowa was the next state to enact their unitrust statute with a well thought out blend of Pennsylvania’s language along with a dash of Delaware’s provisions. Only the trustee has the right to make the conversion under the Iowa statute, but they can do it without court activity, and they can convert, reconvert, or change the method used to determine fair market value without

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\item \textsuperscript{142} See NHRSA §564-A:3-c.
\item \textsuperscript{143} See 760 ILCS 5/5.3.
\item \textsuperscript{144} See SDC §55-15-2.
\item \textsuperscript{145} See id. at §55-15-3.
\item \textsuperscript{146} See id. at §55-15-6(3).
\item \textsuperscript{147} See id. at §55-15-6(7).
\item \textsuperscript{148} See id. at §55-15-7.
\item \textsuperscript{149} See id. at §55-15-8(2).
\item \textsuperscript{150} See id. at §55-15-13.
\item \textsuperscript{151} See id. at §55-15-14. While understandable, protecting the trustee, and particularly the professional trustee, can go too far.
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court involvement. An interested trustee can make the same decisions provided that a disinterested person is appointed to determine the method of valuation and any assets which will be excluded from the calculation. Court approval is required to select a rate different from 4%, and the rate must be in the 3%-5% range provided for in the Proposed and Final Regulations. The Iowa statute provides for an ordering rule concerning capital gains, and a strong protective provision that the trustee may not be held liable for any action or failure to take any action in connection with the statute as long as the trustee has acted in good faith; the sole remedy being the conversion of the trust to a unitrust or the reconversion of the trust from a unitrust, whichever the case may be.

New Hampshire enacted its statute about the same time as Iowa, and based its wording on the Pennsylvania proposal very closely, in fact so closely that the only material differences are that the unitrust rate is 5%, rather than the 4% used in the Pennsylvania statute, and the cross references to the power to adjust in the Pennsylvania statute.

Illinois was the last of the states to adopt its unitrust statute in 2002, signed by their Governor on August 22, 2002. The Illinois statute shows statutory lineage connecting it to Pennsylvania, in opting for a 4% unitrust payout, when conversion is by a notification procedure by the trustee. Conversion by agreement of the trustee and all of the primary beneficiaries of the trust under Illinois trust law is a second avenue for conversion, and the same decisions may be made as if the conversion were made by court procedure, except that where the conversion is by agreement, the rate shall be not less than 3% not more than 5%. Notice, while similar to the procedure in Pennsylvania and elsewhere, is given to the current eligible income beneficiaries and to the beneficiaries who would be in line to receive benefits if the interests of all of the current beneficiaries were terminated. This is quite different from all of the other state statutes, since the beneficiaries who are the “next takers” are probably not the “remaindermen” in most cases, though in some cases they are the remaindersmen. For example, what if the trust provides income for life to spouse, and then on spouse’s death in trust for the children, and then on the children’s deaths, to the grandchildren? The Illinois statute would require notice to the decedent’s spouse and also to the decedent’s children, but not to the decedent’s grandchildren. So one can argue that the Illinois statute ignores the remaindermen’s interests where the next beneficiaries are not the remaindersmen. On the other hand, the provisions of the Pennsylvania statute seem to ignore the interests of the beneficiaries in the middle; in the hypothetical case, the decedent’s children. A beneficiary can bring an action to convert in Illinois, but must first bring her request to the trustee, and then may take the matter to court if the trustee fails to act within 6 months of the request.

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152 See Iowa Code §637.602. Iowa had previously enacted the Uniform Principal and Income Act, but without Section 104 of the uniform act.
153 Id. at §637.604-605.
154 Id. at §637.608.
155 Id. at §637.610.
156 Id. at §637.614.
157 See NHRSA §564-A:3-c.
158 See 760 ILCS 5/5.3(a).
159 See 760 ILCS 5/5.3(b).
160 Id. at 5/5.3(a)(3).
161 See 760 ILCS 5/5.3(c)(2).
The Illinois statute contains an ordering rule which starts with regular net income (accounting income of the trust), then ordinary income not included within regular net income, before distributing short and long term capital gains. Unique to the Illinois statute is the ability of the trustee to release the power to convert to a unitrust just because the trustee feels that it is in the best interests of the trust to do so. In virtually all of the other state laws involving either the power to adjust or the power to convert to a unitrust, the power to release either remedy was based upon tax concerns or difficulties, whereas this statute allows the release just because the trustee thinks that the release is a good idea. The trustee is protected from claims made against him for any actions taken, or not taken, provided the trustee acts in good faith. In addition, the exclusive remedy is the conversion or reconversion to or from a unitrust, whichever is appropriate. The action or inaction of a trustee under the act is presumed further to be reasonable and in good faith, and is barred by the statute of limitations of 2 years from the date that the trustee gave written notice of an action such that the objectant knew or should have known of the action complained of. The Illinois statute did not go in the direction of the Delaware statute in dealing with a situation where all of the trustees are interested, but instead relied upon the court procedure to “cleanse” any decision made by an interested trustee.

Illinois is in the process of amending its law as well to respond to the issuance of the Final Regulations as discussed in Section X, E by adding a section that deals directly with trusts which are expressly drafted as unitrusts.

A detailed discussion of how to approach the implementation of one of these unitrust statutes is provided in Section XIX of these materials, focusing on the statutory provisions applicable in Pennsylvania, and examining the choices and strategies available to the trustees today.

H. OHIO ADOPTS THE FIRST TRU SAFE HARBOR

Late in 2002, Ohio adopted its own version of the Uniform Principal and Income Act effective January 1, 2003. Unlike the majority of the most recent legislation, Ohio did not adopt either the power to adjust or the power to convert to a Unitrust or both in their purest form, but chose instead a hybrid with the power to adjust as provided in the UPAIA with the strongest possible safe harbor provisions for upward adjustments of income not to exceed a 4% unitrust distribution. The power to adjust is contained in O.R.C. §1340.42, with the typical operative language, factors, qualifications, and exclusions, but perhaps the most critical language is contained in §1340.42(G), which provides perhaps the strongest protective language for the

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162 See 760 ILCS 5/5.3(f)(2).
163 Do we want to give the trustee the power to avoid these choices that are so central to investing and distributing the trust? It would clearly increase the comfort level of trustees not wanting to exercise the powers in certain trust situations, but is it a good idea to give them the power to release themselves from considering their options on a continuing basis? This is an easier question to phrase than it is to answer, in this author’s opinion.
164 See 760 ILCS at 5/5.3(k).
165 Id. at 5/5.3(c).
166 Illinois House Bill 1080, passed on June 25, 2004 and sent to the Governor for consideration over the summer.
167 H.B.No. 522, enacting O.R.C. §§1340.40-1340.42, 1340.46, 1340.47, 1340.51-1340.53, 1340.57-1340.59, 1340.63-1340.66, 1340.70-1340.77, 1340.80-1340.86, 1340.90, 1340.91 and repealing various sections.
benefit of the trustee of any of the total return statutes with the possible exception of Illinois’ unitrust conversion statute.168

(G) The liability of a trustee relative to the exercise of adjustment authority conferred by divisions (A) to (F) of this section shall be limited in the following manner:

(1) Unless a court determines that a trustee has acted in bad faith, no trustee shall be held liable for damages for choosing not to make an adjustment.

(2) Unless a court determines that a trustee has acted in bad faith with respect to an adjustment, the sole remedy to be ordered by a court shall be a prospective correction of the adjustment.

(3) For purposes of this section, and subject to division (C) of this section, from time to time a trustee may make a safe-harbor adjustment to increase net trust accounting income up to and including an amount equal to four per cent of the trust’s fair market value determined as of the first business day of the current year. If a trustee determines to make this safe-harbor adjustment, the propriety of this adjustment shall be conclusively presumed. Nothing in division (G)(3) of this section prohibits any other type of adjustment authorized under any provision of this section. (Emphasis inserted)

In a number of ways, the Ohio statute grants trustees far greater protection than Section 105 of the UPAIA. First, Section 105 of the Uniform Act uses a general abuse of discretion standard.169 This is likely the standard under the Ohio statute as well for the court to grant some remedy, but for the trustee to be liable in damages for choosing not to make an adjustment, the court must affirmatively find bad faith, an extremely tough standard; and again, if an adjustment is made, the sole remedy for an adjustment that is allegedly improper shall be a prospective correction of the adjustment unless a bad faith finding has been made.170 Section 105, on the other hand, expressly allows damages from the trustee’s own funds if the parties cannot otherwise be placed in the position they would have been but for the abuse of discretion.171 If the Ohio statute stopped there, it would already grant perhaps the greatest statutory comfort of all total return statutes to the professional fiduciary. But it does not stop there. A trustee can, from time to time, make a “safe-harbor” adjustment to increase the “net trust accounting income” up to and including an amount equal to 4% of the fair market value of the trust as of the first business day of the current year, and if such an adjustment is made, the “propriety” of the adjustment shall be conclusively presumed. Taken as a whole, the power to adjust can be used safely by the trustee subject only to

168 See text at n.161.
169 See text at n.72.
170 O.R.C. §1340.42(G)(1)-(2).
171 See text at n.72.

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a bad faith standard, and if it is within the safe harbor territory up to 4%, the adjustment would be safe from any ordinary attack.

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

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

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

3. It is unclear whether under the Ohio statute, an express unitrust paying out 3% or 4% to a surviving spouse would qualify for the marital deduction under the Proposed and Final Regulations. One could argue that it should, because of the strong safe harbor provisions contained in the power to adjust which allow the power to adjust to function essentially as a unitrust. Still, however, the power to adjust is a power, it is not a unitrust method, and there is no express unitrust definition of income to point to in order to avoid the necessity in a marital trust of having to pay out the income or the unitrust amount, whichever is greater. Interestingly, as discussed later in these materials, Texas adopted a state law unitrust definition of income in addition to the power to adjust, so that a trust drafted expressly as a unitrust paying out a unitrust distribution within the range of 3-5% is considered to be “income” for
state law purposes, and, inferentially, for the marital deduction as well.\footnote{172}{See discussion at n. 222.}

In the absence of additional reliable guidance, preferably in the form of a TAM or Revenue Ruling, it seems unlikely that the Ohio statute is sufficient state law support for a qualifying marital unitrust without paying out the net income if greater than the unitrust amount.

4. The Ohio statute only provides a safe harbor for an \textit{upward adjustment}, not a downward adjustment, and while this is the more pressing need at present, there may come a time when this is unduly limiting. For example, had a trustee had the prescience to sell her equity holdings in February of 2000 and invest entirely in bonds, one would hope that the power to adjust would allow the trustee to allocate at least a little bit of the yield to principal, presumably at least down to 4\%, since otherwise the asset allocation would seem prejudicial to the remainder beneficiaries (although in hindsight, it would have been helpful to both the current and remainder beneficiaries). And it is well to remember that interest rates always take into account inflationary expectations that are effectively built into the interest rates themselves. In the period from 1977 to 1980, inflation as measured by the consumer price index actually exceeded the very high interest rates in those years,\footnote{173}{Intermediate Government Bond Yields 1977-1980 were 6.49\%, 7.83\%, 9.04\% and 10.55\%, respectively, while inflation totaled 6.77\%, 9.03\%, 13.31\%, 12.40\%, respectively. \textit{See Ibbotson Associates}, \textit{supra} n. 21, at Table 2-6, pp. 40-41 and Table A-15, pp. 252-253.} and in such an environment, it is particularly critical that the trustee be able to adjust down, as well as up.

For states desiring hybrid legislation of the safe harbor unitrust standard, Ohio’s more recent statute seems a better model from which to start from than the New Jersey legislation, which provides much less protection for the trustee, with only a presumption that an adjustment within the safe harbor limits is fair and reasonable to the parties involved.

\section{I. INDIANA ADOPTS A UNITRUST STATUTE TO SUPPLEMENT THE POWER TO ADJUST.}

Indiana was the first state in 2003 to enact a unitrust statute, to be effective on July 1, 2003, supplementing its previously enacted Uniform Principal and Income Act with the power to adjust.\footnote{174}{House Enrolled Act No. 1115. IC 30-2-14-15. http://www.in.gov/serv/lsa_billinfo?request=getBill&doctype=HB&docno=1115&year=2003&sess=1} While many of the provisions are similar to the Pennsylvania statute, there are important differences as well. The Indiana statute allows a 4\% default rate for its unitrust conversions, but it allows a selection of from 3-5\% with agreement of the trustees and the beneficiaries, or as ordered by the court, in this respect most similar to the Illinois legislation.\footnote{175}{IC 30-2-15.(c) \textit{Compare} discussion text at n. 157.}

The three year averaging rule is not employed until the third year,\footnote{176}{\textit{Id.} at Sec. 16.} and property used by the beneficiary, such as a personal residence, is not included for purposes of calculating fair

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market value.\textsuperscript{177} The unitrust amount is not to be less than the net income from the trust to the extent necessary to preserve a tax benefit, such as the marital deduction.\textsuperscript{178} The statute contains an ordering rule to funnel out capital gains to the extent necessary to make up the unitrust division, and the statute employs language that the unitrust distribution will be “considered to have been paid” from short and long term capital gains, avoiding any implication of a strict sourcing rule.\textsuperscript{179}

Like the Illinois and Ohio legislation, Indiana’s unitrust conversion statute specifically provides that a trustee is not liable to any person affected by the action or inaction under the statute, as long as the trustee acts in good faith.\textsuperscript{180} The exclusive remedy of an aggrieved party is an order of court directing the trustee to take action to convert to a unitrust from an income trust or from a unitrust to an income trust.\textsuperscript{181}

\section{J. NORTH CAROLINA AND OREGON ADOPT THE POWER TO ADJUST AND THE UNITRUST WHILE COLORADO ADDS THE UNITRUST}

The late spring and early summer of 2003 saw a trio of states adding the unitrust to their principal and income laws, with North Carolina and Oregon adopting the uniform law with the power to adjust at the same time, while Colorado added the unitrust in a separate total return trust bill, having already adopted the uniform act and the power to adjust.

Colorado added a new section to its principal and income law to allow conversions to a total return trust, its style and content borrowing primarily from Pennsylvania and Illinois.\textsuperscript{182} If the trust is converted to a total return trust, the power to adjust does not apply.\textsuperscript{183} A trust may be converted to a total return trust by the trustee, by agreement or by the Court. Conversion by the trustee requires that the trustee send out notice to all of the qualified beneficiaries at least 60 days before the conversion;\textsuperscript{184} those qualifying beneficiaries consisting of the current beneficiary, the next current beneficiary after the current beneficiaries’ interest terminates, and the distributees if the trust terminated at that time.\textsuperscript{185} If none of the beneficiaries objects within the 60 day period, the conversion will occur. This definition of “qualified beneficiary” taken from the Uniform Trust Act, provides full notice to all necessary parties in interest, but only requires that there be a sui juris beneficiary in one of the two latter classes, thus avoiding unnecessary court action in many cases.

Conversion by agreement follows the same general pattern as Illinois, in which an agreement of the trustee and all qualified beneficiaries of the trust allows a conversion and the selection of a rate between 3-5\%.\textsuperscript{186} as does a conversion by the Court\textsuperscript{187}, while 4\% is the

\textsuperscript{177} Id. at Sec. 18.
\textsuperscript{178} Id. at Sec. 23.
\textsuperscript{179} Id. at Sec. 25.
\textsuperscript{180} Id. at Sec. 26.
\textsuperscript{181} Id.
\textsuperscript{182} Colo. Rev. Stat. § 15-1-402 et seq.
\textsuperscript{185} Colo. Rev. Stat. § 15-1-402(10.5).
\textsuperscript{186} Colo. Rev. Stat. § 15-1-404.5(2).
standard for a trustee conversion. The statute incorporates an interesting set of tests to judge trustee liability for acting or failing to act under the statute:

(11) Remedies. (a) A trustee who reasonably and in good faith takes any action or omits to take any action under this section is not liable to any person interested in the trust. An act or omission by a trustee under this section shall be presumed to be reasonable and undertaken in good faith unless the act or omission is determined by the court to have been an abuse of discretion.

It is difficult to see how the trustee’s actions could be held to be “reasonable” if they have already been determined to have been an abuse of discretion, so it is a bit difficult to see how these standards fit together, but the statute taken as a whole is clearly intended to be quite protective of the trustee, and includes a 6 month statute of limitations as against anyone who has received a statement that clearly reveals the matter about which they complain. In addition, the statute expressly provides that there is no duty to inform a beneficiary about the power to convert to a total return trust, nor is a trustee required to review any trust to determine if the section should be applied unless the trustee is requested to do so in writing by a qualified beneficiary. Many of the more minor decisions relating to the trust are left up to the trustee, similar to the Pennsylvania approach.

North Carolina passed and signed its new principal and income law into effect on June 19, 2003, effective January 1, 2004, which contained both the power to adjust and the power to convert to a unitrust. The unitrust portion of the statute resembles the Delaware statute, granting the trustee the discretion to convert to a unitrust and to choose a rate of distribution between 3-5%. If the trustee is independent, she can either make the conversion, reverse the conversion, or change the rate, using the same relatively simple notice process, by adopting a written policy for the trust so that for a unitrust conversion, the future distributions shall be unitrust amounts rather than net income, and she gives notice of the intent to the grantor if living, and all competent current beneficiaries, and all competent beneficiaries who would be remaindermen if the trust were to terminate at the time of the notice.

Like the Delaware statute, if there are no disinterested trustees to take this action or make these choices, the trustees can make the conversion or reconversion, or propose to change the distribution rate by appointing a disinterested person to determine the distribution rate and the method of valuation and any assets to be excluded from the computation.

In making the determination of the proper unitrust rate between 3% and 5%, the trustee or disinterested party (or the Court if court approval were sought) is to take into account “the intentions of the grantor of the trust as expressed in the governing instrument, the needs of the beneficiaries, general economic conditions, projected current earnings and appreciation for the trust, and projected inflation and its impact on the trust.”\(^{197}\) Note that the “needs of the beneficiaries” are expressly stated to be taken into account, while the Uniform Act and the phrasing of other states’ laws is less direct. However, despite the somewhat more oblique language of the Uniform Act, adopted in most cases by the states, it would seem that the needs of the beneficiaries are likely to be taken into account in the exercise of discretion with the power to adjust or the exercise of a power to convert in virtually all cases. How could it be otherwise?

For marital deduction trusts for which a marital deduction has been taken, or which are GST grandfathered, the unitrust amount shall never be less than the net income.\(^{198}\) Interestingly, the statute also gives the surviving spouse for a trust for which the marital deduction has been taken, the power to direct that the trust be converted to a unitrust, or from a unitrust to an income trust.\(^{199}\)

The statute includes section 105 of the Uniform Act, designed to help protect the trustee in its exercise of the power to adjust\(^{200}\), but gives even stronger protection to a person making a decision under the unitrust conversion section, where the statute provides that there shall be no liability for any such discretionary decision\(^{201}\).

Oregon adopted its new principal and income act with both the power to adjust and the power to convert to a unitrust, the latter based most closely on the Pennsylvania statutory model.\(^{202}\) The notice provisions are very similar to the Pennsylvania statute, requiring notice to current and potential remaindermen.\(^{203}\) The valuation date is prescribed to be the first business day of each calendar year,\(^{204}\), but the trustee is given discretion as to how to treat short years, what to do about contributions to or distributions from the trust, what to do about valuing non-liquid assets, and whether to omit “use” property for purposes of the unitrust computation.\(^{205}\) The distribution rate of 4% is prescribed by the statute, and there is no express provision allowing the court or the parties to choose a different rate.\(^{206}\) There is a mandatory ordering provision as well, and a three year smoothing rule is prescribed unless a different period is ordered by the court.\(^{207}\) The Court may order the distribution of net income if greater than the unitrust amount, to “preserve a tax benefit”, presumably the marital deduction or GST grandfathering.\(^{208}\) If all trustees are prohibited from exercising the conversion power because to do so would make the

\(^{198}\) N.C. Gen. Stat. § 37A-1-104.4(c).
\(^{202}\) O.R.S. Sections 129.001 et seq.
\(^{203}\) O.R.S. Section 129.004b(2)(b). But not to “mezzanine” beneficiaries, that is, current beneficiaries who would take after the present income beneficiaries’ interest ceases (which is not necessarily at the termination of the trust).
\(^{204}\) O.R.S. Section 129.004b(4)(c).
\(^{205}\) Id.
\(^{206}\) O.R.S. Section 129.004b(4)(b).
\(^{207}\) O.R.S. Sections 129.004b(4)(b), 129.004b(4)(e) and 129.004b(5).
\(^{208}\) O.R.S. Section 129.004b(5).
trust a grantor trust or includible in an individual’s estate, a trustee may file a petition and seek a court order of the requested action.\textsuperscript{209}

K. ALASKA UPDATES ITS PRINCIPAL AND INCOME LAWS WITH BOTH THE POWER TO ADJUST AND THE UNITRUST

Generally speaking, Alaska is usually a frontrunner in the trust field, with its legislation leading, rather than following, the pack. In this particular area, Alaska did not get into revising its principal and income laws until somewhat later, and as a result became the 17\textsuperscript{th} state to adopt total return unitrust legislation, signed into law July 18, 2003.\textsuperscript{210} Having waited a while longer, however, they were able to adopt a model statute based closely upon the Pennsylvania model, but with some refinements, technical corrections and suggested “improvements”, drawing on prior experience and second guessing of our own legislative efforts in Pennsylvania.

The Alaska legislation provides for both the power to adjust and the unitrust very similar to Pennsylvania, but included some changes; some very fine points, and some more major. On the power to adjust, the Uniform Act prohibits an adjustment from any amount permanently set aside for charitable purposes unless both principal and income are set aside. The Alaska statute limits the proviso so that the power to adjust cannot be so used only if a federal estate or gift tax charitable deduction has been taken. This makes it clear that the power to adjust can be used where there is a partially charitable remainder to an otherwise private trust.\textsuperscript{211} The uniform act requires that the trustee be investing the trust assets as a prudent investor, while the Alaska statute requires that the trustee follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived from appreciation, earnings and distributions, or both.\textsuperscript{212} This is the same criteria used for the conversion to a unitrust later, and it focuses the investment policy on the investment for total return, not the entire prudent investor statute, which includes a lot more than just total return investment policy. Since the Prudent Investor Act is a default statute, it is appropriate that we not require the trust to import all of prudent investing to have the benefit of the power to adjust. In Pennsylvania, we omitted the prudent investment requirement for the power to adjust, as being too limiting, but did not insert an investment for total return requirement. If one were investing for income and appreciation separately, the power to adjust and the power to convert to a unitrust would not really make sense!

Section 105 of the uniform act with appropriate additions for the unitrust conversion power, is added to emphasize that both of these powers are held by the trustee as an exercise of discretion, and no liability will attach unless there is an abuse of that discretion, and there is no other way to put the parties in the position they would have been had the abuse of discretion not occurred.\textsuperscript{213}

\textsuperscript{209} O.R.S. Section 129.004b(7).
\textsuperscript{210} ALASKA STAT. § 13.38.200.
\textsuperscript{211} ALASKA STAT. § 13.38.210.(c)(4).
\textsuperscript{212} ALASKA STAT. § 13.38.210 (a)(3).
\textsuperscript{213} ALASKA STAT. § 13.38.220.

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The unitrust conversion power requires notice to the beneficiaries currently eligible to receive distributions from the trust, those who would be eligible to receive income from the trust if the interest of all of the current income beneficiaries were to terminate immediately before the time of giving notice, and who would receive principal of the trust if the trust were to terminate at that time, borrowing upon the proposed correction to the Pennsylvania statute, which in turn borrowed this standard from the Uniform Trust Act.\textsuperscript{214}

Like the Pennsylvania statute, the unitrust distribution rate will be 4\%.\textsuperscript{215} The three year smoothing rule applies only after the trust has been administered as a unitrust for three years.\textsuperscript{216} This is helpful in the present context in that the three year rolling period, while ordinarily helpful, may be unhelpful when we are just coming out of a bear market, so we still have market values in the three year period that are considerably higher than the present, and thus may lock in a decrease in the distribution in the early years of the unitrust administration. While retaining the ordering provision, which this author thinks is both helpful and appropriate, the language is changed slightly to indicate that the unitrust distribution is “considered to have been paid from net income…” etc.\textsuperscript{217} This is in response to Dick Covey’s correct criticism that the Pennsylvania statute is literally a strict sourcing rule. Does the unitrust payment really have to be paid from those precise funds, or are we really talking about tax theory? This modification allows the trustee not to worry about strict sourcing, if they would otherwise have been concerned. While prohibiting conversions where tax problems may arise, the statute makes it clear that a charitable trust is eligible for conversion, if both the principal and the income are set aside for charity.\textsuperscript{218} This result is inferred in the Uniform Act by only prohibiting the adjustment when not both income and principal are so set aside. Separate provisions are included for charitable trusts electing into the unitrust regime, which, like Pennsylvania gives the trustee the power to adopt a payout of from 2 to 7\%, but in addition adds a specific reference to Section 4942 of the Code to incorporate the minimum 5% distribution proviso where necessary.\textsuperscript{219} It also allows the trustee discretion to opt for a three year smoothing rule, a longer period, or none at all, depending upon what seems best for the charity.\textsuperscript{220} There is no reason to lock the charity into a smoothing regime, when in some cases they may not feel that they need it, and in other cases, it is not effective because of the application of Section 4942, which is based upon the average monthly values of the current tax year, rather than prior tax years. The necessity of adding the provision concerning private foundations is unfortunate, as it does not allow the trustee to know the required grant distribution amounts for the current year until literally the end of the year!

A trustee may reconvert a unitrust to an income trust using the same process as is used for conversion.\textsuperscript{221} After reflection on our Pennsylvania statute and the passage of time, this author has concluded that this seems the better rule. Requiring court approval for a reconversion from a unitrust to an income trust may have a chilling effect upon the trustee adopting the

\textsuperscript{214} ALASKA STAT. § 13.38.300(2).
\textsuperscript{215} ALASKA STAT. § 13.38.330 (b).
\textsuperscript{216} ALASKA STAT. § 13.38.330 (c).
\textsuperscript{217} ALASKA STAT. § 13.38.350(b).
\textsuperscript{218} ALASKA STAT. § 13.38.380(b).
\textsuperscript{219} ALASKA STAT. § 13.38.440-480.
\textsuperscript{220} ALASKA STAT. § 13.38.480.
\textsuperscript{221} ALASKA STAT. § 13.38.400.
unitrust approach, as she may feel “locked in” to the unitrust. It is better to provide equal freedom of movement in both directions.

Alaska also took on the issue of interest on pecuniary bequests and basically eliminated it in favor of an interest in the fractional share of the income in the estate prior to distribution. With the elimination of the deduction for the interest on pecuniary bequests, such interest is clearly best avoided wherever possible.

L. TEXAS DOES ITS OWN THING—WITH THE POWER TO ADJUST, AND NO POWER TO CONVERT TO A UNITRUST, BUT A SEPARATE ALTERNATIVE UNITRUST DEFINITION TO HELP UNITRUST DRAFTERS

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

(2) “Unitrust amount” means a distribution mandated by the terms of a trust in an amount equal to a fixed percentage between three and five percent per year of the net fair market value of the trust’s assets, valued at least annually. The unitrust amount may be determined by reference to the net fair market value of the trust’s assets in one year or more.

Distribution of the unitrust amount is considered a distribution of all of the income of the unitrust and may not be considered a fundamental departure from applicable state law. A distribution of the unitrust amount reasonably apportions the total return of a unitrust. 222

By providing a statutory unitrust definition of income, Texas’ new statute should allow a drafter to use the unitrust for marital deduction purposes without having to provide for the “income if greater” which under the Proposed Regulations would allow the unitrust definition of income to stand on its own only if consistent with applicable state law.

A current chart of all of the jurisdictions having either the power to adjust or the power to convert to a unitrust is added at the end of these materials as Appendix 12. The Appendix also indicates those states with legislation in process that are known to the author at this time. References and URL sites where available are provided in Appendix 12.

M. KENTUCKY AND VIRGINIA ARE ADDED TO THE LIST IN 2004

Virginia joined the ranks of states with both the power to adjust and the power to convert to a unitrust by adopting a unitrust conversion statute modeled very closely upon the Delaware unitrust statute. 223 Thus a trustee is able to convert to or from the unitrust regime without the

223 Va. Code. 55-277.4:1

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need for court approval in almost all cases with 60 days’ written notice to the grantor, if living, the income beneficiary, the remainder beneficiary if the trust provides for termination, or the next income beneficiary if it does not. Like the Delaware statute, the trustee may choose a rate not less than 3%, nor more than 5%, the full range expressly allowed by the Proposed Regulations and the Final Regulations discussed in Article X, D. and E.

Because the Virginia statute was passed subsequent to the Final Regulations, several protective provisions of the Delaware statute were left out—specifically, the requirement that the unitrust amount be not less than the “net income” of the trust if the trust is a marital trust or a grandfathered trust for Generation Skipping Transfer tax purposes. This is helpful, since those provisions should be unnecessary at the present time and are otherwise not desirable from a theoretical standpoint. Apart from eliminating the now unnecessary language referred to above, the Virginia statute is virtually a clone of the Delaware statute, with the exception that the trustee

[s]hall treat the unitrust amount as if it were income of the trust for purposes of determining the amount of trustee compensation where the governing instrument directs that such compensation be based wholly or partially on income.

For trusts where the trustees’ compensation is still computed as a percentage of the income, in whole or in part, then, the unitrust percentage would be treated as “income” for this purpose as well. Some might wonder whether this is a wise provision, as there is the potential for some conflict of interest in the trustee’s decision, but the author suggests that it is perfectly sensible, for the same reason that adjusting the income to a reasonable level with the power to adjust or a unitrust conversion is sensible for the income beneficiary. Other states have not addressed this issue with specific language, though the author suggests that if a trust is converted to a 4% unitrust, and the 4% is “income” for every other purpose, it should also be “income” for determining trustees’ compensation directed to be taken as a percentage of “income”. While there are not a great number of trusts where the trustees’ fees are determined in that manner, the trustee might well be treated unfairly without this interpretation, since the decline in interest and dividend income would affect her just as it would have affected the income beneficiary, and the absence of such a rule would push a trustee towards investing more in high income producing assets, just as the need of the income beneficiary would do so.

Virginia, and any other states modeling their unitrust statute after the Delaware statute, might do well to review the Delaware amendments which improve their statute in several respects and tie in the Delaware statute to the trust that is drafted as a unitrust, as opposed to converted to a unitrust. These provisions are discussed in some detail in Article X, F.

Kentucky modeled its new Principal and Income Act after the Uniform Act, but with some very important differences. It is first important to understand that Kentucky did not adopt

224 Id. at 55-277.4:1.B.
225 Id. at 55-277.4:1.F.
226 12 Del. Code §3527 (g). The Delaware statute has been updated in response to the Final Regulations and this provision has been removed. See Discussion of Delaware updating at Article X, F, with the updated statute set out in Appendix 12.
the Uniform Prudent Investor Act, but a statutory “prudent investor rule”\textsuperscript{228} which applies to banks with trust powers and trust companies, but does not apply to individual fiduciaries, unless the individual fiduciary elects into the prudent investor rule, with Court approval.\textsuperscript{229}

The corresponding section of the Kentucky statute to Section 104 reads as follows:

A trustee may adjust between principal and income to the extent the trustee considers necessary if KRS 287.277 applies by law or by election made and approved under subsection (1) of this Act, the terms of the trust describe the amount that may or shall be distributed to a beneficiary by referring to the trust’s income, the trustee determines, after applying the rules in subsection (1) of Section 2 of this Act, that the trustee is unable to comply with subsection (2) of Section 2 of this Act and the adjustment, including an adjustment method such as an annual percentage distribution if the percentage is not less than three percent (3%) nor more than five percent (5%) of the fair market value of the trust assets determined annually, is approved by the District Court.\textsuperscript{230}

The term “District Court” is a defined term, requiring the consent of all current beneficiaries; all remainder beneficiaries in the oldest generation; and the court.\textsuperscript{231}

The requirement that an adjustment be approved by the beneficiaries and the District Court is a very significant modification to the Uniform Act that would take away much of the flexibility afforded the trustee by the power to adjust. To ask the permission of all parties and the court before making any adjustment would severely discourage making any sort of \textit{ad hoc} adjustments on a year to year or from time to time basis. Interestingly, though, Kentucky elevated a portion of the comment from the Uniform Act Section 105 discussed previously to the text by explicitly allowing “an adjustment method such as an annual percentage distribution if the percentage is not less than three percent (3%) nor more than five percent (5%) of the fair market value of the trust assets determined annually.” This increases the strength of authority for the District Court to effectively convert a trust to a unitrust, though without expressly saying so.

In melding the power to adjust with the power to convert to a unitrust, and requiring beneficiary and court approval, Kentucky also left out the factors listed in the Uniform Act for consideration, which were in part borrowed from the Prudent Investor Act.\textsuperscript{232} In all likelihood, this was done to avoid the perception that the trustee would have to document consideration of all of those factors, though there is nothing placed in the statute to take its place in providing guidance to the trustee, with the exception of the reference to the adoption of a unitrust payout of between 3% and 5%.

\begin{thebibliography}{9}
\bibitem{228} KRS 287.277.
\bibitem{229} KRS 386.454.
\bibitem{230} KRS 386.454, Section 3.(2).
\bibitem{231} KRS 386.454, Section 1.(3).
\bibitem{232} See UNIF. PRINCIPAL AND INCOME ACT, \textit{supra} note 10, §104(b) discussion at Article V, C.
\end{thebibliography}
It would appear to the author that there may be some difficulty with the implementation of a unitrust philosophy through the Kentucky statute, in the protective language of Act, at least as respects marital trusts or trusts intending to qualify for the gift tax annual exclusion:

(4) A fiduciary shall not make an adjustment:
   (a) That diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax deduction would be allowed, in whole or in part, if the fiduciary did not have the power to make the adjustment;
   (b) That reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion.

For a marital trust, depending upon the interest rate climate, a conversion to a 3% or 4% unitrust could diminish the income interest if the income at some future time were to be greater than the 3% or 4% unitrust payout. Hence, to be safe that the adjustment method is justified under the statute, a Kentucky court would presumably have to describe the method for a trust which qualifies for the marital deduction as a unitrust method or income, whichever is greater, rather than as just the unitrust payout. This is not ideal, as at some future time, this sort of a distribution scheme may produce the type of conflict of interest between the income beneficiary and the remainder beneficiary that the Uniform Act and the unitrust conversion statutes are intended to avoid in the investment process. As discussed in Article X, E., the Final Regulations would allow a unitrust payout to be followed without the “income if greater” language for a state with a unitrust definition of income. This is not likely to be possible in Kentucky, because of the built in limitations of the power to adjust, which cannot be used to decrease the interest of the spouse in a marital trust.

Adding further difficulty to the application of the Kentucky statute to create a unitrust interest is the fact that the “actuarial value” of an “income” interest for tax purposes is based upon what amounts to a payout of the 7520 rate of interest. Hence, a life income interest of a 50 year old surviving spouse would be 70.005% at the August, 2004 7520 rate of 4.8%. A 4% unitrust interest for a 50 year old surviving spouse would be 64.015%, a decrease in the actuarial value. Of course the problem is not the Uniform Act or the unitrust method so much as it is the way the IRS values income interests, which assumes that the total return equals the 7520 rate, and that the entire return is distributed to the “income” beneficiary, neither of which assumptions is realistic or an accurate reflection of trust investing and distributing. But taken at face value, neither a marital trust, nor one intended to obtain an annual gift tax exclusion (a much less important class of trusts, to be sure) could be converted into a straight unitrust by virtue of the Kentucky statute.

Many of the state unitrust statutes passed before the Final Regulations provided for the payout of the “income” if greater than the unitrust amount automatically, so the problem is not limited to Kentucky, but it is submitted that constructing a unitrust statute separately is the better choice, along with the alternative of the power to adjust, rather than simply using the power to
adjust to create a *de facto* unitrust. They are fundamentally not the same thing—one is a power, the other a method, with separate and different virtues and deficits.

It is also particularly appropriate to address the ordering of income so that a unitrust amount can include short and long term capital gains. This is helpful both in creating a clear rule, and in allowing a larger distribution to be prudent, since the payment of capital gains taxes by the trust when much of the capital gains benefits are likely being distributed by virtue of a unitrust payout or an adjustment from principal to income. This is less of a problem with the Uniform Act, since the trustee can take the tax effect into account in making her adjustment, but with the use of a unitrust method, it must have support in applicable local law and be applied on a consistent basis, as discussed in connection with the Final Regulations in Article X, E.

**VII. DESIGNING A NEW GENERATION OF TRUST VEHICLE**

How do all of these changes in state laws relate to our trust and estate planning goals? What are the options for the future as we plan and draft our trusts? Once we examine these choices and the way the options stack up against one another, the reasons for the trends in state laws will become relatively clear.

**A. GOALS**

In designing a new generation of trust vehicle, taking into account the principles and problems we have uncovered, our objectives should be stated clearly.

- The trust must enable the trustees to invest for the highest total return consistent with the level of risk acceptable to the trust and its beneficiaries.

- If possible, it should create an identity of interest between the current beneficiary, the trustee and the remaindermen relative to investment decisions.

- It should allocate returns well and fairly in all types of markets even when there are times of unusual volatility, whether up or down.

- The flow of distributions to the current beneficiary should be as smooth as practicable while maintaining the identity of interest among the parties to the trust.

- It will be desirable for our trust document to state clearly the goals of the trust in investing and distribution, recognizing that goals are not always attainable.
B. ALTERNATIVES

In response to these objectives, a number of approaches could be followed, including the use of fully discretionary trusts, indexed payout trusts, or total return unitrusts. Each alternative is considered briefly here, followed by a more detailed examination of the total return unitrust and the other leading candidates.

1. The Old Reliable - Do Nothing

One alternative is to draft documents as before and wait for the new Principal and Income Act to be adopted in our home state to see if the Act helps. That answer works for a dwindling number of states as more and more states have dealt with the problem. And for those who already have new laws, the next excuse for doing the old reliable was to wait until the Internal Revenue Service issued its Final Regulations, since the Proposed Regulations were not final and in effect. But as discussed later, we now have Final Regulations too! The reality is that planners no longer have any good excuses for not changing the way they plan to react to the great changes in the best practices for estate planners, for trustees and investment advisors to trustees. Yet it is difficult to fundamentally change the way we think and the way we draft our documents. Anything really new creates anxiety for the drafter. And as a group, trust and estate lawyers are a rather conservative (some might say stodgy) crew, and some may continue to draft as they have. However, doing so will destine many beneficiaries and their families to disappointment, and may subject the planner to criticism (or worse) for failing to live up to the current standards of practice. But if the drafter drafts the usual way, the trustee may be placed in the position of trying to respond to the needs of the current income beneficiary and the expectations of the remaindermen in the traditional way, with the duty of impartiality forcing them into their only alternative of disappointing the income and remainder beneficiaries equally!

2. Fully Discretionary Trusts

The use of fully discretionary trusts that allow the distribution of some or all of the income and some of the principal, perhaps to a variety of beneficiaries, should be expanded. A fully discretionary trust in this context would allow the trustee to invest for total return and then exercise discretion in distributing a fair and reasonable return to the current beneficiary while maintaining the balance in the trust corpus. This type of trust offers the ultimate in flexibility for investing and distributing. It could be viewed as Section 104 extended to its logical limit. This type of trust is extremely useful where investment flexibility for the trustee is of paramount importance and where there are no concerns about the arbitrary use of that power by the trustee. This is particularly appropriate in a closely-knit family and in situations in which income and estate tax planning is paramount.

We will see in our section on Estate Planning With Total Return Trusts just how helpful this type of trust can be where it is used to leverage the applicable credit amount or the GST exemption in a perpetuities trust. And we will find that it is particularly helpful when it is placed in tandem with our total return unitrust, with these two very different types of trust often providing an ideal balance of flexibility and method.
It does have its drawbacks, however. It does not typically give the trustee any kind of guidance as to how to exercise that extraordinary discretion, nor does it give the beneficiaries any basis to establish rational expectations for distributions from the trust. And the fulfillment of expectations, human nature being what it is, is 90% of a person's perception of performance.

One might well draft a discretionary trust subject to guidelines or standards (either ascertainable under Code §2041 or not, depending upon the identity and independence of the trustee), which will decrease the flexibility but perhaps increase the predictability and comfort level of the trustee’s exercise of discretion. It is submitted that a fully discretionary trust without some indication of the settlor’s goals and priorities for the trust is an invitation to trouble; productive of disappointment, misunderstandings and perhaps even litigation.

3. The Use of Indexed Payout Trusts

Professor Dobris and Bill Hoisington have argued persuasively that often the intent of a settlor or testator is to provide an adequate flow of distributions increasing on a yearly basis by some inflation factor such as the Consumer Price Index (CPI) or the GNP deflator. Because an indexed payout is linked to an external factor, inflation, which is not correlated with return, but in fact is often inversely correlated to return, it is necessary that such a payout be set at a low initial level to be safe. During a period of high inflation, stock and bond markets are frequently adversely affected, and yet in such an indexed payout trust, the distribution to the current beneficiary would have to increase. For example, during the two-year period from 1973 to 1974, the CPI measured inflation of 21% while the total return for large company stocks was a minus 41.13%. The increase in payout would have required liquidation of assets at low prices, having a negative dollar averaging effect. In contrast, a payout that was keyed to asset values would have reduced the depletion of capital and produced positive dollar averaging as illustrated later in these materials. The indexed payout trust will have its place in the sun, but it will not be safe enough to be used frequently.

4. The Total Return Unitrust

The final category of trust alternatives is the total return unitrust (TRU). This type of trust is a private, non-charitable unitrust that provides a trust partnership between the current beneficiary and the remaindermen, facilitates total return investing and creates expectations in the income beneficiaries that are likely to be fulfilled. By directing the trustee to pay out a specific percentage of the trust set forth by the grantor or testator, this type of trust instrument removes the great difficulty in fulfilling the duty of impartiality. Trustees are able to invest in any type of asset, whether it is over-productive or under-productive of accounting income, and to make the payments as needed from those investment returns. One of the noted advantages of charitable remainder unitrusts is freedom from conflicts between the interests of beneficiaries. The trustee is not required to balance the interests of one beneficiary against the other. The trustee need only to consider the risk tolerance of the beneficiaries and the likely duration of the

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233 Dobris, supra note 11, at 22-29. Hoisington, supra note 11, at 5-15.
234 Ibbotson Associates, supra note 21, Table A-15 at 252-53 and Table A-1 at 224-25, respectively.

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trust. The trustee then may invest as the trustee thinks best. Automatically, the life beneficiary profits in lock step with the remaindermen because what is good for one is good for the other. Furthermore, the expectations of the income beneficiary in the first year will always be met, making a suitable foundation for the relationship between the life beneficiary and the trustee. With this background and the reasons for the selection of a TRU as a model trust deserving serious study for the future, the characteristics of the TRU and some desirable special provisions can be examined.

VIII. CHARACTERISTICS OF THE TOTAL RETURN UNITRUST (TRU)

A. THE TRUSTEE-LIFE BENEFICIARY-REMAINDER MEN PARTNERSHIP

The trustees' compensation, the life beneficiary's distribution, and the remaindermen's share rest upon the growth in the market value of the trust corpus. The welfare of all three participants in the trust triangle depends upon performance, and the interests of the parties are the same in encouraging the growth of capital and income. The investment decision must be grounded upon the duration of the trust and the ability of the trust, given the needs and the time involved, to withstand volatility as a result of different asset allocation mixes. The questions of risk and return are the same for the trustee, the life beneficiary, and the remaindermen. Volatility affects trustee fees, life beneficiary distributions, and, potentially, the value to the remaindermen, which typically comes to fruition at the death of the life beneficiary.

B. THE NEED FOR A SMOOTHING RULE

A private, non-charitable unitrust would clearly have been effective on an historical basis even if the unitrust bases its distribution on a once a year valuation. At this point we must jump ahead to use the computer modeling which is described in greater detail in Section XII. Appendix 1 (available by request) illustrates a $100,000 trust invested in common stocks with the same returns as the Standard & Poor's 500 through 1998. The illustration assumes a 5% payout throughout this entire period as well as a number of other assumptions discussed in more detail later. Note that the Standard & Poor's 500 dividend yield between 1926 and 1944 was almost always between 4% and 6%, so that the use of an income rule trust throughout that period might not have made a substantial difference. As noted previously, U.S. government bonds actually sold at significantly lower yields than stocks during the first half of the 20th Century. The reason for this was particularly clear during the Depression: the overriding need for safety.

The returns from the Depression era provide a real perspective on just how badly the stock market performed beginning in 1929. During that period, a 5% payout (and the market value) would have decreased by 73% for 1929 to 1933. Interestingly, the dividend income on the Standard & Poor's 500 decreased almost as much, down 56% from 1930 to 1934.236

Throughout this seventy-three-year period of the hypothetical trust from 1926 through 1998, there were 28 years in which there was a reduction in the distribution, 16 years in which

235 This is in contrast with the fully discretionary trust, where the trustee's discretion might or might not be exercised to share the benefits of total return between the beneficiaries.
236 See infra Appendix 1 (column for accounting income).
the reduction was more than 10% and 11 years in which the reduction exceeded 15%. The most recent major decline of the market in 1974 and 1975 would have resulted in a 46% reduction in distribution. At the same time, this seventy-three-year record of distributions on a Standard & Poor's 500 portfolio with a 5% unitrust payout is still quite impressive, with a beginning market value of $100,000 growing to an end market value as of December 31, 1998 of $2,439,062. Even with that impressive overall performance, however, the volatility of distributions for a strict unitrust seems too great for most private trusts. A smoother stream of distributions would be more desirable for the welfare of the life beneficiary, usually the spouse or other dependent of the testator or settlor.

By using a three-year rolling average of market values to determine the annual payout, the trust can provide much smoother streams of distributions. Appendix 2 shows the same hypothetical trust illustration as was shown in Appendix 1, but with a three-year rolling average smoothing rule. Note that the market value at the end is $2,549,675, a 2450% increase. With the three-year smoothing rule, instead of 28 negative years, there are only 19 negative years and only 7 with a decline of greater than 10%. We tested out other potential smoothing rules with the following results:

<table>
<thead>
<tr>
<th>Effect of Smoothing Rule on Frequency of Declines in Distributions (5% TRU / 100% Equity) - (1926-1998)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Smoothing Rule</td>
</tr>
<tr>
<td>--------------------</td>
</tr>
<tr>
<td>Decline &gt; 5%</td>
</tr>
<tr>
<td>Decline &gt; 10%</td>
</tr>
<tr>
<td>Decline &gt; 15%</td>
</tr>
</tbody>
</table>

While one can make an argument for the four- and five-year smoothing rules, the three-year rule gets most of the smoothing without diminishing the important partnership between the

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237 This increase constitutes a real (after inflation) increase of 178%. The cumulative inflation rate is 914% from 1926-1998. IBBOTSON ASSOCIATES, supra note 21, at Table A-15 at 252-53.

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current and remainder beneficiaries and the trustee. The longer smoothing periods allow the distribution to continue to go up and down long after the market is pointing the other way. And this would also have a significant cost in dollar averaging benefits.

Because of these results generally favoring the selection of the three-year smoothing rule, it is used in our model document. It appears to represent the best compromise between the need for smoothness in the distributions and the need to increase or decrease distributions along with market performance quickly enough to preserve the trustee-life beneficiary-remaindermen partnership. When drafting a trust for a seventy-five-year-old beneficiary, a five- or ten-year smoothing rule may simply be too long to adequately produce the identity of interest that is at the heart of the TRU.

The following graph of a TRU with no smoothing rule shows how in a severe bear market, the volatility is likely too great on a year to year basis for the comfort of most current beneficiaries. Over a three year period, the distributions decline 50%, in line with the decline in the market value, which is made larger by the relatively high payout, along with taxes and expenses in the trust. Predictably, the distribution for 2004 increases by 22.2%, based as it is on the year end 2003 value, which included a gain in market value for the S & P 500 of 26.38%, which after expenses and pruning to provide cash for the 5% distribution allowed an increase in a corresponding amount in the trust market value.

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Let's examine graphically the effects of the three-year smoothing rule, and update the data through 2004 (based on year end 2003 data) so that we may examine the smoothing rule when a super strong bull market from 1995-1999 turns into a super strong bear market of 2000-2002 and then rallies in 2003. We will find that the three year smoothing rule rounds the edges and smooths the results, but the market value of an all equity trust is a real roller coaster during a time of unprecedented volatility:

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

Note also that the distribution in this trust will likely continue to decline modestly in 2005 as well, because the market value at the end of 2003 is still considerably lower than it was at the end of 2001. It will take an almost 25% return on the S & P 500 in 2004 to allow the year end market value for 2004 to exceed what it was in 2001, which would raise our three year rolling average. These are the consequences in an extremely volatile market of being 100% invested in equities with a high 5% payout. Still, the three year smoothing rule even in this period changes a 3 year decline of over 50% into a 4 year decline of “only” 35%.

If it were likely that we would have the type of extreme volatility in the markets that we have seen over the last 8 years, there would be a much stronger case for the 5 year smoothing rule. But the difficulty of having that long of a rolling average is that the distribution would continue to go up and down much longer in counterpoint to the market, so while the distributions under a five year rule would have a smoother ride, the ride of a bear market might well continue as much as three years after the bear market was over! While mathematically understandable, that would cause some public relations problems with the current beneficiary.

Despite the mediocre performance of the three year smoothing rule during the period 1995-2004 for a high payout all equity trust, overall, having a three year smoothing rule seems to this author to be a good thing. In effect, by lowering the volatility of the distributions to the current beneficiary, we effectively lower the volatility as it relates to the current beneficiary, without significantly affecting the results to the remaindermen. The loss in dollar averaging is likely more than offset by the increase in the likelihood of steady trust investment management. A longer smoothing rule, while helpful in this high volatility period, would produce dissonance in most investment periods, where the movement of the markets doesn’t create such steep mountains of risk and return!

C. MEETING EXPECTATIONS

One of the most difficult problems facing the trustee is meeting the expectations of a life beneficiary. Beneficiaries often compare their income return with the rates available for fixed income investment. Only the relatively sophisticated beneficiary will understand that a 2% current yield in a trust may very well translate itself into substantial long-term gains and substantial growth in income distributions. By providing a clear rule, such as 4% or some other percent of the initial value of the trust, the drafter can insure that at least in the first year the trustee and the beneficiary will have a meeting of the minds. Four percent of $1,000,000 will be
$40,000 every time, and the trustee will meet the beneficiaries' expectations in year one of the trust. After that, trustees are on their own to capture as much of the available return as they can from the investment markets without incurring inappropriate risk. The importance of expectations to human nature makes this feature very significant in helping to bond the triangle of the trustee, the life beneficiary, and the remaindermen.

D. **DO WE NEED A *FORCE MAJEURE* POWER TO CHANGE THE SPENDING RULE?**

It can certainly be argued that no trust payout is perfect for all seasons. An examination of seventy-eight years of investment history and computer modeling with different trust payout rules suggests that a unitrust with a three-year smoothing rule with a payout rate of 3% to a maximum of 5% works reasonably well at least if the trust is invested largely in equities. However, it is possible that substantial changes in the investment markets might cause any fixed payout rate to be too high or too low to accomplish the goals of a trust. Accordingly, if a trust is intended to last for a very long time, it could be important for the trustee to have a power under extraordinary circumstances to change the distribution rate to accomplish the intended goals. Any such power of course shifts a substantial responsibility to the trustee and should be weighed carefully before inserting in the trust. Such a power should only be included in a trust that has an independent trustee, since its discretion would go far beyond ascertainable standards.

E. **DRAFTING THE TRU**

The following TRU model is based on a number of practical considerations as well as the research and computer modeling contained in these materials:

1. **The Marital Deduction**

We have included a belt and suspenders approach to the marital deduction by providing optional language which requires the distribution of all the income at least annually, even if it is more than the unitrust distribution amount, and a provision which specifically allows the surviving spouse to make property "productive" by giving notice to the trustee. Of course a 3% or more unitrust payment from a unitrust is clearly “productive” for the current beneficiary, regardless of the source of the payment being dividends and interest or portfolio growth, but unless your state has a unitrust definition of income so as to clearly come within the provisions of the Final Regulations discussed in Part X it is best to be careful.

2. **Contributions and Distributions-Adjustment Years**

Real trusts are often funded in several installments, and if there are powers of invasion or withdrawal, there may be significant distributions. While the three-year averaging works fine to smooth the distributions in most markets, it is deceived of course by such multiple year distributions or contributions. Predictably, complicated lawyerly language is provided to adjust for this so as to normalize the smoothing rule.
3. **Income Earned in Estate Prior to Trust Funding**

The New York legislative approach initially adopted a complete unitrust substitution for income, even in the context of an estate. The form provided in these materials assumes that income will be defined in the traditional way during the course of an estate administration because of the extraordinary number of receipts and distributions that are typical in an estate administration. It is the author's view that while a unitrust percentage will work adequately during the estate administration, the traditional method will be easier to work with in this context. As noted previously, New York's final revised report abandoned the use of the unitrust in estates in response to concerns expressed by the Bar and the New York Bankers' Association.

4. **Source of Distribution Amounts**

The trust model follows the traditional conduit theory but extends it to the matter of capital gains, which gains are, after all, the point of having a total return unitrust. The trust model which follows attempts to funnel out accounting income, then other ordinary income, then short-term capital gains, then long-term capital gains, and then principal from the trust because this makes the most sense in terms of the taxation treatment of the trust distributions as discussed in more detail below.

5. **Discretionary Power**

The need for flexibility in a TRU is important just as it is for an income rule trust. We have only changed the ordinary spending rule, but not the need to provide for unusual needs. We insert the usual ascertainable standards. If an independent trustee is involved, the powers can be expanded and customized to the desires of the client. The ability to set the distribution rate should decrease the frequency of instances in which the discretionary powers will be used, but they should always be included in the document.

6. **Goals of the Trust**

Surprisingly, stating the goals of a trust is something new, as most trusts do not reveal their goals for investment and distribution. These should of course be customized depending on the payout rate used and the actual goals of the settlor. They should also be reviewed along with the rest of the client’s documents from time to time, since financial conditions, laws and the family itself may change over time in such a way as to demand change in the goal language as well.

7. **Independent Trustee's Power to Alter Distribution Rate**

Language is provided to allow an independent trustee to alter the distribution rate based on truly extraordinary occurrences. It is not intended that the distribution rate would be changed simply because of a bull market or a bear market. Something quite fundamental would have to change in order to make the distribution necessarily inappropriate for its intended goal, at least if the rate is initially set thoughtfully in light of historical norms. It is actually quite difficult to
imagine such a market, since the TRU adapts to up and down markets by buying low (and protecting the trust) in down markets and selling high (and giving the current beneficiary a share) in up markets. This should be considered carefully before it is inserted. At least in terms of additional distributions, the normal discretionary powers may be preferable.

8. **Trustee's Powers**

You will note that the trustee's powers contain many of the useful powers contained in the Prudent Investor Act. If the state law applicable to the trust does not contain the Prudent Investor Act, this should be particularly helpful.

9. **Reformation Power**

The trust provisions give the independent trustee, if one is serving, the power to modify the trust to make the best uses of the applicable tax credits and exemptions. This puts the independent trustee in the position of trust protector, but this clearly must be given thoughtfully (if at all) if the trustee is anything but completely independent.

**IX. THE TOTAL RETURN UNITRUST FORM**

The following TRU model is drafted based on the research and discussion set forth in the author's articles and published materials. While the TRU is a relatively new form of trust, it is based on well established principles of current law, including the trends as the Prudent Investor Act and the new Uniform Principal and Income Act have now become the norm for fiduciary law.

THE TOTAL RETURN UNITRUST (TRU)

I give the residue of my estate to my trustee ___ to hold as a Total Return Unitrust under the following provisions:

A. During _________ 's life. In each trust calendar year or such portion thereof in the first or final year of the trust ("Trust Year"), my trustees shall pay to or for the benefit of my _______, _______, during h___ life, in quarter-annual installments, an amount equal to the unitrust amount set forth below ("Unitrust Amount").

B. **Unitrust Amount.** The Unitrust Amount for the trust shall be equal to the average of the fair market values ("Average Value") of the assets of the trust as of the close of the first business day of the trust year (or the date of first funding in the first trust year) and the two previous trust years (or such lesser number of trust years as are available for the first two years of the trust) multiplied by the _________ (%) percent ("Applicable Unitrust Rate"). In the case of a short Trust Year, the Unitrust Amount shall be calculated as set forth in subparagraph C below. In the case of additions to or distributions from the trust, the Unitrust Amount shall be determined as set forth in subparagraph D below. Expenses which would be deducted from income if the trust were not a unitrust shall not be deducted from the payment of the unitrust amount.

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[Non-accrual alternative: The obligation to pay the Unitrust Amount shall cease with the last regular payment before my ___________ death.]

C.  Short year.  For a short Trust Year, including the year of initial funding [Delete for Non-accrual alternative: and the year of a beneficiary's death], the Unitrust Amount shall be based upon a prorated portion of the Unitrust Amount set forth above, comparing the number of days in the short Trust Year to the number of days in the calendar year of which the short Trust Year is a part.  [Note: This accrual may be helpful in securing "present interest" status for the annual gift tax exclusion, if that is important.]

D.  Adjustments for Additions and Distributions.  [This complicated language is needed to accommodate multi-year funding of trusts from estates and discretionary distributions in light of the three-year smoothing rule.]  In a Trust Year in which assets are added to the trust (other than the first funding of the trust) or distributed from the trust (other than the Unitrust Amount), the Unitrust Amount for such year (hereinafter "Adjustment Year"), shall be increased in the case of an addition, or decreased in the case of a distribution, by an amount computed by first multiplying the fair market value of the assets added or distributed (as of the date or dates of addition or distribution) by the Applicable Unitrust Rate for the trust.  The result is then multiplied by a fraction, the numerator of which is the number of days from the addition or distribution to the end of the Trust Year and the denominator of which is the number of days in the calendar year.

Further, the fair market value of the assets of the trust for the Adjustment Year and the Trust Year immediately preceding the Adjustment Year shall be increased or decreased as the case may be, by the net addition or distribution during the Adjustment Year for purposes of determining the Average Value applicable for subsequent trust years.

E.  [Insert for QTIP, if your state does not have a statutory unitrust option so as to validate a unitrust payout for marital deduction purposes under the Final Regulations discussed in Section X.E. infra.  If your state is a unitrust state, you may be able to delete and re-letter subparagraphs.  Note also that the Final Regulations specifically approve a state unitrust statute which permits rates from 3% to 5%, so the Applicable Unitrust Rate should be at least 3% for a marital deduction trust.  Further, if your TRU state law has a specific conversion rate, such as 4%, you may not be safe in adopting a rate lower than the default rate for your state, unless there is a specific provision in your statute that allows a lower rate, such as 3%, to be considered “income”.  See detailed analysis of the Final Regulations at Section X. E.  ]  If in any Trust Year, the net income of the trust exceeds the Unitrust Amount, such excess net income shall be distributed to my ________ at least annually.  [You may also consider a provision to eliminate this proviso, if it is or becomes unnecessary]  If at the time of my death, the distribution of such excess net income is not necessary to qualify this trust for the marital deduction, then such excess net income shall not be distributed.

F.  Valuation.  All computations of the trust's fair market value or the value of any additions or distributions as set forth above shall include accounting income and principal, but no accruals shall be required.  Liabilities of the trust, other than the Unitrust Amount or ordinary operating expenses such as trustee’s fees, investment advisory fees or fiduciary income taxes, shall be taken into account in determining the fair market value of the assets of the trust.  If the trust includes assets for which there is no ready market, the trustees shall adopt such method of valuation as they deem reasonable in their discretion.
G. Income earned in Estate prior to Total Return Unitrust funding. In addition to the Unitrust Amount as determined above, the net accounting income earned in my estate or from other assets payable to this trust after my death but prior to the full funding of this total return unitrust (hereinafter "TRU") shall be paid to my __________. The foregoing income distribution recognizes that until full funding of the TRU, assets awaiting distribution to the TRU will not be taken into account in determining the Unitrust Amount.

H. Discretionary distributions of additional amounts. In addition to the Unitrust Amount as set forth above, my trustees shall distribute such additional amounts of the trust, to my said __________ as the trustees deem advisable for my ____________'s health, education, maintenance and support in h_____ accustomed standard of living, taking into account such other income or assets which are available to h_____ and are known to the trustees. [Comment: Discretionary distributions may be advisable for the same reasons as they are in any trust. Consider giving an independent trustee broader powers to enable beneficiary "to make estate planning gifts," "for ______ welfare" or "for any purpose in which money is needed."]

I. Ordering Rule. The Unitrust Amount for the trust and any discretionary distributions from the trust shall be considered to have been paid first from net accounting income of the trust, next from ordinary taxable income not allocable to net accounting income, next from net realized short term capital gains, next from net realized long term capital gains, and finally, from the principal of the trust. (If your state has a statutory unitrust with the foregoing ordering rule, Reg. 1.643(a)-3(e), Example 11, 12 and 13, taken together, support the proposition that the ordering rule will be respected. It is likely that if the foregoing ordering rule is in the governing instrument, and state law looks to the terms of the governing instrument as to the trustee’s instructions in this regard, that it will also be respected, though this is less certain. See discussion at Section X. E. If this were not the case, computer modeling suggests that the payout rate should be lowered .25% to .35% to have a roughly equivalent possibility of preserving the value of the trust after the effect of taxes, expenses and inflation, assuming the trust has a portfolio with a current or stepped up cost basis, and perhaps twice that effect, or .50% to .70% for a trust with an extremely low cost basis portfolio).

J. Total Return Unitrust Design. I have created a Total Return Unitrust for my __________ in order to allow the trust to be invested for total return without the artificial distinction between accounting income and principal appreciation. By doing so, the trust can be invested without conflict between the interests of the current beneficiary and the remainder beneficiaries.

K. Death of __________. On the death of my _____, the trustees shall [Optional: pay any accrued distribution amount to my ____________'s personal representative, and] distribute the balance in said trust to ________________, subject to the Trust Continuation Provisions hereinafter.

L. Goal of trust (Optional: and Trustees' Power to Alter Distribution Rate.) In making a determination concerning discretionary distributions in addition to the Unitrust Amount, my trustees may wish to take into account that Alternative 1: the welfare and support of my _____ is the most important goal of these trusts, with the preservation and building of wealth for the remainder beneficiaries of secondary importance. Alternative 2: my intent is to provide a permanent and increasing source of funds for the lifetime of my ______ and that the buildup of value be passed forward for the benefit of the remainder beneficiaries is of considerable importance.]

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If, as a result of permanent, substantial, and fundamental changes in
the investment marketplace, the corporate trustee becomes convinced that the goals of the trust
as set forth above cannot be attained because of the selection of the Applicable Unitrust Rate, the
corporate trustee, acting alone, shall have the discretion to change such rate. [Optional: provided
that such change shall not make the Applicable Unitrust Rate less than 2% nor more than
7%. One might wish to limit it from 3-5%, to bring it within the safe harbor suggested by
the Final Regulations.] The foregoing is intended to provide flexibility to the corporate trustee
only in the event of extraordinary and unforeseen change in the investment marketplace from
those markets generally experienced during the 20th Century. The trustees shall not be held
liable for the good faith exercise or non-exercise of this power. [Note: If the trust is intended to
qualify for the marital deduction, it would be wise to add language that would prohibit the
reduction of a payout for a surviving spouse. Because the modeling of these trusts
demonstrates that TRU’s work well and predictably for the periods 1926-2003, 1960-2003
and 1973-2003, and in numerous rolling period analyses, it is not clear that this discretion
is needed, or even wise. It may, however, give clients (perhaps some estate planners too!) an
added level of comfort - no small thing. Then again, how many times (apart from tax
considerations) have you ever regretted putting in too much flexibility in your documents?
How often have you regretted later not having enough? The Supplemental Forms at the
end of these materials provide optional language to increase the Applicable Unitrust Rate
pursuant to ascertainable standards, for comparison purposes.)

2. Executors and trustees powers. In addition to the powers conferred by
law, my execut____ with respect to my estate, and my trustees, with respect to any trust, shall
have the following powers, to be exercised in their absolute discretion, without the necessity of
application to any Court, in the capacity to which such powers may be applicable. [Optional:
except that they shall have no power as to the Marital Trust which would disqualify it for
purposes of the marital deduction]

[Customary Provisions Omitted]

* * *

B. Investments. To invest in any type of investment that plays an appropriate role in
achieving the investment goals of the trust, which investment shall be considered as part of the
total portfolio. It is my specific direction that no category or type of investment shall be
prohibited. I specifically do not wish to limit the universe of trust investments in any way other
than is dictated by the trustees’ exercise of reasonable care, skill, and caution. In connection
with the trustees’ investment and management decisions with respect to this trust, the trustees are
specifically entitled to take into account general economic conditions, the possible effect of
inflation or deflation, the expected tax consequences of investment decisions or strategies, the
role that each investment or course of action may play within the overall trust portfolio that may
include financial assets, interests in closely-held enterprises, [Note-consider valuation
problems here] tangible and intangible personal property, and real property; [Note-valuation
problems] the expected total return from income and the appreciation of capital; other resources
of the beneficiaries, the needs for liquidity, regularity of income and preservation or appreciation
of capital, and the asset's special relationship or special value, if any, to the purposes of the trust
or to one or more of the beneficiaries. Nor shall my trustees be limited to any one investment
strategy or theory, including modern portfolio theory, the efficient markets theory or otherwise,
but should be free to consider any appropriate investment strategy or theory under all the circumstances.238

[Insert for QTIP if your state does not have a statutory unitrust, and it is suggested that it be inserted even if it does: Should the trustee invest in property which is unproductive, my spouse shall have the right to require the trustee to convert the same into productive property within a reasonable time.]  [You may also wish to consider provisions for personal use property such as residential real estate or tangible personal property. If such property is contemplated, it should presumably not be included in the market value of the trust for determining the distribution. The author suggests that the inclusion of the foregoing language does no harm and is an important safeguard if there were assets that were not included in the calculation of the unitrust amount and which were unproductive of income.]

C. Delegation. The trustee may delegate investment and management functions that a prudent person of comparable skills would properly delegate under the circumstances. Should the trustee delegate such function, the trustees shall exercise reasonable care, skill, and caution in selecting an agent, establishing the scope and terms of the delegation consistent with the purposes and terms of the trust, and periodically reviewing the agent's actions in order to monitor performance and compliance with the terms of the delegation. Should such delegation occur as set forth above, the trustees that comply with the requirements for delegation shall not be liable to the beneficiaries or to the trusts for the decisions and actions of the agent to which the function was delegated, but by accepting the delegation of a trust function by the trustee of this trust, the agent submits to the jurisdiction of the courts of this state. [Most of this paragraph is imported from the Uniform Prudent Investor Act.]

* * *

I. Reformation. The corporate trustee, acting alone and in its sole discretion, shall have the power to reform this instrument, with or without Order of Court, in order to make any changes necessary so as to preserve and make the best use of the marital deduction for federal estate tax purposes and the exemption from generation-skipping transfer tax; to avoid the unintended inclusion of the market value of the trust in the estate of a trustee or beneficiary; or to carry out my intent regarding the ordering provisions for income as prescribed in this will. Any provisions of this will shall be interpreted or reformed so as to preserve these benefits and carry out my intent wherever possible, provided that such interpretation or reformation does not do violence to my primary intent to provide for my _______________________________[insert appropriate language e.g. “my wife and children,” or “my issue.”].

X. TAX ASPECTS OF THE TRU

A. QUALIFYING FOR THE MARITAL DEDUCTION-TRADITIONAL ANALYSIS

Many of the trusts that employ the TRU form will be used for a surviving spouse, and one of its best uses would be for Qualified Terminable Interest Property (QTIP) marital trusts. QTIP marital trusts may be formed for generation-skipping transfer tax reasons to allow a

238 Concern expressed by Bob Freedman in his article was the basis for granting the trustee the express power to employ any appropriate investment strategy, not just the one that is currently most popular. Robert Freedman, Proposed New Prudent Investor Rule, PA. B. NEWS 10 (Sept. 23, 1996).
reverse QTIP election under I.R.C. §2652(a)(3). One of the major reasons for this type of trust is concern about a second marriage, when the life beneficiary is a second spouse and the remaindernen are children by a prior marriage. In these situations, the potential conflict of interest is particularly strong between the life beneficiary and the remaindernen. The testator's use of a TRU with a specified percentage payout will make the trustee's job a great deal easier both by taking away the need for the trustee to determine how much income is enough for the surviving spouse, and also by making the duty of impartiality rest more easily on the trustee's shoulders. To be a qualifying income interest for life under I.R.C. §2056(b)(7)(B)(ii), the surviving spouse must be entitled "to all the income from the property, payable annually or at more frequent intervals," and "no person [may have] a power to appoint any part of the property to any person other than the surviving spouse." Even if there were no smoothing rule, the distribution rate might be less than the amount of the income under some economic conditions, so the total return trust form includes optional language to ensure that it distributes all of the income in a QTIP. Without the added language the trust is unlikely to qualify under the traditional analysis of the marital deduction, even though it may pay out significantly more to the surviving spouse than a conventional income rule trust under present economic circumstances. Optional language in the trust form is also added to deal directly with the question of unproductive or under productive property. This is probably unnecessary because state law generally will reach the same result. Section 240 of the Restatement (Second) of Trusts provides:

Unless it is otherwise provided by the terms of the trust, if property held in trust to pay the income to a beneficiary for a designated period and thereafter to pay the principal to another beneficiary produces no income or income substantially less than the current rate of return on trust investments, and is likely to continue unproductive or under-productive, the trustee is under a duty to the beneficiary entitled to the income to sell such property within a reasonable time.

Section 240 of Restatement (Third) of Trusts defines property as under productive if the income is "substantially less than an appropriate yield on the trust investments." Even prior to the Proposed and now Final Regulations, the following portion of the QTIP regulations provide some authority that payment from something other than income of the trust should cure this problem:

... [f]or example, assume that the corpus of a trust consists substantially of property which is not likely to be income producing during the life of the surviving spouse and that the spouse cannot compel the trustee to convert or otherwise deal with the property as described in subparagraph (4) of this paragraph. An interest passing to such a trust will not qualify unless applicable rules for the administration require, or permit the spouse to require, that the trustee provide the required beneficial enjoyment, such as by payments to the spouse out of other assets of the trust.

---

240 Dobris, supra note 11, at 17 n. 47.
241 Restatement (Second) of Trusts, supra note 14, at 240.
242 Id.
Interestingly, those regulations almost point to a non-income unitrust standard:

Such degree of enjoyment is given only if it was the decedent's intention . . . that the trust should produce for the surviving spouse during her life such an income, or that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation.\textsuperscript{244} (emphasis inserted)

One could argue that a 4% TRU given the modeling and research that follows gives precisely such an interest, and far better than an accounting income interest! In any event, the TRU marital trust form provides language which would require that any net income in excess of the distribution amount be distributed at least annually and specifically allows the spouse to compel the trustee to make the property productive. While it is likely that the new unitrust laws in 19 states may allow these additional protections to be eliminated, the drafter should do so only with caution, based upon a thorough analysis of the Final Regulations, the trust document and applicable local law. If there is any doubt, then leaving the additional supports for the I.R.C. §2056(b)(7) election in place may be appropriate, although the distribution of “excess net income” may produce problems for the trustee in some future market when interest rates and dividend yields are much higher than they are today.

The unitrust interests prescribed by the statutory changes discussed previously should evidently qualify for the marital deduction because state law would be redefining income in a way which is clearly reasonable and in fact would on the whole increase the benefit distributable to the surviving spouse. It is analogous but more thorough going than a statutory rate of interest applicable to pecuniary bequests which is held to be appropriate interest under the GST regulations.\textsuperscript{245} But until the Proposed and now Final Regulations, we had no way to know what Treasury would think about all of this.

\textbf{B. STOCK PRUNING, CAPITAL GAINS TAX AND JGTRRA - MAKING MORE INTO EVEN MORE}

With the current financial markets, the use of a TRU will encourage the use of a greater proportion of stocks and other equity investments, as opposed to fixed income, by virtue of the flexibility the TRU provides and the fact that equity securities over longer periods tend to produce a higher total return.

In the current financial markets, the use of the TRU invested in equities would inevitably lead to periodic use of a small amount of the principal every year to meet the distribution payouts required by the trust. Traditionally this practice, which I have named “stock pruning” would seem aggressive or even speculative, but the investment data presented in these materials tends to show otherwise. In fact, the use of a little bit of the growing portfolio to make up a portion of the distribution is not just a necessity, it is actually a tax planning opportunity. And this tax

\textsuperscript{244} Treas. Reg. 20.2056(b)(5)(f)(1) (1994).
planning opportunity, which was tremendous before the Job Growth and Tax Revenue Reconciliation Act of 2003 ("JGTRRA")\textsuperscript{246}, is just amazing after JGTRRA!

To demonstrate the tax advantages, two different portfolios of $100,000 each will be created, one invested in taxable fixed income and the other in a widely diversified group of individual stocks with a current level of dividends of 2\% and appreciation of 6\% per year. To level the playing field, the same total return of 8\% will be assumed for both trusts as well as a constant trust payout of 4\% per year. The rate of tax inside the trust for any reinvested ordinary income will be 31\%.\textsuperscript{247} A 31\% tax bracket will be assumed for the trust beneficiary as well. Both the fund balance and the after-tax distribution to the trust beneficiary appreciate significantly in this all fixed income model but the tax does its damage. Every dollar of return is taxed every year. See Table 1 which follows.

\textsuperscript{246} Public Law 108-27.
\textsuperscript{247} This rate is a conservative assumption considering that the 35\% bracket begins at $6,850 in taxable income and the 38.6\% bracket begins at $9,350 for a trust or estate in 2003.
TABLE 1
TOTAL RETURN TRUST-TAXABLE FIXED INCOME
RETURN OF 8% PER YEAR AND A 4% PAYOUT
TAX RATE OF BENEFICIARIES AND TRUST 31%

<table>
<thead>
<tr>
<th>Fund Year</th>
<th>Balance</th>
<th>Taxable Interest</th>
<th>Before Tax</th>
<th>After Tax</th>
<th>Distribution</th>
<th>Distribution</th>
<th>End Fund Balance</th>
</tr>
</thead>
<tbody>
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<td>4,000</td>
<td>2,760</td>
<td>102,760</td>
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<td></td>
</tr>
<tr>
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<td>8,221</td>
<td>4,110</td>
<td>2,836</td>
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<td></td>
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<td>4,224</td>
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<td></td>
</tr>
<tr>
<td>4</td>
<td>108,511</td>
<td>8,681</td>
<td>4,340</td>
<td>2,995</td>
<td>111,506</td>
<td></td>
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<tr>
<td>5</td>
<td>111,506</td>
<td>8,920</td>
<td>4,460</td>
<td>3,078</td>
<td>114,583</td>
<td></td>
<td></td>
</tr>
<tr>
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<td>114,583</td>
<td>9,167</td>
<td>4,583</td>
<td>3,162</td>
<td>117,746</td>
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</tr>
<tr>
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<td>117,746</td>
<td>9,420</td>
<td>4,710</td>
<td>3,250</td>
<td>120,995</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>120,995</td>
<td>9,680</td>
<td>4,840</td>
<td>3,339</td>
<td>124,335</td>
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<tr>
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<td>124,335</td>
<td>9,947</td>
<td>4,973</td>
<td>3,432</td>
<td>127,766</td>
<td></td>
<td></td>
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<td>127,766</td>
<td>10,221</td>
<td>5,111</td>
<td>3,526</td>
<td>131,293</td>
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<td>10,503</td>
<td>5,252</td>
<td>3,624</td>
<td>134,916</td>
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<td>11,397</td>
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<td>150,439</td>
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<td>18</td>
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<td>6,354</td>
<td>4,384</td>
<td>163,243</td>
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<td>19</td>
<td>163,243</td>
<td>13,059</td>
<td>6,530</td>
<td>4,505</td>
<td>167,748</td>
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<tr>
<td>20</td>
<td>167,748</td>
<td>13,420</td>
<td>6,710</td>
<td>4,630</td>
<td>172,378</td>
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</table>

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

The 4% payout in Table 1 after 31% tax gives an after-tax return of 2.76% and the 4% income earned in the trust yields the same 2.76% compounded. This result still seems appealing until it is compared to the use of the TRU with equities. For purposes of showing the effect of JGTRRA on the effective tax rate, we have provided both pre and post JGTRRA tax rates and results. See Table 2, which follows.
<table>
<thead>
<tr>
<th>Year</th>
<th>Trust Fund Balance</th>
<th>Taxable Dividend</th>
<th>Growth</th>
<th>Distribution</th>
<th>Stock “Pruned” &amp; Distributed</th>
<th>Cost Basis Used</th>
<th>Remaining Cost Basis</th>
<th>Pre-JGTRRA after tax Distribution</th>
<th>Post-JGTRRA after tax Distribution</th>
<th>Year End Fund Balance</th>
<th>Pre-JGTRRA Effective tax rate on Pruned Principal</th>
<th>JGTRRA Effective tax rate on Pruned Principal</th>
<th>JGTRRA Increase in after tax income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>100,000</td>
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<td>6,000</td>
<td>4,000</td>
<td>2,000</td>
<td>1,887</td>
<td>98,113</td>
<td>3,357</td>
<td>3,683</td>
<td>104,000</td>
<td>1.1%</td>
<td>0.8%</td>
<td>9.7%</td>
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<td>104,000</td>
<td>2,080</td>
<td>6,240</td>
<td>4,160</td>
<td>2,080</td>
<td>1,851</td>
<td>96,262</td>
<td>3,469</td>
<td>3,814</td>
<td>108,160</td>
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<td>9.9%</td>
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<td>1,816</td>
<td>94,446</td>
<td>3,586</td>
<td>3,950</td>
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<td>3.2%</td>
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<td>10.1%</td>
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<td>2,250</td>
<td>1,782</td>
<td>92,664</td>
<td>3,708</td>
<td>4,092</td>
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<td>4,394</td>
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<td>4.4%</td>
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<td>4,555</td>
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<td>5,693</td>
<td>2,847</td>
<td>1,590</td>
<td>82,656</td>
<td>4,559</td>
<td>5,078</td>
<td>148,024</td>
<td>8.8%</td>
<td>6.6%</td>
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<td>2,960</td>
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<td>81,097</td>
<td>4,723</td>
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<td>11.5%</td>
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<td>79,566</td>
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<td>75,147</td>
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<td>73,729</td>
<td>5,650</td>
<td>6,336</td>
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<td>9.1%</td>
<td>12.1%</td>
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<td>7,492</td>
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<td>6,577</td>
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<td>9.4%</td>
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<td>7,360</td>
<td>219,112</td>
<td>13.8%</td>
<td>10.3%</td>
<td>12.5%</td>
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<table>
<thead>
<tr>
<th>Total After Tax Distributions</th>
<th>Pre-JGTRRA</th>
<th>JGTRRA</th>
<th>Pre-JGTRRA increase Over Fixed Income Trust</th>
<th>JGTRRA Increase Over Fixed Income Trust</th>
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<tr>
<td>95,075</td>
<td>105,997</td>
<td>31.4%</td>
<td>46.4%</td>
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<tr>
<td>Trust Balance After 20 Years</td>
<td>219,112</td>
<td>27.1%</td>
<td>27.1%</td>
<td></td>
</tr>
<tr>
<td>Trust Cost Basis After 20 Years</td>
<td>68,320</td>
<td>68,320</td>
<td></td>
<td></td>
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<tr>
<td>If all Trust Securities sold at that time - Tax</td>
<td>30,158</td>
<td>22,619</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Would still leave remaining after tax assets of</td>
<td>188,954</td>
<td>196,494</td>
<td>9.6%</td>
<td>14%</td>
</tr>
<tr>
<td>Total Net After Tax After 20 Years</td>
<td>284,029</td>
<td>302,491</td>
<td>16.0%</td>
<td>23.6%</td>
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</table>

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

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

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

Assuming a full payment of capital gains taxes at the end of the 20 year period, the total net after tax to the beneficiaries would be 16% greater before JGTRRA and 23.6% greater after JGTRRA, assuming a full recognition of capital gains taxes at the end of the period.

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248 Note that in this simple model, there is no turnover in the trust, except for that needed to pay the beneficiary her 4%. The portfolio is transparent, with no separate tax calculations inside a trust portfolio, expenses or other tax events that occur within the real trust portfolio, particularly one that is not a grantor trust. The computer model constructed and illustrated later will take the many complexities that actually occur in a real trust into account, and the effects of JGTRRA can be studied with this more refined model as well, but the effects will be similar, and in the same direction.

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

250 I.R.C. §1014(a).
The graph which follows shows the dramatic increase in after-tax income generated by the use of this stock pruning. In the first year there was 21% higher after-tax income prior to JGTRRA. But JGTRRA increases the benefit to over 33% in the first year! By the twentieth year the gap widens to over 41% in the Pre-JGTRRA world and a 59% differential after JGTRRA. And this twenty year period might well be a representative period for a trust. If the comparison were continued, the gap would grow ever wider year after year.

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

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

C. THE ALLOCATION RULE AND CAPITAL GAINS—WILL THE TRADITIONAL RULE ALLOW A SENSIBLE CONDUIT APPROACH?

Until very recently, the question of whether capital gains will be taxed to the current beneficiary as a part of distributable net income has been an open one, despite the income allocation provision in the TRU model set forth previously in these materials. The issue is whether the IRS will treat a total return unitrust like a charitable remainder unitrust that has an ordering rule for the taxation of the trust beneficiary. A CRUT acts as a conduit for ordinary income, then short-term capital gain, then long-term capital gain, then nontaxable income and finally a nontaxable return of capital. Subparagraph H of the TRU instructs the trustee to largely mimic the CRUT approach directing that they distribute accounting income. Then to the extent that accounting income is insufficient, the trustee distributes any other ordinary income, then short-term capital gain, then long-term capital gain, and if still insufficient, the principal of the trust. In other words, the TRU uses a pure conduit approach draining off the highest taxation progressively to the lowest, with the exception of tax free accounting income, which should come out first just as in an income rule trust. The reason that this allocation rule is inserted into the form is to attempt to null down the issue and not provide for any unnecessary tax questions. It should also allow the trust beneficiary's taxable income to more clearly reflect the beneficiary's cash flow income. By mandatory allocation of capital gains to income, the TRU essentially redefines income as a unitrust amount just as was done by the statutory changes in the early unitrust statutes passed in New York and Missouri, but unlike the New York and Missouri statutes, which do not address the inclusion of capital gains into distributable net income, the TRU addresses it through the allocation mechanism provided by the regulations under Section 643 as discussed below. The entire thrust of the TRU is to allow the trust beneficiary to participate in the benefits of both the increase in value and capital gains enjoyed by the trust. Given this background, it seems less than sensible to tax all of the capital gains to the trust.

Prior to the changes brought about by the Final Treasury Regulations, §1.643(a)-3(a) provided that gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income unless they are (1) allocated to income under the terms of the governing instrument or local law, (2) allocated to corpus and actually distributed to the beneficiary during the taxable year, or (3) utilized under the terms of the governing instrument or the practice followed by the fiduciary in determining the amount which is distributed or required to be distributed. On the face of the regulation, the model allocation rule should function as intended. The examples in that regulation and some older authorities can be read as requiring that the recognition of capital gain must affect the amount of the distribution in order to be a part of distributable net income.\(^{251}\) In order for the mandated allocation of income contained in the trust instrument to be respected, it can be argued that there must be economic consequences apart from the allocation of income tax effect. This is stated specifically for the allocation among beneficiaries of classes of income in Treasury Regulation §1.652(b)-2(b). However, Treasury Regulation §1.643(a)-3(a) dealing specifically with capital gains, on the other hand, lacks the

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language specifically requiring economic effect and the governing instrument allocates capital gains to income.

Even prior to the issuance of the Proposed Regulations, Bob Rosepink\textsuperscript{252} argued that if the trustee is given the power to allocate receipts and disbursements between income and principal and does so by allocating capital gains to income, then the distribution from a TRU will carry out capital gain as a part of DNI in light of a Private Letter Ruling involving an annuity trust.\textsuperscript{253} And governing instrument provisions relied upon in this context must also pass the test of Sect. 1.643(a)-i:

\textit{Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose [defining income.]}

As Rosepink notes,

\textit{[S]ince the total return trust itself purposely departs from traditional distinctions between income and principal, the traditional concepts of what constitutes income should not apply to the total return trust.}\textsuperscript{254}

Indeed, as states have gradually adapted their laws to incorporate or address unitrusts, a unitrust distribution is no longer a real departure from “fundamental” state law concepts of income. With 40% of the states having unitrust legislation of one type or another, it is now a mainstream notion.

This author took the position that if the Service were to allow the trustee to allocate returns between income and principal so as to be able to effectively shift capital gains from the trust to the beneficiary or back to the trust again, surely they should allow or even prefer a fixed allocation rule contained in the governing document which requires that capital gains be taxed to the beneficiary to the extent that the distributable amount in a given tax year exceeds the net ordinary taxable income.

Why not give the trust its pure conduit effect, pouring out income and then short and long-term capital gain in sequence?

If the case for a pure conduit approach to the TRU were rejected, the overall economic benefits of the TRU would remain undiminished. Computer modeling would suggest that the effect on the trust corpus would be equivalent to an increase of about 1/4% in increased payout to the current beneficiary, though the differential would be considerably greater for an old trust with very low cost basis securities that was converted to a unitrust. So if we were attempting to maintain the precise proportion of benefits as between the current beneficiary and the remaindermen, we should in theory reduce the payout by an appropriate amount. This may

\textsuperscript{252} Robert J. Rosepink, \textit{The Total Return Trust - Where and How to Tax Capital Gains}, \textit{Trusts & Estates} 12 (October 1998).
\textsuperscript{253} PLR 8728001.
\textsuperscript{254} ROSEPINK, \textit{supra} note 252, at 18.
imply a far greater intent for accuracy in the division of economic benefits than is common in the real world. In light of the fact that drafters have for many years simply drafted trusts directing the trustee to hold the principal and pay the income, with no guidance at all as to how much the payment ought to be, this amount of adjustment, while significant, pales by comparison. It is rather like worrying about a windage adjustment for sighting a rifle when what we are used to with the ordinary income rule trust is firing with our eyes closed!

D. TREASURY LEADS THE WAY WITH THEIR PROPOSED REGULATIONS!

1. Overview Of Regulations—Facilitating Helpful Change

While the Proposed Regulations were an anticipated fulfillment of Treasury’s plan for guidance for the year 2000, they arrived on February 15, 2001 as a welcome one day late Valentine for practitioners and state lawmakers awaiting that guidance.\(^{255}\) The Prudent Investor Rule, with its encouragement of total return investment, and the concomitant reconsideration of the concepts of principal and income with the newest version of the Uniform Principal and Income Act, raised significant questions. How did these changes in the notion of “income”, namely the power to adjust under Section 104 of the UPAIA\(^ {256}\) and the non-charitable unitrust, fit into the tax mosaic? The concept of trust income is not only vitally important to the trustee and the beneficiary of the trust, but it is interwoven in the tax code at a number of critical junctures, which in this context produced the following questions:

1. First, and perhaps most importantly, a transfer to a trust for a spouse is required to distribute all of the income to the spouse during his or her lifetime in order to obtain the benefit of the gift and estate tax marital deduction.\(^ {257}\) Does a unitrust interest or an income interest subject to the power to adjust qualify for that all-important deduction?

2. Generally speaking, capital gains realized by a trust do not form a part of distributable net income that is passed out and taxed to the beneficiary. When might such realized capital gains be included in distributable net income and therefore passed out to the beneficiary in the context of the power to adjust and the non-charitable unitrust?\(^ {258}\)

3. How does the addition of the power to adjust or a conversion to a unitrust regime under state law affect the grandfathered status of older trusts for Generation-Skipping Transfer Tax purposes?\(^ {259}\)

4. How does a state law change to allow the power to adjust or a unitrust definition of income affect net income charitable remainder trusts and pooled income trusts under IRC Sections 664(d)(3) and 642(c)(5)?\(^ {260}\)

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\(^ {256}\) UNIFORM PRINCIPAL AND INCOME ACT, supra n. 10.  
\(^ {257}\) I.R.C. §§ 2523(e) and (f) and 2056(b)(5) and (b)(7).  
\(^ {258}\) See Wolf 2, supra n.11 at 153-154; Wolf Miami, supra n. 11 at I-C-47–I-C-48; ROSEPINK, supra n.239.  
\(^ {259}\) See Wolf Miami, supra n.11 at 102-103.  
\(^ {260}\) PROPOSED REG., supra n. 242, Explanation of Provisions at 10397-10398.
5. How does a state law change in the definition of income affect the tax treatment of distributions in kind?\textsuperscript{261}

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

2. \textit{The Marital Deduction}

Certainly the most critical concern of drafters and state legislatures considering a change in state law regarding the definition of income was the fear that the change to a unitrust definition of income might not be considered to be, in the words of the existing regulation:

Such degree of enjoyment …that the trust should produce for the surviving spouse during her life such an income, or that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation.\textsuperscript{262}

As noted previously, the use of the unitrust was advocated by this author and others precisely so that the surviving spouse beneficiary and other beneficiaries of trusts could enjoy a reasonable stream of income which is consistent with the value of the trust corpus and with its preservation. But without the Proposed Regulations, the only way to be sure that the marital deduction would be allowed was to provide for a payout of the unitrust amount or the income, whichever is greater, at least annually.\textsuperscript{263} This may be undesirable, since in a high interest rate environment, when the financial markets are typically depressed, the income rule would require the trustee to distribute excessive income in a portfolio rich in bonds at a time when the trust portfolio is likely to be losing ground to the effects of high inflation.

The power to adjust potentially raised the issue as to whether the trustee’s authority to make adjustments between principal and income could be a power to appoint trust property to a person other than a surviving spouse, impermissible under Reg. Section 20.2056(b)(7).\textsuperscript{264}

Fortunately, the Proposed Regulations made a thoroughgoing change to the definition of income under 1.643(b)(1):

Trust provisions that depart fundamentally from traditional principles of income and principal, that is, allocating ordinary income to income and capital gains to principal, will generally not be recognized. However, amounts allocated between

\textsuperscript{261} \textit{Id.} at 10398.


\textsuperscript{263} Wolf 2, \textit{supra} n.11, at 83-84, Wolf Miami, \textit{supra} n. 11, at I-C-42.

\textsuperscript{264} CUSHING, \textit{supra} n. 262, at B-15-GLC.
income and principal pursuant to applicable local law will be respected if local
law provides for a reasonable apportionment between the income and remainder
beneficiaries of the total return of the trust for the year, including ordinary
income, capital gains, and appreciation. 265

If the Proposed Regulation stopped there, one would be very concerned that Treasury was
going to require a year by year allocation of total return, which sounds fine in theory but in
practice would be a volatile disaster for the beneficiary, whose income would be completely
subject to the whims of the market. Fortunately, they did not stop there:

For example, a state law that provides for the income beneficiary to receive each
year a unitrust amount of between 3% and 5% of the annual fair market value of
the trust assets is a reasonable apportionment of the total return of the trust. Similarly, a state law that permits the trustee to make equitable adjustments
between income and principal to fulfill the trustee’s duty of impartiality between
the income and remainder beneficiaries is generally a reasonable apportionment
of the total return of the trust. These adjustments are permitted when the trustee
invests and manages the trust assets under the state’s prudent investor standard,
the trust describes the amount that shall or must be distributed to a beneficiary by
referring to the trust’s income, and the trustee after applying the state statutory
rules regarding allocation of income and principal is unable to administer the
trust impartially. 266

Both the power to adjust and the unitrust have been blessed as qualifying for the marital
deduction under the Proposed Regulations, provided that the state law provides the requisite support. Questions remained, as they always do. The language describing the power to adjust
sets out all of the requirements contained in the UPAIA, including the application of a prudent
investor standard. In theory this could mean that in a state without the prudent investor standard,
or whose version of the UPAIA does not refer to that standard, might not receive the Treasury’s blessing for the application of the power to adjust. Surely this nuance is descriptive and should
not be a necessary limitation. It is logical to grant an adjustment power to a trust which for one
reason or another is not subject to the prudent investor standard of the state, such as a trust which
by its terms has opted out of that standard, but in which the trustee still has the goal of treating
the beneficiaries impartially and investing for total return.

3.  Capital Gains As A Part Of Distributable Net Income

Generally speaking, capital gains incurred in a trust do not form a part of distributable net
income, and are therefore taxed to the trust, rather than to the beneficiary. 267 As discussed
previously, the prior regulations listed three exceptions:

(a) Capital gains were allocated to income by the governing instrument or
local law;

265 PROPOSED REG. supra n. 255, §1.643(b)-1.
266 Id.
267 See CUSHING, supra n. 262, at B-5-GLC.
(b) Capital gains were allocated to corpus and actually distributed to the trust beneficiaries during the year; or

(c) Capital gains were utilized in determining the amount that is required to be distributed pursuant to the governing instrument or the practice followed by the fiduciary.\(^{268}\)

Within the context of the total return unitrust or the power to adjust, these requirements raised questions. As this author and others had urged, it was sensible to have an ordering provision for the non-charitable unitrust which functioned largely like the regulations for the charitable remainder unitrust; that is, the accounting income would be distributed first, then other ordinary income, then the short term capital gains, then the long term capital gains, and then the principal of the trust.\(^{269}\) If this were not the case, one would have the anomalous situation in which the trust beneficiary of a trust invested largely in equities might be getting a generous payout of 3% to 5% of the value of the trust, but because of the low accounting income and the deductibility of trustees’ fees, the beneficiary might pay little or no income tax on the unitrust distribution, while the trust itself paid any capital gains taxes as a result of the total return approach. In substance, as long as the approach to allocation of the capital gains to the trust or the beneficiary was consistent, there would be no important tax policy offended by giving the drafter or the trustee the choice of allocation. And Treasury accepted this philosophy with the addition of the following language to the definition of income:

In addition, an allocation of capital gains to income will be respected if the allocation is made either pursuant to the terms of the governing instrument and local law, or pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law.\(^{270}\)

The Proposed Regulations added a number of examples that make it clear that an ordering rule within the state statute will be respected. Example 9 describes a unitrust statute with a 4% payout where state law provides that the unitrust amount shall be considered paid first from ordinary income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal.\(^{271}\)

This ordering rule is specifically approved by the examples. Examples 10 and 11 which follow are premised upon the fact that neither state law nor the governing instrument has an ordering provision rule for the character of the unitrust amount, but leaves such a decision up to the trustee. Collectively they provide that the trustee can adopt either approach for the reporting of capital gains: either including it in DNI or excluding it from DNI, provided that the exercise of discretion is consistent on a year to year basis.\(^{272}\)

\(^{268}\) Treas. Reg. §1.643(a)-3(a).
\(^{269}\) Wolf Miami, supra n.11, at I-C-40, I-C-47.
\(^{270}\) PROPOSED REG., supra n. 255, §1.643(b)-1.
\(^{271}\) Id. at 1.643(e), example 9.
\(^{272}\) Id., examples 10 and 11.
This provides very helpful discretion to the trustee, though one remaining question is whether in the absence of an ordering provision in state law or the governing instrument, a fiduciary which had allocated capital gains to corpus and paid the tax at the trust level because it did not think that any other treatment was permissible would be able to change its method consistently for the future. Such a decision should be permitted, since for most trusts this would not have been permissible prior to the changes brought about by the Proposed Regulations. There seems no reason to deny existing trusts the benefit of this otherwise helpful flexibility, now that it is available.

Several additional points were suggested by this author for the Final Regulations. First, since almost all of the new state statutes utilizing a private unitrust as a definition of income use a smoothing rule, in order to make the beneficiary’s distribution less volatile 273 it would be helpful if such a smoothing rule were expressly approved as part of the definition of income.

The ordering rule speaks of “ordinary income” rather than “accounting income”. This terminology leaves tax-free income out of the picture, since it is neither ordinary income nor a “return of principal” and the author suggested that there should be a reference to tax-free income. For example, some of the state statutes refer to the first tier of income ordering is the “net income” as it would be defined if the trust were not a unitrust. This would allow the beneficiary to receive proportionate benefit of the tax-free income after reduction of deductible expenses, prorated as between the classes of accounting income. While the TRU is similar to a CRUT in its general design, it does not share the tax free standing of the CRUT, so that the placement of the tax free income out of order in the CRUT four tier system is not justified in the case of the TRU. It is therefore most sensible to order the distributable net income as traditional net accounting income, other ordinary income not included in net accounting income, short term capital gains, long term capital gains and then the principal of the trust.

On a finer note, the Explanation of Provisions for the Proposed Regulations state that capital gains are to be included in distributable net income to the extent that they are so treated pursuant to the governing instrument or local law. In the definition of income in the Proposed Regulation itself, the word and not or is used. This is different from the standard set forth for the exercise of the discretionary authority in the trustee that must be made either “pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law.” 274 A clarification of these standards would have been helpful in the Final Regulations. While the author thinks that a consistent standard of “of not inconsistent with state law” is the most sensible standard both for a mandatory ordering rule and a trustee power to determine the method, the Final Regulations maintained, and perhaps even increased the opacity of the rule, as discussed in the following section on the Final Regulations.

It was not clear how the Proposed Regulations affect other types of total return trusts, such as indexed annuity trusts, TRUCAP indexed trusts and others discussed later in these materials. As a general proposition, Treasury should have allowed an ordering rule or a

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273 See discussion in Section VI, supra.
274 PROPOSED REG., supra n. 255, §1.643(a)-3(b).
consistently applied exercise of discretion pursuant to the governing document or applicable state law, even though the payout regime is different from the power to adjust or the unitrust, the most common ways of dealing with the issue of trust income. As we will see we were not blessed with an answer here either. This is one of several areas in which the Final Regulations left unanswered or inadequately answered questions.

JGTRRA inserts an interesting question or two here as well. Since “qualifying dividends” are treated as long term capital gains for income tax purposes, will a state law or trust that referred to “ordinary income” shovel out the qualifying dividends along with taxable interest in the first tier, or would it be distributed as part of the long term capital gain portion of DNI? It would seem to this author that having qualifying dividends distributed out first as part of traditional accounting income makes the most sense, since categorizing them as long term capital gains for tax purposes was more a matter of convenience than a sensible theoretical structure which should somehow affect how they enter into DNI. The new treatment of qualifying dividends will not change their status as “income” under state trust law, and so in this author’s opinion, the qualifying dividends should flow out first as part of net accounting income, along with tax free income, just as they would in the traditional trust regime. And the character of the income and the apportionment of deductible expenses in the trust takes on an added importance under JGTRRA. Perhaps surprisingly, the 2003 tax forms confirmed the taxpayer friendly position that deductions in a trust are taken against the highest taxable income category first, such as taxable interest or nonqualifying dividends, allowing the benefit of the qualifying dividends to be undiluted by deductible expenses, unlike tax free income, which requires proration.

The foregoing suggests an interesting planning pointer for trust investments. If a trustee has a choice between taxable Treasury interest and tax free municipal interest, where the trust is primarily invested in stocks producing qualifying dividends and long term capital gains, the trust may be better advised to invest in the higher yielding Treasuries to allow the Treasury interest to “soak up” the trustee’s fees and other deductions. Let us assume that we have a 75% equity and 25% fixed income portfolio with 1% trustee’s fees, and that we have a dividend yield of 1.67%, in line with the S & P 500. Let us assume further that we are deciding between a 10 year Treasury Note at 4.3% and a AAA municipal bond yielding 3.73%. This would appear to be a no brainer, since even at a tax rate of 25%, the net income from the Treasury Not will be 3.225%, much less than the 3.73%. But it’s not as simple as that. The 1% trustee’s fees would offset the Treasury interest first, leaving only .075% left to be taxed from the Treasury interest. Hence the net after tax interest from the treasury note would be 1.05625%. The qualifying dividends would be taxed at 15%, 75% times 1.67% times 85% leaves us with 1.0625%. The Treasury mix under JGTRRA leaves us with a yield of 1.05625% plus 1.0625% or 2.115%. The municipal bond mix would leave us with .93% net from the municipal bond income and 1.1485% from the qualifying dividends (dividend income of 75% of 1.67% less .10149% tax after pro rata trustee’s fees deduction). This gives us a total net yield of 2.0785%. Therefore, one should consider taxable securities in a trust portfolio if the fixed income portion can “soak up” the trustees’ fees and other deductions entirely. The effect would be different in a portfolio where there was both tax free and taxable interest bearing securities, since the tax free securities would take away from the

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275 See CUSHING, supra n. 262, at B-18-GLC, B-19-GLC.
276 I.R.C. §1(h)(11).
JGTRRA produced tax free treasury yield, so that in a 50% equity, 25% Treasury and 25% municipal bond portfolio, the Treasury favored result would not hold. Of course, state taxes enter into the planning mix here as well, and Treasuries may provide an edge here too if the municipal bonds are not all exempt from state income taxes.

4. **Is This Ordering a Good Idea?**

This author has consistently contended that an ordering rule was beneficial in state laws for a number of reasons:

a. It is helpful to know what the tax treatment is going to be, rather than leaving it open as a question. This is particularly important in light of any decisions concerning the rate of distribution which will be affected by the tax regime. Granting the trustee a choice of treatment could be helpful flexibility, but for the most part it is likely to add to the confusion, and the complexity of fiduciary income tax return preparation.

b. The current beneficiary of a TRU is obtaining the benefit from total return investing, and particularly from capital appreciation and capital gains incurred in the trust, and should therefore pay her fair share of taxes on them to the extent of distributions, just as she would pay taxes on interest and dividends.

c. Including capital gains in DNI allows the trust tax regime to be more purely a conduit approach, while the payment of taxes by the trust on capital gains incurred when principal is distributed to the current beneficiary increases the possibility of resentment by the remainder beneficiaries of the distribution of virtually tax free income to the current beneficiary. The current beneficiary already gets a double benefit from the deduction of trustees’ fees and other administrative expenses from taxable income, even though the majority (or all of it in a TRU) is paid for by the corpus of the trust, and not out of the beneficiary’s share.

d. Where capital gains are taxed to the trust, it produces a conflict of interest for the trustee in making her investment selection between investments which produce ordinary taxable income and those that produce capital gain, even if they were likely to produce the same net after tax return, since the identity of the payer would be different. If a taxable bond were to produce 5%, of which 4% was taxed to the current beneficiary, the trust would be left with 1% retained in the trust and taxed to the trust. If a non-income producing stock were purchased instead, with the same 5% realized return, the trust would pay more tax on the capital gain asset, even under JGTRRA, because all of the tax would be born by the trust, as opposed to only a third of it.
e. An ordering rule is needed in order to allow a more generous payout as provided by most state statutes and most TRU documents. If an ordering rule were not included in the tax regime of a state or in a TRU trust document, the amount that could be paid out to the beneficiary while still retaining a reasonable chance to preserve the value after taxes, expenses and inflation, should be reduced.

The foregoing reasons are reiterated because there has been criticism of the ordering mechanism in Richard Covey’s *Practical Drafting* issue of April 2002. He correctly points out that with an ordering mechanism, that there will be an inefficiency with respect to the investment in taxable versus non-taxable investments, such as municipal bonds. Clearly, a 4% distribution of tax free income is worth more in economic terms than a 4% distribution of taxable interest, or even 4% comprised of qualifying dividends or long term capital gain. In this respect, the unitrust does not eliminate the investment conflict altogether for the trustee as between the interests of the current beneficiary and the remainderman. However, if the ordering rule is not employed, there will be an even more frequent conflict with respect to the alternative investment in capital gain versus ordinary income property as noted in d. above. In any event, all of the other reasons for favoring the ordering rule noted above will still apply.

Covey correctly notes that the most perfect method of taxation for the unitrust would be to tax all income to the trust in all events, as this would produce an investment regime truly agnostic to the tax character of the potential investment. In such case the trustee would be absolutely free to invest in whatever form of investment is believed likely to produce the highest after tax return, free from worry about the allocation of the tax burden, if any. Unfortunately perhaps, such a regime does not exist within Subchapter J of the Code, since ordinary accounting income will flow out to the current beneficiary as part of DNI whether we like it or we do not. If such a regime did exist, it would be critical to significantly reduce the TRU payout to the current beneficiary to reflect the added burden on the trust and the tax free nature of the current beneficiary’s distribution, likely to a 2 ½ or 3 % maximum rate.

5. What About Grandfathered Trusts?

Final regulations were issued in December of 2000 for modifications of existing trusts which expressly approved a conversion of an income only trust to a unitrust where the modification provided for the payment of income in excess of the unitrust interest if the income were greater than the unitrust amount. This left open the question of whether an income only trust paying out a current yield of perhaps 2%, if converted to a 4% unitrust, would be exposed to the GST tax if the trust were previously grandfathered. Fortunately and sensibly, the Proposed Regulations answer this question as to the unitrust and as to the power to adjust:

In addition, administration of a trust in conformance with applicable state law that defines the term income as a unitrust amount, or permits the trustee to adjust

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277 Richard Covey, U.S. Trust – Practical Drafting, April 2002, pgs 6809-6838.
278 *Id.*
280 See Wolf Miami Part II, *supra* n.11 at 1-C-90.
between principal and income to fulfill the trustee’s duty of impartiality between income and principal beneficiaries, will not be considered to shift a beneficial interest in the trust, if the state statute provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of Section 1.643(b)-1 of this chapter.

Conversion to a unitrust payout which comports with the general definition of income under §1.643(b)-1 will not create any difficulty for GST purposes, nor will the adoption of the power to adjust under UPAIA cause a problem for these sensitive GST grandfathered trusts. Note, however, that for trusts in a state without this beneficial legislation, the power to adjust is not available, and even if a unitrust conversion were accomplished under some other statute, or under applicable case law, the change would have to use a “unitrust or income, whichever is the greater” approach to fall within the original final GST regulations, since it would not gain relief from these Proposed Regulations, or, for that matter, under the Final Regulations as discussed below. And, as discussed below, there are other tax worries in this event that will slow us from making such a conversion in the absence of a specific state statute in most cases.

6. How Did The Proposed Regulations Deal With Charitable Split Interest Trusts?

The Proposed Regulations deal somewhat less kindly with changing definitions of income under state law in the context of Pooled Income Trusts and Charitable Remainder Unitrusts. For Pooled Income Trusts, where long term capital gains receive the benefit of the charitable deduction, the power to adjust at the discretion of the trustee and a unitrust definition of income are expressly disallowed.\(^{281}\) For the Pooled Income Trust, where the theory of the charitable deduction for capital gains is that all capital gains will eventually go to the charity, the change to a unitrust definition realistically introduces the probability that a portion of the capital gains will really go to the non-charitable beneficiary, clearly justifying the position of the Proposed Regulations.

The revision of the charitable remainder unitrust regulations proposed raises more interesting questions.\(^{282}\) On the surface, the change seems sensible enough. The Net Income Unitrust provides that the distribution to the non-charitable beneficiary shall be the lesser of the income earned in the trust or the stated unitrust amount, which must be at least 5%.\(^ {283}\) If a unitrust income definition of perhaps 4% were adopted, what would be the result? Functionally one would have a unitrust within a unitrust, not very sensible or useful from the point of view of the non-charitable beneficiary, who is generally seeking some flexibility to defer income until it is needed later; at retirement for example. But what tax policy is being protected here? One might suppose that once a NICRUT were in effect, the change from an ordinary definition of income to a unitrust definition of income would probably raise the income to the non-charitable beneficiary, though no benefit from this deduction is enjoyed on the front end, since the valuation method is the same for the charitable interest, whether a straight unitrust or a NICRUT is used.

\(^{281}\) PROPOSED REG., supra n. 255, §1.642(c) – 2.
\(^{282}\) PROPOSED REG., supra n. 255, §1.664-3.
\(^{283}\) I.R.C. §664(d)(2).
But this raises a more interesting and important point about unitrusts generally, which are required to pay out at least 5% per year. Because of the recently added 10% requirement for the charitable interest,\textsuperscript{284} the 5% minimum precludes the use of a CRUT for a very young person. At the August 2004 §7520 rate of 4.8%, a CRUT could not be started for a 24 year old, simply because her interest at a 5% payout exceeds 90% using the applicable treasury tables.\textsuperscript{285} Why as a matter of policy should the payout not be allowed down to some sensible limit, such as 3%? This would take away the arbitrary age limitation from the combination of the current requirements, and allow planners to use more conservative rates of payout for CRUT’s generally. Why not allow a 3% CRUT to be drafted for a 50 or 60 year old? For the donor, it would increase the available deduction, but there is no subterfuge here. The charity will get much more benefit with a lower rate unitrust payout. The logic which likely precipitated the 5% minimum used in Section 664 came from the minimum investment return rules of Section 4942 imposed to be sure that charitable interests really participated in the trust’s charitable purposes. Without any minimum unitrust payment, the minimum investment return rules could be avoided by simply providing for a very low payout, such as 1% to a charity. Indeed, while Treasury is looking in a broad sense at the income and principal rules, it would make sense to revisit Section 4942 as well. The 5% minimum investment return requirement for private foundations can only cause trouble for the trustee and the beneficiaries of such trusts, particularly in states which have not allowed a change in their income rules to allow a total return unitrust approach for these trusts as well. Without that relief, the trustees are forced to produce enough accounting income to satisfy the payout requirement, substantially impairing the prudence of their trust investment portfolio. A far more prudent rule would be to require a minimum investment return\textsuperscript{286} of at least 3%, and permit charitable remainder unitrust rates down to the same 3% level. This would allow a Charitable Remainder Unitrust to be formed for a person of any age, as the remainder interest of a newborn would be 12.715%.\textsuperscript{287} This would require a statutory change, but such change would be beneficial to the charitable community without any harm to tax policy. The 5% requirement for private foundations is too high a mandatory rate in light of the existence of restrictive state laws and governing documents often requiring the distribution to be made from accounting income. Such requirements press the trustee in invest in fixed income investments which largely eliminate the possibility of preserving the real value of the charitable fund, as these materials demonstrate. Sadly, at least with respect to the private foundation rules, the foregoing is highly unlikely to occur, since the pressure is on to force higher, and not lower distributions from private foundations to make up for the last three years of bear market which have decreased the contributions to charities from this source.\textsuperscript{288}

\begin{footnotes}
\item 284 I.R.C. §664(d)(2)(D).
\item 285 According to Leimberg & LeClair’s Numbercruncher, a 24 year old’s interest in a 5% CRUT payable quarterly at, using the August 2004’§7520 rate of 4.8% represents 90.024% of the value, too high to pass the 10% test.
\item 286 The minimum investment return is really a misnomer. The real intent is a minimum payout requirement with far too many computational requirements that add significantly to the expense of such private foundations.
\item 287 Again using Leimberg & LeClair’s Numbercruncher, a Charitable Lead Unitrust for a person of age 0 with the unitrust interest payable quarterly to the charity at 3%, using the August 2004 §7520 rate of 4.8% produces a life interest of 87.031% of the value, leaving 12.969% for the remainder interest. The calculation would be the same for a CRUT, were the rate allowed.
\item 288 S.1514, introduced by Kay Bailey Hutchison, R-Texas in 2003, would have reduced the investment excise tax on foundations from 2 percent to 1 percent, but would remove expense items from qualified distributions, which would effectively raise the minimum distribution rate. The Bill did not move, likely because of revenue concerns.
\end{footnotes}
7. **How Do The Proposed Regulations Deal With Distributions In Kind?**

The answer to this question is clear enough under the Proposed Regulations. The satisfaction of a unitrust payout defined as “income” under Section 643(b) will result in recognition of gain, even if the distribution is done on a fractional basis, because the payment would be in satisfaction of the obligation of the trust to pay income as newly defined. 289

8. **What Did The Proposed Regulations Mean For Drafters And States Considering Changes In Their Definitions Of Income?**

The promulgation of these Proposed Regulations indicated that Treasury viewed the sea change in the definitions of income and the way distributions are described in trusts as inevitable and sensible. The Proposed Regulations facilitated, if not outright encouraged these changes, which are, in the final analysis, tax neutral and helpful to trustees and beneficiaries.

The issuance of the Proposed Regulations shifted the legislative dynamic. Prior to the promulgation of these regulations, the question was why a state would want to be first to make these important changes? Now the question is whether any state can afford to be the last to do so? States making these beneficial changes in their state law will benefit not only the trustees and beneficiaries of trusts within their borders because of the freedom which the new provisions grant, but will also be providing in the process a more favorable tax climate for their trusts. The treatment of income under the Internal Revenue Code was and continues to be a concept tied to state law. Those states that are quick to adopt statutory changes to allow both the unitrust and the power to adjust will offer these advantages over those that do not:

(a) A unitrust distribution will qualify for the marital deduction without also requiring a distribution of the “income or unitrust amount, whichever is the greater”. This eliminates the possibility of future conflicts of interest in high interest rate environments.

(b) A conversion to a unitrust will not create risk from a generation skipping tax perspective, even without introducing the “income or unitrust amount, whichever is greater.” Example 11 in the Proposed Regulations seems also to lessen any concerns that such a conversion, when pursuant to a state law change, might generate transfer tax questions by including a fact pattern in which the beneficiaries must consent to the conversion.

(c) A state with a statutory ordering rule for unitrust distributions will create a clear path for trustees to include short and long-term capital gains as part of DNI. This allows a prudent payout to be higher than would be possible if the gains were taxed to the trust. Those states desiring to grant

289 PROPOSED REG., supra n. 255, Section 1.651(a)-2(d). Presumably if the trust situs were not in a state for which the unitrust would qualify as income under the Proposed Regulations, distribution in kind of an appreciated security as part of a fractional distribution requirement might continue to be a non-recognition event. Conceptually, a TRU is more fractional than pecuniary so one could argue with the Proposed and Final Regulations, but their wording is quite clear.
discretion to the trustee to include or not include capital gains as part of DNI might do well to specifically include it in their statutory language, since otherwise such discretion might well be uncertain under most governing documents and applicable state law.

(d) The power to adjust could never be drafted into a marital trust without an empowering state law provision, despite its usefulness.

(e) A QDOT could never be drafted as a unitrust, since distribution of “principal” would trigger federal estate tax.

States promptly considering and acting upon these beneficial state law changes were placed at a significant competitive advantage in the attraction and retention of trust business, when contrasted with states that did not have these changes in place. This has been an important accelerant to the passage of total return legislation in general, and to the passage of total return unitrust statutes in particular.

Within one year of the enactment of the first unitrust statute on June 21, 2001, there were 11 more states to enact such legislation, if one includes Illinois, which passed but was waiting for its Governor to sign on June 21, 2002. One dozen states changing the concept of principal and income in one year and seven more since then—all the more remarkable in light of the fact that the principal and income laws have not undergone fundamental changes to this extent for literally centuries.


A 2002 Private Letter Ruling raised another question not addressed in the Proposed Regulations about which guidance was clearly needed. In PLR 200231011, decedent created a trust for his grandson, giving him an annuity interest for life, and leaving the remainder at his death to 3 charities.290 Within a year after decedent’s death, the trust was restructured with the consent of the court and the beneficiaries to provide annual income distributions to the grandson instead of the annuity set forth in the will, but with a minimum and maximum yield as specified in a “performance chart” agreed to by the parties, in part in exchange for partial payments from the trust to the charities. Differences arose among the parties as to the continued administration of the trust, and a global settlement was reached, whereby the charities’ interests in the trust were cashed out, and grandson’s interest in the trust was significantly reformed. He would now receive a 7% unitrust distribution; the trustee would have authority to distribute additional funds to him if needed for his “reasonable support”. In addition, he was given a general power of appointment over the trust corpus exercisable by will, the latter inserted in order to obtain a favorable ruling for generation skipping transfer tax purposes. Grandson then applied for a private letter ruling that there was no loss of GST exemption, that there was no taxable gift as a result of the transaction, and that the implementation of the proposed agreement and court order would not result in capital gain or loss or taxable income to any party to the order.

290 The trust apparently was not a charitable remainder annuity trust, however.
The ruling was favorable for purposes of generation skipping transfer tax, since the general power of appointment assured that no beneficial interest of a transfer to a skip person would be increased, nor the transfer extended.\footnote{Treas. Reg. §2601-1(b)(4)(i)(D).} The gift tax part of the ruling was also favorable, since the dispute and resolution of the differences concerning the interests of the charities and grandson were based on arms-length negotiations. But the income tax part of the ruling appears to have been highly unfavorable to taxpayer, with a holding that grandson’s interest in the trust had been “exchanged” in a taxable transaction pursuant to \textit{Cottage Savings Association v. Commissioner}, 499 U.S. 554 (1991). \textit{Cottage Savings} involved the exchange of mortgage loans made to different obligors and secured by different homes that in the opinion of the court embodied sufficiently different legal entitlements that the taxpayer was entitled to realize losses when it exchanged interests in the loans.

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

The question raised by the PLR is whether conversions to a unitrust under the express provisions of a state statute, and as approved in the Proposed Regulations under Section 643 could attract an argument that there has been a gift transfer or that there has been a sale or exchange under \textit{Cottage Savings}? Could the mere passage of a state statute granting the trustee the power to adjust entail such a risk? It is submitted that either treatment would be improper in the author’s opinion, but the issue will retain vitality in states where there is not unitrust conversion statute, and more broadly in the expanding context of trust modifications which are likely as the Uniform Trust Code\footnote{\textit{See} \textsc{Uniform Trust Code} §§410, 417, 7C U.L.A. (2000). The Uniform Trust Code has been adopted in 9 states plus the District of Columbia at the time of this writing. \textit{See} the nccusl legislative fact sheet at http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-utc2000.asp.} makes progress in state law. This PLR is highly distinguishable from a state law authorized unitrust conversion for the following reasons:

\footnotesize
\begin{quote}
\textsuperscript{291} Treas. Reg. §2601-1(b)(4)(i)(D).
\end{quote}
The effect of a unitrust conversion statute and a unitrust definition of income are to give the unitrust interest a legal equivalency. For example, under the Pennsylvania statute, after the conversion,

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

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

Under the Proposed Regulations, a state law which allows an election into a unitrust definition of income should be respected for marital deduction purposes both for federal estate tax and gift tax purposes. The premise of the Proposed Regulations in this regard is that the marital interest is not affected in such a way that it is no longer a fair income interest entitled to the marital deduction and “consistent with the value of the trust corpus and with it’s preservation.” So for this tax policy purpose, the marital interest, if converted into a unitrust interest, particularly within the range of 3-5% mentioned specifically in the Proposed Regulations, has not been diminished in such a way as to cause its character for tax purposes to be changed.

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

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293 20 Pa.C.S. §8105(d)(3).
294 See text at nn. 262 and following.
295 See n. 262, supra.
beneficial interest in the trust. Examples 11 and 12 thereunder specifically provide that if an adjustment or if a trust is converted pursuant to such a state statute providing for a 4% unitrust payout, with the consent of all of the beneficiaries, that there is no shift of beneficial interest. Since the application of this Proposed Regulation could be to provide a unitrust interest to either a skip person or a non-skip person, this portion of the Proposed Regulation even more clearly indicates Treasury’s view that the unitrust option, at least within the limits noted in the Proposed Regulations, produces no shift of beneficial interest. If there is no shift of beneficial interest, there is clearly no exchange of a beneficial interest, at least from a tax policy point of view.

(4) Under the Proposed Regulations, if an income distribution is now defined as a unitrust interest or is subject to the power to adjust under applicable state law, and if that income distribution requirement is satisfied with property in kind, a gain or loss is realized by the trust under Proposed Regulation 1.661(a) 2-(f). Here again, and this time for income realization purposes, the unitrust interest is proposed to be the legal and tax equivalent of the prior income interest.\(^{296}\) If the trust interest of the income beneficiary were exchanged at the inception of the unitrust conversion, by the application of the \textit{Cottage Savings} doctrine, this section in the Proposed Regulation would cause an incongruous engrafting of a second realization event. It would be strange indeed if this minor realization event were included without reference to a realization of the entire unitrust interest!

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

It was therefore the author’s opinion that it was highly unlikely that the reasoning of PLR 200231011 would be extended to attack a state law sanctioned unitrust conversion,\(^{297}\) or the passage of the power of adjustment without a release of that power. But:

1. The Proposed Regulations were not in effect except for calendar years beginning during the year after final regulations have been published. The tax policy they reflect is clear enough in this regard, and there is no better available guidance as to Treasury’s attitude towards these changing state law definitions of income, the Proposed Regulations, by their terms, were not guidance upon which we could rely.

\(^{296}\) Whether this actually makes sense, in light of the fact that a unitrust distribution, in essence, is more fractional by its inherent nature, than truly pecuniary, is less clear. But the Proposed Regulation in this regard is clear enough.

\(^{297}\) Barbara A. Sloan, \textit{Consequences of PLR200231011: Cottage Savings or Cottage Industry?}, 29 ACTEC Journal 102, 105, Fall 2003.
2. Literally speaking, the Section 643(b) definition of income does not necessarily apply to what could be more broadly viewed as a Section 61 definition of income question, so that additional guidance was needed to put the question to rest.

3. In states where there is no unitrust definition of income, the foregoing reasoning and arguments are unlikely to apply, so that in non-unitrust states, the Cottage Savings issue is a considerably larger issue.

4. In states where there is a unitrust conversion statute, but the conversion allows a unitrust payout that is not between 3-5%, such as 2% for a long term GST trust, or a 6-7% return, for a marital trust, the situation is much less obvious and the attitude of Treasury less predictable.

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

E. TREASURY GIVES ITS “FINAL” ANSWERS AND LEAVES A FEW QUESTIONS

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

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

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

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

As previously described in detail in these materials, there are a total of 43 states that have enacted total return legislation providing either the power to adjust under the Uniform Act, the power to convert to a unitrust or both.

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

1. Cause a loss of the federal estate tax marital deduction,
2. Trigger a taxable transfer for gift tax purposes,
3. Result in a taxable sale or exchange (ala Cottage Savings), or
4. Undo GST grandfathering.

Particularly with respect to trusts which were GST grandfathered, and for marital trusts, because the Proposed Regulations were not final and in effect, and by their express terms they could not be relied upon until the year after they were made final, much of the process of review and response had been delayed pending the final answers provided by the Regulations. The reason for this is simple enough. The consequences of losing a marital deduction, or GST grandfathering, or the possibility of a sale or exchange treatment was sufficiently threatening that even a low level of concern was sufficient to keep many trustees from applying these new statutes to the majority of their existing trusts. The Final Regulations alleviate these concerns and

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301 See Blattmachr and Gans, *supra* fn. 300 for an exhaustive analysis of the Regulations, particularly with reference to the inclusion of capital gains in Distributable Net Income, at 898-907.

302 See Appendix 11 for a chart of all of the states.

303 According to Suzanne Ross, Senior Vice President of PNC Bank, N. A. her trust division had a total of 6,000 of such trusts upon which final decision had been delayed pending the Final Regulations.
protect the tax benefits under recent state law changes providing for a unitrust definition of income and/or the power to adjust between principal and income.

It is therefore now time for trustees and practitioners to fully implement the changes afforded by the legislatures of almost every state, and integrate a total return investment and distribution philosophy into their daily professional lives.

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

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

1.643(b)-1 Definition of income. For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, “income,” when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. (new language underlined).

This first part of the Regulation reaffirms the statutory requirement that the tax law will recognize the meaning of “income” for Subchapter J to be that which is determined under the terms of the governing instrument and applicable local law, but trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. The emphasized portion of the Regulation above is new language in response to comments that observe that the prior language, which talked of “ordinary income” and “capital gain” did not actually relate to state trust law concerning income and principal. Ordinary income and capital gain are tax concepts, not concepts of principal and income. The writers added some language to describe in a general way what is intended to be considered as “traditional principles of income and principal”. The word “traditional” was newly inserted in the Proposed Regulations and was retained in the Final Regulation. The prior language was to exclude those notions which “depart fundamentally from concepts of local law”, but local law has undergone an extremely thoroughgoing change with the advent of the unitrust and the power to adjust. It appears to the author that the term “traditional” was inserted to allow the Service to reject local law which it thinks goes too far in redefining income in a way that might be altogether too convenient and flexible to the taxpayer and the trustee.

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304 See discussion, Blattmachr and Gans, supra n.300, at 895.
But on with our income definition story. This portion of Regulation Section 1-643(b)-1 is the heart of the change in the law.

However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances. In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law. This section is effective for taxable years of trusts and estates ending after January 2, 2004. (new language underlined).

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

a. **3% to 5% Unitrust Statutes Approved.** It identifies as appropriate unitrust statutes that allow a 3% and 5% rate, or anything in between, and specifically allows the use of a a multiple year smoothing rule, which is important because a three year smoothing rule is provided or

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allowed in all of the states with a unitrust conversion statute or a unitrust definition of income. Note that for such states, the unitrust amount is determined to be a reasonable apportionment of total return. There is no “generally” qualification.

b. **Power to Adjust Statutes Approved.** Perhaps concerned with differing state versions of the power to adjust, they retain the qualification from the Proposed Regulations that a state statute providing for the use of the power to adjust is “generally” a reasonable apportionment of total return. This isn’t particularly comforting, but the qualification is likely inserted to curtail state law variations which differ fundamentally from the Uniform Act in their power to adjust, with which the Service has concluded that it is comfortable. The Final Regulation more helpfully inserted the word “Generally” before the description of the preconditions of the use of the power to adjust. Here, the Summary explains that because some states do not condition the use of the power to adjust on the trustee technically acting as a “prudent investor” or the lack of the word “equitable” in the state statute, should not prevent the power to adjust from being an acceptable exercise under the Regulations.305

c. **Sprinkle and Spray Trusts Included.** The Regulations make it quite clear that sprinkle and spray trusts may be included in the new definitions of income.

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

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

f. **Allocation of Gains to Income by Trustee Approved.** Lastly, an allocation of gains from the sale of a capital asset to income will generally be respected if it is done pursuant to the terms of the governing document and applicable local law, or by the reasonable and impartial exercise of a power given to the trustee by applicable local law, or in the governing instrument if not prohibited by applicable local law. This means that one could grant the power to apportion gains to income, provided it were exercised reasonably and impartially and this power would not disqualify the “income”, so defined, as income for federal tax purposes. This should not be confused with the power to adjust, however, since the uniform act and all state statutes of which the author is aware do not speak of the allocation of gains to income, but rather principal to income, and income to principal. It remains to be seen whether this last provision is going to be all that useful a provision, except perhaps in the context of a net income Charitable Remainder Unitrust, as discussed later.

3. **What the New Income Definition Did Not Do**

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

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

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

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

b. **And Not Just Any State Statute-3% to 5% is the Safe Harbor.** Treasury approved of the trend in the unitrust statutes and what they understood about the power to adjust in the Uniform Act, but there was an overriding requirement for tax recognition that the statute provide for a “a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year.” Two commentators suggested that any percentage

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306 See Blattmachr and Gans, supra n. 300, at 897.
307 See n. 305 supra.
provided by state statute should be O.K. but Treasury didn’t take the bait, stating in the Summary: “The IRS and the Treasury Department believe that when establishing a unitrust percentage that attempts to yield the equivalent of income over a long period of time that may encompass wide variations in economic conditions, a range of 3% to 5% will be considered a reasonable apportionment of a trust’s total return.” Treasury was obviously aware that while they were comfortable with the legislative trends which had altered the traditional notions of income and principal in a fundamental way, there were limits to that comfort. While there is nothing that states that a 2.8% unitrust or a 5.3% unitrust might not pass muster, unitrust statutes which provide for payouts of less than 3% or more than 5%, and unitrusts drafted in that manner, are simply not within the safe harbor of the Regulation.

c. What Did We and They Forget? How About the Trust Drafted as a Unitrust? In retrospect, we as commentators should have requested a clear reference in the Final Regulations to a trust that was drafted as a unitrust from the beginning in a state with a unitrust conversion statute. The author views this as more the fault of himself and other commentators than that of Treasury, since it is we, and not they, who have been drafting unitrusts, and in the case of the author, drafting them for quite some time. The problem is really two fold: First, do the state statutes dealing in most cases only with conversions of an income trust to a unitrust clearly tie in to the final regulations? And second, do our state statutes deal with trusts that are expressly drafted as unitrusts deal properly with the issue in this context? The Final Regulations require that for example, if there is a state statute which provides that income “is” a unitrust amount of not less than 3% nor more than 5%, then that amount will be considered to be “income” for federal tax purposes as well. In essentially all of the state statutes, “income” is defined as a unitrust amount if the trust is converted to a unitrust pursuant to the provisions of that statute. So, on a very literal and technical basis, if the trust were not a converted “income” trust, the state statute would not provide that the unitrust amount, even if defined identically with the unitrust amount for a converted income trust, is “income”. Now the reason these conversions were the focus of all of our concern was that they were the ones that were causing the problem; the squeaky wheels, so to speak. After all, for future trusts, we could always draft the trusts as unitrusts and then provide for the payment of net income at least annually if the net income were greater than the unitrust. But we forgot to ask for explicit guidance on this point, and so we did not get it. It is submitted that it was not intended by the Regulation writers that in Pennsylvania and New York, which have unitrust conversion statutes with a 4% default rate, that a 4% unitrust would not qualify for the marital deduction—or that we would be forced to write the trust as an “income” trust and then convert it to a unitrust to bring it within our statute. And discussions with representatives of Treasury confirm this opinion, but more official guidance would be helpful in this regard for those who want to be able to clearly define the legal support for their tax opinions (which includes the author). And those of us who participated in the drafting of these principal and income statutes should have considered dealing directly with the “express unitrust”; that is a unitrust that is drafted as a unitrust from the beginning. It is particularly clear in states, like Pennsylvania and New York, that while there may continue to be good reasons for selecting a default rate of 4% for income trusts which are converted, there is probably no good reason not to expressly condone by state statute the full 3% to 5% range expressed in the Final

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310 Cathy Hughes of Treasury was kind enough to discuss this with the author.
Regulations as permissible. After all, the reason for not selecting a range of payouts was to provide a point of reference and a legislative imprimatur on a distribution rate thought, on balance, to be fair. But reasonable minds can and do differ on the best rate to use, and there is no reason to limit the freedom of the settlor of a trust to draft a 3% or a 5% unitrust, if that is their wish. And there are other matters, such as providing state law support for the treating of capital gains as part of a unitrust distribution or part of a distribution pursuant to the power to adjust or a discretionary principal distribution, which will be useful additions to our legislative menu. The next section following the detailed discussion of the Final Regulations discusses suggestions for legislative update in light of the Final Regulations, with Delaware’s amendment, once again the first in the nation, as a worthwhile template.

**d. What is “Income” in a Retirement Account Payable to a Trust?**

Where a retirement account is payable to a trust, the issue of what portion of a distribution from the retirement account is “income” for trust accounting purposes can be particularly thorny. Some retirement benefits, such as from a defined benefit plan are simply a stream of retirement income. There is no discrete investment account or sum of money from which the income for that benefit is paid. The 1962 Uniform Act prescribed that for deferred compensation, 5% of the inventory value of the asset was income, and anything received in excess of that was principal. Since the inventory value would typically be the present value of the future income stream, the inventory value would depend upon interest rates at the time the asset was being valued.\(^{311}\) That rule, while sharing a similarity or two with a unitrust rule, was viewed as too rigid, in light of the fact that the amount of the income did not change with the rise and/or fall of the amount actually distributed to the trust.\(^{312}\) The “New” Act took a very different approach. Section 409 of the Act is clearly intended to apply to private, commercial and employer-paid annuities, deferred compensation, IRA’s, profit sharing, stock bonus and other qualified plan benefits.\(^{313}\) Section 409(b) provides that where payments from such a plan are characterized as interest or dividends, then they are to be treated as income for purposes of the trust as well, and the balance of such payments are principal. This provision, is, however, primarily to take into account plans such as ESOPs, which are required to make such distributions, and not the more common and important (from the point of view of estate planners) individual retirement accounts.\(^{314}\) Section 409(c) provides the general rule for retirement account payments as follows:

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

\(^{311}\) Uniform Principal and Income Act, supra n. 10, §409, comment.

\(^{312}\) Id.

\(^{313}\) Id. §409(a).

\(^{314}\) Natalie B. Choate, “Trustees’ Dilemma With Section 643”, Trusts and Estates, 26, 27 (July 2004).
“required to be made” to the extent that it is made because the trustee exercises a right of withdrawal.\textsuperscript{315}

In the context of the required minimum distribution regulations under Section 401(a)(9), this rule produces some very strange results. If the sole beneficiary of the trust is considered to be the surviving spouse of the participant, there is no required distribution at all until the deceased participant would have reached 70 ½.\textsuperscript{316} And where there is a required distribution, the amount that is required is entirely dependent upon the age of the beneficiary, and not the “return”, in any sense of the word, from the underlying investment assets in that retirement account. For example, a 20 year old beneficiary has a life expectancy of 63 years, so that the required distribution would be 1.58% of the IRA balance as of the end of the prior year. Under the Uniform Act Rule, this would mean that .158% ($158 on $100,000) would be considered to be “income” from the IRA. A 63 year old, on the other hand, would have a life expectancy of 22.7 years, and a required distribution of 4.4%, of which 10%, or .44% ($440 on $100,000) would be considered to be income. As Natalie Choate succinctly put it in her recent article,

\[ \text{[t]he amount of a required distribution from a retirement plan, under the rules of IRC Section 401(a)(9), has nothing to do with any traditional concept of income or principal of the plan.}\textsuperscript{317} \]

This is a significant problem, because under the Final Regulations, in order for an amount to be treated as “income” it must either be income under traditional notions of income or principal, or, if supported by state statute, a non-traditional notion such as the unitrust or the power to adjust income or principal, or, if the approach is considered to be a reasonable apportionment of total return. And the regulations clearly define what they think is a “safe” distribution percentage, 3-5% when income is to be determined based upon the market value of the trust. In order for Section 409(c) to produce a distribution equal to 3% of the value of the retirement account, the beneficiary would have to be 98 years of age!\textsuperscript{318} Since the age of the beneficiary cannot have anything to do with what the investment “income” might be on an Individual Retirement Account in any sensible economic way, this 10% of the distribution rule is very unlikely to qualify as “income” under the Final Regulations. If it does not qualify as “income” under the Final Regulations, then the IRA payable to a QTIP trust will not qualify for the marital deduction!

Fortunately, Section 409(d) provides a safeguard

(d) If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.\textsuperscript{319}

\textsuperscript{315} Uniform Principal and Income Act, \textit{supra} n. 10, §409(c).
\textsuperscript{316} Choate, \textit{supra} n. 314, at 28.
\textsuperscript{317} \textit{Id}.
\textsuperscript{318} \textit{Id}.
\textsuperscript{319} Uniform Principal and Income Act, \textit{supra} n. 10, 409(d).
The only difficulty with this provision is that it does not tell the trustee what to allocate in order to obtain the benefit of the marital deduction. The Comment to the rule does suggest that the trustee should look back to Rev. Rul. 89-89, 1989-2 C.B. 231, which would direct that the income and dividends inside the IRA should define the amount that would define the income from an IRA distribution. In the opinion of this author, and others\textsuperscript{320} the 10% rule simply will not qualify as income under Section 643, and hence will not qualify for the marital deduction without the safe harbor provision, which must take us back to the old rule or in a different, but more acceptable, direction. It is submitted also, that while the power to adjust was blessed under the Final Regulations as an acceptable modification to the traditional rules of income and principal, the fact that it might be available to adjust the 10% rule seems unlikely by itself to save the marital deduction.

A second related area of uncertainty arises where an IRA is payable to a trust that has been converted to a unitrust under applicable state statute. How is the “income” to be defined for the IRA payable to a unitrust? The approach used under Rev. Rule 89-89 would tend to look at the IRA as a separate trust, and indeed the Service has looked to require separate qualification for each under the marital deduction rules. Does the fact that a QTIP trust itself defines income as a unitrust amount carry over to the IRA? While the IRA distribution provisions could be defined by use of a unitrust payout supported by appropriate state law, it is submitted that it would not necessarily have to be so in order to qualify, because of the separate trust approach employed by the Service up to the present time. It is submitted that the best approach from a state law point of view would be to use the Rev. Rule 89-89 approach as the default approach, similar to that which has been incorporated into the Pennsylvania Principal and Income Act, discussed later, with the proviso that a settlor or a trustee converting to a unitrust should also be able to prescribe either a unitrust approach for both the trust and the IRA, or maintain a traditional income and principal approach for that IRA. Since the qualification for the marital deduction has been required for both separately, the Service should not require that the election of a method of determining “income” be consistent for both, as long as both qualify under applicable local law as paying the “income” out to the surviving spouse at least annually. In the current investment climate, the use of a unitrust distribution payout of “income” will in some situations require a greater payout than might otherwise be necessary as a required minimum distribution or a distribution of “income” under traditional income and principal notions, and in those cases might be less desirable. In most cases involving the marital deduction, where the surviving spouse is at least 67 years of age, the minimum distribution is going to be more than a unitrust distribution of 3-5% and more than the “income” earned inside the IRA under traditional notions of income and principal.

\textbf{e. How do We Value an Income Interest Subject to the Power to Adjust or the Power to Convert to A Unitrust?} One additional area that does not seem to have been addressed is how to correct and synchronize the method of valuing income interests in light of the power to adjust and the power to convert to a unitrust. If one converted an “income” trust to a 4% unitrust, would the value of the income interest change, or remain the same? If it did change, then does the value change only if the power is exercised or if it is merely possessed? An income interest normally is valued using the 7520 tables, so if the 7520 rate were 4.6%, then for a 50 year old beneficiary, the income interest would equal 68.7% of the whole. A 4% unitrust, on the

\textsuperscript{320}Choate, supra n. 314, at 28.

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other hand, would be valued at 64.1% for a Charitable Lead Unitrust if the payment were made annually (the same assumption that is used in the valuation of income interests). There is nothing wrong with the method of valuation of the unitrust, but of course the income interest is likely overvalued. This issue needs to be considered for a variety of purposes where the “income” interest must be valued, such as for the previously taxed property credit under Section 2013, under Section 2702 and otherwise.321

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

4. Much Adieu About Ordering and Capital Gains

As contrasted with the relatively short portion of the new Regulations that deals with the core definition of income under Section 643(b), there is a lot more written about when capital gains can be included in distributable net income under Section 643(a), both in the Regulations themselves and in Commentary on the Regulations in the published articles on the Regulations.322 What is more, there are 14 examples of when the Regulations allow capital gains to be included in DNI as opposed to none under the definition of income. For the most part, it is the author’s opinion that the emphasis in and on this portion of the Regulations is overblown. First of all, the difference that having the power to adjust or the power to convert to a unitrust can be the difference between a payout of 2% from a trust and 4%, and the difference between having a 50/50 stock and bond asset allocation and having an 80/20 asset allocation. Any income beneficiary will tell you that doubling their income is a big deal, and any investment advisor worth her salt will say that the difference between an 80% equity and 20% bond portfolio and a 50/50 portfolio is likely to be huge over time. But whether the additional distribution to the current beneficiary pulls out with it capital gain as part of DNI will matter much, much less. For a portfolio with low turnover and a current income tax cost basis, the difference will be in the range of 25 to 35 basis points over a long period of time, and with a low basis portfolio and high turnover, the difference will be about 45 to 60 basis points, depending upon whether you assume JGTRRA top rates of 15% or the prior top rate of 20%. What it really reflects upon more than anything is the choice of an appropriate payout used by the unitrust or accomplished through the power to adjust. Clearly, if the capital gains are not part of DNI, it would be prudent to select a slightly lower rate for a unitrust or for a transfer of slightly less principal to income under the power to adjust. Then too, the consequences of getting it wrong are less likely to be draconian than the loss of GST grandfathering, loss of the marital deduction or the treatment of a change in the definition of income as being a “sale or exchange” of the income interest under Cottage Savings discussed in detail previously.

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

321 See Blattmachr and Gans, supra n. 300, at 913.
322 Id. at 900-907.

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1.643(a)-3 Capital gains and losses.

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

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

(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

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

a. pursuant to the terms of the governing instrument and applicable local law, or

b. pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law.)

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

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

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

§643(a)(3) CAPITAL GAINS AND LOSSES. —Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year ... 323

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

One commentator suggested that a discretionary power to allocate capital gains to income should not have to be exercised consistently. The exercise of the power generally affects the actual amount that may or must be distributed to the income beneficiaries and affects whether the trust or the beneficiary will be taxed on the capital gains. Thus, the IRS and the Treasury Department agree that the power does not have to be exercised consistently, as long as it is exercised reasonably and impartially. However, if the amount of income is determined by a unitrust amount, the exercise of this discretionary power has no effect on the amount of the distribution, but does affect whether the beneficiary or the trust is taxed on the capital gains. Under these circumstances, a discretionary power must be exercised consistently. One commentator suggested changing the phrase "if not inconsistent with local law" because powers to allocate capital gains to income will almost always be inconsistent with the default provisions of state law. Accordingly, the phrase has been changed to "if not prohibited by local law." 324

Now this change the author thinks may cause some confusion. Literally, if capital gains are allocated to income, and income must be distributed, then of course the allocation has direct economic substance in that it goes to the income beneficiary, rather than staying in the trust. But changing the term to “impartially” sounds like the language was borrowed from Section 104 of...

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323 I.R.C. §643(a)(3).
the Uniform Act, which in fact says nothing at all about allocation of capital gains to income or principal. While the tax effects of an adjustment are to be taken into account, no state law version of the power to adjust speaks to whether capital gain is included in distributable net income, nor requires that an adjustment from principal to income come from either proceeds or capital gain!

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

Two commentators requested examples of the inclusion of capital gains in DNI when the trustee exercises a power to adjust between income and principal under applicable local law. The circumstances in which a power to adjust is exercisable may vary among states and may be determined by the powers of the trustee to make distributions of income and principal under the terms of the governing instrument. For example, if a trust instrument does not permit the trustee to distribute any corpus and the power to adjust under local law may be exercised only with respect to receipts from the sale of trust assets, the amount allocated to income under the power to adjust may have to be from the realized appreciation in the value of the assets that were sold. On the other hand, if the trust instrument permits discretionary distributions of principal and the power to adjust under local law may be exercised only with respect to appreciation in the value of trust assets, the power to adjust may be similar to a unitrust amount that is payable irrespective of whether appreciated assets are sold during the year. Because of the potential variations in the circumstances and ramifications of exercising a power to adjust under applicable state statutes, additional examples would be unlikely to provide meaningful or complete guidance; thus, the final regulations contain no additional examples concerning inclusion of capital gains in DNI when the trustee exercises a power to adjust. 325

What the author thinks all of that means is that where the power to adjust or a discretionary distribution power works like a unitrust, where the distribution is not contingent upon there being realized capital gain that is allocated to income and distributed, then a discretionary power is going to have to be exercised consistently, as is expressly required for a unitrust. If the exercise of discretion with regards to capital gain under the power to adjust and the governing instrument actually results in increasing the distribution to the beneficiary, then the exercise of discretion must be impartial, but not necessarily consistent year to year. This is the only way in which the foregoing makes sense within a tax perspective; that is, that where the inclusion in capital gains in income is merely a tax construct, and does not affect what is distributed, it must be done on a consistent basis, because it is a tax accounting function, not an economic concept, and the Service is more sensitive to changes in accounting methods.

But what can we learn from the 14 examples provided by the Final Regulations?

325 Id. at 16.
Example 1 reads as follows:

Example 1. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.\textsuperscript{326}

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

Example 2. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.\textsuperscript{327}

Example 3 indicates that if a trustee “intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments,”\textsuperscript{328} that would be considered to be

\textsuperscript{326} Treas. Reg. 1.642(a)(3) ex. 1.
\textsuperscript{327} Treas. Reg. 1.642(a)(3) ex. 2.
\textsuperscript{328} Id. at ex. 3.
a reasonable exercise of discretion by the Service as well. This raises the possibility that if there is a particular class of investment, for example real estate, a closely held business, or even a very large block of a company’s stock, for which it is desirable to have the capital gains taxed in the trust or to the beneficiary, that would be possible, though this sort of a discretionary power is very unlikely to be included in the trust instrument or for that matter in state law either at this point. It is a point where additional guidance by the service will be needed.\textsuperscript{329}

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

Example 4. The facts are the same as in Example 1, except that pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.\textsuperscript{330}

This example seems clear enough in providing that if the governing instrument requires that capital gains be allocated to income, as long as the provision to do so is not prohibited by applicable local law, then capital gain will be included in DNI. Commentators are not in agreement in what one takes from this Example. Some think that it is strong evidence that the governing instrument and applicable local law should be read together to determine whether the necessary requirement or authorization exists.\textsuperscript{331} Others argue that the regulation does not specifically address the issue of what happens if the governing instrument, or applicable local law, but not both, direct that capital gain be part of income.\textsuperscript{332} Still others would argue that “and” means “or” in this context.\textsuperscript{333} This author believes that the determination would be made by examining local law and the governing document together and if the direction is in either, it should be followed and respected by the Service. This means that it would be respected if the document provided that distributions of principal would be deemed to include capital gain realized in the tax year, and state law was silent about it (as essentially all state law is, at the moment). And if state law said that it would be deemed to include capital gains and the document was silent on the matter, it would be respected also. If, however, state law prohibited such a characterization, regardless of the governing instrument, it would not be respected even if the governing instrument so provided. If the governing instrument prohibited it, and state law merely allowed it, it would not be respected. But none of the foregoing suggests real meaning for the “and” in the Regulation apart from a reading of both together.

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

\textsuperscript{329} See Sloan, supra n. 300, at 40.
\textsuperscript{330} See supra, n. 326, at ex. 4.
\textsuperscript{331} See Sloan, supra n. 300, at 39.
\textsuperscript{332} See Blattmaehr and Gans, supra n. 300, at 901.
\textsuperscript{333} See Blattmaehr and Gans, supra n. 300, at 901, Professor Mark Ascher’s view noted in fn. 29.
true for an allocation to income as well, where the income is required to be paid out to the beneficiary.

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

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

This example could reflect a statute such as Pennsylvania, which has an ordering rule that directs that the unitrust payout is to be paid first from income defined as if the trust were not a unitrust (this would be very similar, though not identical with “ordinary and tax-exempt income”), and then from short term gains, long term gains and then the principal of the trust. From the example, the governing instrument does not have the ordering requirement expressly stated, and yet the example says that is all right. Since two of the specific examples do not comport with the most literal and strict (and perhaps impractical) interpretation of the Final Regulations that would require an ordering rule to be in both state law and in the governing instrument, the author thinks that in this instance the word “and” is used to mean that the state law and the document should be read together. If the state law said something opposite from the governing instrument, or vice versa, then there is a question as to whether the ordering rule would be respected. But with Examples 4 and 11 to support us, it is most likely that silence in the governing instrument or the applicable local law, but not both, will not preclude an ordering rule to be respected.

334 Treas. Reg. 1.642(a)(3), ex. 11.
335 “Net income” would have the apportionment of trustee’s fees applicable to it, whereas all of the trustees’ fees would be deducted before determining the ordinary income and tax free income are part of DNI. Hence “net income” is generally greater than DNI because the income beneficiary gets the benefit of the deduction for all of the trustees’ fees even though the majority of the fees may have been paid by the trust, and not deducted from the income account.
And sound tax policy stands firmly in back of such an interpretation. Why should an allocation rule, which is obviously much less manipulable than a power, be placed at a disadvantage?

Examples 12 and 13 assume the same facts as in example 11 (that is a 4% unitrust statute) but posit that if neither applicable state statute not the governing instrument has an ordering provision, but “leaves such a decision up to the Trustee” the trustee’s decision will be respected, provided the power is exercised in a consistent fashion. That all sounds sensible, but what does it mean for the statute and the governing instrument to “leave” such a decision up to the Trustee? Is silence sufficient to do so? The author would argue that it is; that the powers of a trustee are otherwise plenary in the context of dealing with trust assets and the making of tax elections, perhaps in a fashion similar to the 9th Amendment to the U.S. Constitution

which leaves unenumerated powers to the people, as opposed to the Federal Government. Hence the trustee retains those powers which are otherwise not addressed, provided that they are not against fundamental trust principals. Having made that argument, the author suggests strongly that states address this power directly in their statutes, as has been done by a number of the states with unitrust statutes, such as Delaware, Pennsylvania, Alaska and others.

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

But what about the inclusion of capital gains in DNI pursuant to the exercise of the power to adjust? As noted above, Treasury refused to provide any examples of the way the power to adjust might apply to allow the inclusion of capital gains in distributable net income, and commentators are split on the likely result.

The summary, it seems to this author, clearly indicates that the Regulation writers thought that it could have that effect, but that it would depend upon the way the power to adjust statute was written and applied. If the allocation of capital gains did not affect the amount of the distribution, such as in a unitrust, then it is likely that the power to adjust would bring with it the same consistency requirement imposed upon the unitrust. So the overall rule would be that if the allocation of capital gains to income did not influence the amount that was paid out, then it was really just a tax accounting practice that must be applied consistently. If under the terms of the statute, the adjustment of principal to income were dependent upon the realization of capital gains during the tax year, then the power would only have to be exercised impartially, not consistently.

Since neither the Uniform Act nor any state statute adaptation of the power to adjust ties the adjustment to realized capital gains, the author concludes that for a trustee to have the power

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337 “The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people.” U.S. Constitution, Amendment IX.
339 See Blattmachr and Gans, supra n. 300, at 905 and 906 advising that the result is uncertain, versus Professor Ascher at fn. 53 who apparently argues that capital gains would always be included in DNI in conjunction with an exercise of the power to adjust principal to income, and contrast with Sloan, supra n. 300, at 40 arguing that without some specific provision in the governing document, capital gain would not be part of DNI in connection with the power to adjust.
to include capital gains in DNI, the trustee would have to make that decision on a consistent basis.

Whether in the absence of state law or a provision in the governing instrument that allows such a treatment of capital gains as part of DNI, it is possible to have that power, is simply undecided at this point. This is likely to have no great effect in most cases, as the adjustment can simply take into account the tax effects, as noted in the Uniform Act. If a trustee were to not include capital gains in DNI, then the trustee could have relative certainty, since if the trustee had the power to include the capital gains in income, then by filing without doing so, the trustee would have exercised that power, which it is likely to have to do consistently in future. If the trustee did not have that power, then capital gain should be taxed to the trust, as that is the default rule. It is difficult to see a scenario in which the trustee can include capital gain in DNI and have certainty, unless the governing document grants the trustee the express power to do so, which is unlikely at the present time, unless a general power to make tax elections were considered to be sufficient, which is subject to some considerable doubt if proof of that power is required to be quite specific. 340 If one looks at a trustee’s power as residual in nature—that is, the trustee has all appropriate powers to deal with trust property except those which are denied to it, then a trustee’s power to allocate capital gains to DNI will probably be present in the majority of trusts in the majority of states, since most state laws and most governing instruments are silent on the subject.

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

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

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

(D) * * *
(2) * * * In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)-1 of this chapter.

Example 11. Conversion of income interest to unitrust interest under state statute. In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

Example 12. Equitable adjustments under state statute. The facts are the same as in Example 11, except that in 2002, State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state.
whose statute does not authorize the trustee to make adjustments between income and principal or if the situs was changed to such a state from State X.\footnote{\ref{footnote341}}

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

And even better, examples 11 and 12 very clearly give Treasury’s blessing to a change in situs from a state without total return legislation to one with total return legislation. In such case the conclusions would be the same as if the trust had stayed in a state where the law had changed. A change in situs will not automatically bring with it a change in state law concerning income and principal, as for example where the trust instrument contains a choice of law provision as to administration of the trust even if the situs has changed,\footnote{\ref{footnote342}} but in the absence of such a provision it is likely that the administration of the trust will be governed by the state of administration.\footnote{\ref{footnote343}} While the determination of governing law could otherwise be a bit thorny, it is likely that such changes in situs will occur primarily when there is consensus among all of the parties, which as a practical matter is likely to smooth the process, particularly if the Service does not have a bone to pick concerning the change of situs to obtain more favorable administrative provisions.

So if you have a trust in Massachusetts or North Dakota, where you don’t have a favorable total return trust law as of yet, you may be able to move your trust next door to South Dakota, which has unitrust legislation, or Maine, which has both the unitrust and the power to adjust, and take advantage of those more modern laws. The laws and process of changing situs of a trust depend upon state law as well and, of course, the terms of the governing instrument, so every trust may not be able to do this successfully, but this should significantly increase the pressure on states which do not have total return legislation to put it on their agenda or suffer the financial consequences to their trust industry.

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

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

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

A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder

\footnotesize{\begin{itemize}
\item \footnote{\ref{footnote341}} Treas. Reg. 26.2601-1(4)(i)(D)(2).
\item \footnote{\ref{footnote342}} See Sloan \textit{supra} n. 300, at 30.
\item \footnote{\ref{footnote343}} See Blattmachr and Gans, \textit{supra} n. 300, at 914.
\end{itemize}}
beneficiaries that meets the requirements of §1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

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

7. Distribution in Kind to Satisfy New “Income”.

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

8. Charitable Remainder Unitrusts-NICRUTs and NIMCRUTs.

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

The NICRUT or NIMCRUT trust provisions may direct that post contribution realized gain may be allocated to income if not prohibited by applicable local law, and a discretionary

344 Uniform Principal and Income Act, supra n. 10, §104(c)(3).
345 Treas. Reg. § 1.664(3)(i)(a)(1)(b)(3). Just as an aside, this makes only marginal practical sense, since the deduction granted for the NICRUT assumes actuarially that the 5% is paid out. Why prohibit a taxpayer from paying herself less and thereby giving the charity more later?

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power to make this allocation can be given to the trustee, but only to the extent that the
discretionary power is given to the trustee to treat the beneficiaries impartially.\textsuperscript{346} It is possible
that this will be a useful power, but because the power given in the uniform act does not limit
the adjustment to post contribution gains, it is not likely to be available unless amendments are
made to fit within the Regulation. Indeed, the Uniform Act should preclude the exercise of the
power to adjust because of the provision contained in Section 104(c)(4) that an adjustment must
not be made

\begin{quote}
(4) From any amount that is permanently set aside for charitable purposes under
a will or the terms of a trust unless both income and principal are so set aside.\textsuperscript{347}
\end{quote}

Literally, the charitable remainder unitrust is a trust for which the portion not distributed is set
aside for charitable purposes. The phrasing of the exclusion is identical to that used in Section
642(c), however, so that in states following the language in the Uniform Act, it may not be
entirely clear that the power to adjust or a power to convert to a unitrust is entirely precluded for
a NICRUT or NIMCRUT, if this limitation applies only to those trusts relying upon the Section
642(c) set aside deduction, since the NICRUT and NIMCRUT rely upon Section 664 for their
exemption from tax, rather than the 642(c) deduction to escape taxation for capital gains
incurred.\textsuperscript{348} Unfortunately also, the Comments do not provide any helpful insight, as there is no
comment concerning the (c)(4) exclusion, and a comment limiting the (c)(3) exemption (the
power to adjust is not applicable to a trust that pays out an annuity or unitrust amount) could
infer that it does apply:

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

This is an argument outside the literal wording of the Uniform Act, and so in this author’s
opinion, the power to adjust should be precluded for a NICRUT or NIMCRUT. This is helpful,
in that otherwise the Regulation could cause disqualification of the trust, clearly not an intended
result. Some other states, such as Pennsylvania, added language to preclude the application of
the power to adjust and the power to convert to a unitrust only where a gift or estate tax
deduction has been taken.\textsuperscript{349} Since a gift or estate tax deduction will always have been taken for
a NICRUT or NIMCRUT (though not a deduction under Section 642(c)), this should be
sufficient to preclude the application of the power to adjust or the power to convert to a unitrust.

Going forward, drafters should take this Regulation into account, and it may be helpful
to add language to legislation applicable to the NICRUT and NIMCRUT that fits within the
Regulation’s requirements, clearly precluding a unitrust conversion in all cases and permitting
adjustments only from post contribution gains, and then only as required to satisfy the duty of
impartiality. In the meantime, it is unlikely that there will be any way to use the power to adjust

\begin{footnotes}
\footnote{Id.}
\footnote{Uniform Principal and Income Act, supra n. 10, §104(c)(4).}
\footnote{Id. See Blattmachr and Gans, supra n. 300, fn. 61.}
\footnote{Id. See 20 Pa.C.S. §§8104(c)(4), 8105(i)(2).}
\end{footnotes}
or the power to convert to a unitrust with these trusts—the best result being simply that these powers are inapplicable. If there are concerns under applicable state law about whether the power to adjust or the power to convert to a unitrust might apply, a release of the power to adjust under Section 104(e) or a release of the power to convert might be advisable to insure that qualification under Section 664 is not threatened.

9. **The Pooled Income Fund.**

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

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

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

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350 See Treas. Reg. 1.642(c)(5).
351 See Treas. Reg. 1.642(c)(2).
It is the author’s opinion that this reformation should be required in very few instances, because the language of the Uniform Act provides a savings provision that causes the power to adjust not to be applied to charitable split interest trusts. In addition, even if it were held to apply, the trustee could permanently release the power to adjust principal to income under Section 104(c)(e). Whether this release would be considered a “nonjudicial reformation” is not entirely clear, but it should be considered as such.

It is unfortunate that trustees may feel compelled to commence such a reformation proceeding for pooled income funds, since it is likely that the protective provisions of the uniform act and most state laws will preclude the application of the power to adjust, and the power to convert to a unitrust. But even if that is not true, it is submitted that the trustee should consider carefully whether the power to adjust or the power to convert to a unitrust should be eliminated, since without these powers, the trustee may well not be able to invest for total return, and the ability to invest for total return is likely more valuable than the charitable deduction on capital gains!

For example the ability to invest for total return may allow the trustee to invest in 80% equities and 20% fixed income, while without such power the trustee might invest in 50% equities and 50% fixed income. Assume that the equities in both portfolios are highly appreciated (80% capital gain) and that the portfolio is actively managed with a 25% turnover ratio. Even in that situation, the average ending market value for a 4% unitrust payout over all of the rolling 20 year periods in history would be significantly greater than having the more conservative asset allocation and never paying out any principal or capital gains. In the foregoing example, the average ending market value for the 4% unitrust enabled to invest for total return is over 43% more than the average ending market value of the more conservatively invested and distributed trust.

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

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

While not mentioned in the Final Regulations, the summary makes clear that the new regulations and the new state law definitions of income apply to Qualifying Subchapter S Trusts because the 643(b) definition of income is incorporated through Section 1361(d)(3). This may be particularly important with the power to adjust, which can flexibly respond to situations involving a closely held company held in a trust.
The QDOT regulation was changed to specifically allow the new state law definitions of income under 26.2056A-5(c)(2) which should be particularly helpful in the context of the Qualified Domestic Trust because of the imposition of the federal estate tax on the payment of any principal during the life of the surviving non-citizen spouse. Discretionary powers to distribute principal in such a trust could not sensibly be utilized, so that a unitrust definition of income or the power to adjust would be particularly helpful in this context, wherein there is no practical alternative to modernizing our notion of income.

F. DESIRABLE LEGISLATIVE RESPONSES TO THE REGULATIONS.

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

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

For existing trusts, trustees will continue to be trapped in many cases in an “income” regime that does not allow them to invest for total return and puts them in the middle as between the current income beneficiary and the remainder beneficiary. Without a unitrust conversion statute, even if the trustee could convince a local court that it had the power to reform the income trust into a unitrust, there would be all of the questions surrounding the conversion that practitioners were worried about before the Regulations were made final. It is quite clear that where there is such a conversion, the trustee and her attorney may not be safe in assuming that the generation skipping transfer tax grandfathered status has been preserved, or that the marital deduction is safe or even that the income interest may not have been “sold” in the process with extremely uncertain results.

For new trusts, the drafter in a non-unitrust state is likely to be required to draft their unitrusts which are intended to qualify for the marital deduction as requiring the unitrust amount or the net income, whichever is greater. And there may well be a time in the world of finance when that may once again be a real problem. And a QDOT simply could not be drafted as a unitrust without a unitrust statute nor could the power to adjust be added other than by statute. However, this cannot be done in a state without a unitrust definition of income. So Texas, while it lacks a unitrust conversion statute, should be in good shape for drafting unitrusts for marital trusts and QDOTs, because it has adopted an alternative unitrust definition of income, while California, with only the power to adjust, falls behind temporarily.353

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

353 California is working on adding the unitrust component to its trust law, which already allows for the power to adjust.

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Just as the Proposed Regulations resulted in a spurt in legislation across the country, so the Final Regulations should also in the coming months and the next few years be the catalyst of change to motivate the states which have not been quick to act.

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

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

First, a number of states required that for marital trusts and trusts which are grandfathered for generation skipping transfer tax purposes, that a trust converted into a unitrust must pay out the income or the unitrust, whichever is greater. This is no longer necessary, and is therefore an unfavorable provision to retain in the law, since it could force too large a distribution in a future period of high interest rates.

Second, but probably more important, in the author’s opinion, is that essentially none of the legislation deals adequately with the trust that is drafted as a unitrust. It is very important that states consider adding provisions aimed at this increasingly common situation. The Final Regulations give their imprimatur to methods of defining income which reasonably apportion the annual total return from a trust and which are “pursuant” to a state statute. The concern is that the drafting of a unitrust as a unitrust is “consistent with”, but not “pursuant to” a state statute. This may be an overly technical reading of the Final Regulations but the Regulations have taken pains in the definition of income 1.643(b)-1 to use the word “statute” rather than the prior reference to “applicable local law”, which after all came from the Code Section 643(b) itself. While it is the author’s opinion that the Service will, for example accept a 4% unitrust for the marital deduction in a state with a unitrust conversion statute with a default rate of 4%, and a Treasury representative has orally indicated her agreement with this, it will be a great deal more comfortable to point to a state statute that discusses express unitrusts as such, so that there can be no doubt that the trust drafted as a unitrust is “pursuant” to a state statute. A second reason for revisiting these statutes is to consider whether the provisions that are appropriate for a trust which are converted are the same as the provisions which are appropriate for those trusts drafted as a unitrust. Quite a few states have a default rate of 4% for their converted unittrusts, but with the Final Regulations giving a clear go-ahead to the 3-5% range, they may wish to add, where necessary, a statutory recognition of that range for trusts expressly drafted as unittrusts, to eliminate any question about whether the applicable state law requirement is met for those trusts. In the meantime, for example, a marital trust drafted in Pennsylvania must have a payout rate of at least 4% to be a safe bet to qualify for the marital deduction, and this may not be desirable in quite a few cases, particularly if the marital trust may be exempt from GST taxes and be intended to go on for multiple generations.

Third, in order for trustees to have better assurance that they know what their options are with respect to including capital gains in DNI, state laws need to address that area for unitrusts.

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and for the power to adjust at a minimum, and in the opinion of the author and other commentators, ought to insert additional language giving the trustee discretion over this capital gain issue wherever possible, such as for other discretionary distributions of “principal”.

The areas that ought to be addressed depends upon what general statutory background is available presently:

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

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

(c) A trustee may not make an adjustment:

(1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment;

(2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

* * *

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

(5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment;

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

(7) if the trustee is a beneficiary of the trust.\textsuperscript{355}

Should any of these tax protective provisions be withdrawn or revised at this time in light of the Final Regulations? There is nothing in the Final Regulations whatever that requires the power to

\textsuperscript{355} Uniform Principal and Income Act, \textit{supra} n. 10, §104(c).

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adjust in the context of a marital deduction trust to never adjust the income downward. Indeed, it makes no sense for the power to adjust only to be the power to adjust upward, since the duty of impartiality runs uphill and downhill, depending upon the market conditions, yields and circumstances. It was never intended to be a one way street, as is noted in Example 2 to Section 104, which suggests that income should be transferred to principal. So should that provision be removed at this point?

And what of the other protective provisions, such as prohibiting an adjustment that reduces the actuarial value of an income interest where the gift tax exclusion is desired, or perhaps most importantly if the power to adjust would make all or a part of the trust as includible in the estate of an individual with the power to remove or appoint a trustee, or if the trustee is a beneficiary of the trust?

It is the author’s opinion, giving due regard to the judgment of James Gamble, Co-Reporter for the Uniform Act, that it may be premature to withdraw these protective provisions. At the moment, they probably do no harm, and it is likely that changes to them should await further guidance from the Service. When the Regulations were written, Treasury had these provisions before them, so it is not clear what effect their withdrawal might have in several of the cases.

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

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

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

(4) The adjustment is from any amount which is permanently set aside for charitable purposes under the governing instrument and for which a Federal estate or gift tax deduction has been taken unless both income and principal are so set aside.\(^{356}\)

Whether this is ideal or not, it at least makes it clear that if the trust is one receiving no special charitable tax benefits, that the exclusion should not apply. The word “charitable” should

\(^{356}\) 20 Pa.C.S.§8104(c)(4).
probably be inserted before the word “deduction” to eliminate the possibility that a marital trust might be excluded.

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

**Power to Treat Gains as Part of a Distribution of Principal.**

Unless prohibited by the governing instrument, the trustee of a trust shall have the power to consider gains from the sale of capital assets in the trust to be part of a distribution of principal to a beneficiary, and if such power is exercised, such gains shall be treated consistently by the trustee on the trust’s books, records and tax returns as part of a distribution to a beneficiary.

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

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

**b. Delaware Style Unitrust States.** Just as Delaware was the first state to adopt a unitrust conversion statute, it was also the first state to make significant changes to its statute to take into account the provisions of the Final Regulations.357

The changes made by Delaware represent a very good attempt to fine tune their statute to the new environment illuminated by the Final Regulations. It provides a worthwhile template for other states which have patterned their unitrust statute in whole or in part upon Delaware’s statute.358 They eliminated the unnecessary provisions concerning distribution of the income if greater than the unitrust amount for marital trusts and GST exempt trusts; they patched a gap in their notice provisions that clarify the persons entitled to receive notice; they expressly provide for the conversion of a wholly charitable trust to be converted to a unitrust under the statute also, and they added the following section to deal expressly with the unitrust that is drafted, rather than converted:

§3527A. Express total return unitrusts.

(a) The following provisions shall apply to a trust that, by its governing instrument, requires or permits the distribution, at least annually, of a unitrust amount equal to a fixed percentage of not less than three (3) nor more than five (5) percent per year of the fair market value of the trust’s assets, valued at least annually,

357 See n. 91, supra.
358 These states might include Colorado, Indiana, North Carolina and Virginia.
such trust to be referred to in this section as an ‘express total return unitrust’.

(b) The unitrust amount for an express total return unitrust may be determined by reference to the fair market value of the trust's assets in one year or more than one year.

(c) Distribution of such a fixed percentage unitrust amount is considered a distribution of all of the income of the express total return unitrust.

(d) An express total return unitrust may or may not provide a mechanism for changing the unitrust percentage similar to the mechanism provided under §3527 of this title, based upon the factors noted therein, and may or may not provide for a conversion from a unitrust to an income trust and/or a reconversion of an income trust to a unitrust similar to the mechanism under §3527 of this title.

(e) If an express total return unitrust does not specifically or by reference to §3527 of this title deny a power to change the unitrust percentage or to convert to an income trust, then the trustee shall have such power.

(f) The distribution of a fixed percentage of not less than three (3) percent nor more than five (5) percent reasonably apportions the total return of an express total return unitrust.

(g) The trust instrument may grant discretion to the trustee to adopt a consistent practice of treating capital gains as part of the unitrust distribution, to the extent that the unitrust distribution exceeds the net accounting income, or it may specify the ordering of such classes of income.

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

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

    (2) from ordinary income not allocable to net accounting income;
(3) after calculating the trust’s capital gain net income as described in I.R.C. §1222(9), from net realized short-term capital gain as described in I.R.C. §1222(5) and then from net realized long-term capital gain described in I.R.C. §1222(7); and

(4) from the principal of the trust.

(i) The trust instrument may provide that:

(1) assets for which a fair market value cannot be readily ascertained shall be valued using such valuation methods as are deemed reasonable and appropriate; and

(2) assets used by a trust beneficiary, such as a residence property or tangible personal property, may be excluded from the net fair market value for computing the unitrust amount.

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

The foregoing amendments to Delaware’s statute make that statute perhaps the most flexible unitrust statute available at the present time. It could be that as indicated in the first portion of this discussion applicable to the power to adjust, that the discretion to deem capital gains as part of a distribution should be inserted more broadly than just for the unitrust statute, and one can argue that the payout rate for a charitable trust should be broader than the 3-5% incorporated in the Final Regulations and in the above statute, by virtue of the differences in taxation with the charitable trust, but overall it is an excellent example of prompt reaction to the Final Regulations. Note also, that if one took the view that for an ordering rule to be respected, that it really must be in both the governing instrument and in an applicable state statute, then the default rule should be that the trustee should have discretion, rather than the ordering rule set forth above. The ordering rule has the advantage of making the process simpler for the trustee, unless the drafter has selected a trustee she desires to fine tune the planning to the maximum extent. For the unitrust, though, the most likely choice is going to be to treat the income as being distributed in the order set forth above.

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

359 See Blattmachr and Gans, supra n. 300, at 915.
c. Pennsylvania Style Statutes. A total of 7 state statutes have drawn significantly on the Pennsylvania model.\textsuperscript{360} One of the non-tax fix-ups that is needed with the Pennsylvania statute is to make sure that the proper classes of persons receive notice. Under the current statute, the notice would be given to the current income beneficiary and to the remainderman if the trust were to terminate at the time of the giving of notice. What is missing is the person or people in between. For example, a trust for mother, and then for daughter, and then for grandchildren, terminating when the grandchildren reach age 30 should have notice to all three classes of beneficiaries representing the three generations, but the current statute may not require notice to the daughter. The following, drawn from language in the Uniform Trust Act, is suggested:

(2) The trustee gives written notice of the trustee’s intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including what initial decisions the trustee will make under this section, to all the sui juris beneficiaries who:

(i) are currently eligible to receive income from the trust; [and]

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

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

However, if all three classes would require representatives who are sui juris, there may be more requirement for court activity than is necessary, and hence the following is suggested:

(2) There is at least one sui juris beneficiary under paragraph (2)(i) and at least one sui juris beneficiary under either paragraph (2)(ii) or (2)(iii).\textsuperscript{361}

The second class of beneficiaries, the “next” income beneficiaries, is thought to be sufficient to represent the remainder beneficiaries, and in any event it seems that such a more flexible requirement will eliminate what are likely to be unnecessary court proceedings. A suggested form of revision for the Pennsylvania statute as it related to express total return unitrusts follows.

\textsuperscript{360} Alaska, Maine, Maryland, New Hampshire, Oregon and Washington.

\textsuperscript{361} This suggestion, made by Bob Freedman and Ted Watters of Philadelphia, is the best solution the author has seen as to who should receive notice and who must be sui juris for court activity to be avoided. The deficiency was pointed out by Lyman Welch of Chicago, whose Illinois version contained the first two classifications, but not the remaindermen, out of concern that guardians ad litem and court activity would be too frequently required if this class was inserted.
While it has not been officially proposed or adopted in Pennsylvania, it seems appropriate food for thought for those states with similar statutes:

§8107. Express Total Return Unitrusts. The following provisions shall apply to a trust which by its governing instrument requires the distribution at least annually of a unitrust amount equal to a fixed percentage of not less than three nor more than five percent per year of the net fair market value of the trust’s assets, valued at least annually, such trust to be referred to as an “express total return unitrust”:

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

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

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

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

(e) The governing instrument may grant discretion to the trustee to adopt a consistent practice of treating capital gains as part of the unitrust distribution, to the extent that the unitrust distribution exceeds the income determined as if the trust were not a unitrust, or it may specify the ordering of such classes of income.

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

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

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

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

(5) from the principal of the trust estate.

(g) The trust document may provide that assets used by the trust beneficiary, such as a residence property or tangible personal property, may be excluded from the net fair market value for computing the unitrust amount. Such use may be considered equivalent to the “income” or unitrust amount.

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

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

1. It would expressly allow a distribution of 3% to 5% to be defined as income. This is appropriate without court approval because it is the drafter and settlor who are making the rate decision.
2. It allows the freedom to use a 3 year smoothing rule, or a 5 year rule, or no rule at all. This sort of a technical difference is not fundamental to the concept, and thus it should be allowed, as it is in the Regulations.
3. A payout of more than 5% is categorized as a distribution of principal to the extent that exceeds 5%, while the first 5% is considered to be a distribution of all of the income of the trust.
4. Freedom to afford the trustee the discretion of including capital gains in the unitrust distribution or not is granted, but if it is not exercised, the ordering rule is imposed.
5. Note that “ordinary income” apart from accounting income is placed in the rule. This seems appropriate, and consistent with the law and practice prior to the “income” revolution. It may be helpful if IRD is paid into the trust to avoid unfortunate results because of telescoping of the income tax brackets.
6. “Use” property is expressly excluded from the unitrust computation if this is desired by the drafter, which often it is. The “use” should be the substitute for the unitrust amount for
property such as the residence property which is part of a marital trust for the spouse.

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

Total Return Unitrusts-Alternative Definition of Income—The following provisions shall apply to a trust which by its governing instrument requires the distribution at least annually of an amount equal to a fixed percentage of not less than three nor more than five percent per year of the net fair market value of the trust’s assets (the “unitrust amount”), valued at least annually, such trust to be referred to as a “total return unitrust”:

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

2. Distribution of such a fixed percentage unitrust amount is considered a distribution of all of the income of the total return unitrust and shall not be considered a fundamental departure from applicable state law.

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

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

5. The governing instrument may or may not grant discretion to the trustee to adopt a consistent practice of treating capital gains as part of the unitrust distribution, to the extent that the unitrust amount exceeds the net accounting income, or it may specify the ordering of such classes of income.

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

   (a) from net income determined as if the trust were not a unitrust;
(b) from ordinary income not allocable to net income;
(c) from net realized short-term capital gains;
(d) from net realized long-term capital gains; and
(e) from the principal of the trust estate

9. The trust document may provide that assets used by the trust beneficiary, such as a residence property or tangible personal property, may be excluded from the net fair market value for computing the unitrust amount. Such use may be considered equivalent to the “income” or unitrust amount.

e. Consider Clarifying the Rules Concerning Retirement Accounts. As discussed previously, the rules concerning retirement accounts should be addressed specifically, and in light of the Final Regulations, it would be well to consider some alterations of Section 409 of the Uniform Act or whatever version of those rules have been adopted in your state. Pennsylvania’s provision might be a place to start:

§8149. Retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments.
   (a) General rule.--
      (1) The trustee shall allocate to income the greater of:
         (i) the portion of a payment characterized by the payor as interest or a dividend or a remittance in lieu of interest or a dividend; or
         (ii) the portion of the payment characterized as imputed interest for Federal income tax purposes.
      (2) The balance of any such payment shall be allocated to principal.
   (b) Allocation under contract calling for equal installments.--
      (1) If no part of a payment under a contract calling for equal installments over a fixed period of time is allocable to income under the provisions of subsection (a), the difference between the trust’s acquisition value of the contract and the total expected return shall be deemed to be interest.
      (2) The trustee shall allocate to income the portion of each payment equivalent to interest on the then unpaid principal balance at the rate specified in the contract or a rate necessary to thus amortize the difference between the expected return and the acquisition value, where that rate is readily ascertainable by the trustee.
   (c) Allocation when internal net income of fund is readily ascertained.--
(1) If no portion of a payment from a separate fund held exclusively for the benefit of the trust is allocable to income under subsections (a) and (b) but the internal net income of the fund determined as if the fund were a separate trust subject to Subchapters B (relating to decedent’s estate or terminating income interest) through E (relating to allocation of disbursements during administration of trust) is readily ascertainable by the trustee, the portion of the payment equal to the then undistributed net income of the fund realized since the trust acquired its interest in the fund shall be deemed to be a distribution of such income and shall be allocated to the trust income account.

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

(d) When not otherwise allocable to income.--

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The foregoing provisions should avoid the issue for IRA’s discussed previously of trying to determine what the income is and is required to be in order to satisfy the Final Regulations under Section 643 and the all important marital deduction. In addition, for a unitrust state, it makes sense to tie in the definition of income on a retirement account payable to a trust where the trust
has been converted or is drafted as a unitrust, so that the state law is clear on the matter. The following might accomplish that result:

Retirement Benefits payable to a unitrust. Where retirement benefits are payable to a trust converted to a unitrust under Section 8105, or to an Express Unitrust under Section 8107, income shall be determined as set forth in Section 8149, unless in the case of the trust which has been converted to a unitrust the trustee elects to determine the income from such a benefit by a percentage of the market value of the retirement account if the trust has been converted to a unitrust, in which case the unitrust rate shall be 4%, or such other rate as established in such conversion proceeding by the court, or unless the governing instrument provides for a unitrust payout from the retirement account in the case of an Express Unitrust. If the income from a retirement account is elected to be determined on a unitrust basis, the unitrust amount may be calculated based upon the market value of the retirement account over one or more years.

Generally speaking, it may be best to leave the old conventional definition of income in place for an IRA payable to a unitrust so as not to cause an increase in the distributions from the IRA to the trust, increasing income tax to the trust and/or the trust beneficiary in the bargain. However, if under all of the circumstances it is determined that the old “income” rule might cause difficulty in investing the IRA appropriately, as for example in a high interest rate period, then giving the trustee the option of converting to a unitrust both with regards to the trust and to the IRA “trust within a trust” may be helpful flexibility. Without this clarification, the treatment under many state statutes may not be as clear as we might like, and if the Uniform Act language is employed, the clear but arbitrary rule in the Uniform Act could lead to difficulties with the marital deduction under the Final Regulations, or at the very least, to trustee confusion as to how to increase or adjust the income distribution sufficiently to be “safe”.

Having set the table by reviewing recent developments in state law and Treasury’s Final Regulations, which clear the way for total return trusts, these materials will now turn to a more in-depth examination of the effects and capabilities of estate planning with total return trusts.

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

[the trustee] may consider the amount that would be distributed each year based on a percentage of the portfolio’s value at the beginning or end of an accounting period, or the average portfolio value for several accounting periods, in a manner similar to a unitrust, and may select a percentage that the trustee believes is appropriate for this purpose and use the same percentage or different percentages in subsequent years.\(^{362}\)

\(^{362}\) UNIFORM PRINCIPAL AND INCOME ACT, supra n. 10, §105, comment.
Does this give sufficient support for a unitrust definition of income to allow a drafter in a state with only the Uniform Act to draft a unitrust without an “income if greater” provision and claim qualification for the marital deduction? Is there support within the Uniform Act for the proposition that a court approved conversion to a unitrust in a Uniform Act state is “pursuant” to an applicable state statute, and thus protected by the Final Regulations from concerns of loss of the marital deduction, GST grandfathering or sale or exchange treatment under *Cottage Savings*?

At least one I.R.S. representative apparently thought so according to Jim Gamble, Co-Reporter for the Act, in recounting a private letter ruling request brought by a Michigan practitioner, where in response to the request, it seemed sufficiently evident to the I.R.S. representative that he declined to issue a ruling!

The foregoing seems to be a truly liberal reading of the Uniform Act and the Final Regulations, though there is no doubt that Section 104 was intended to allow the adjustment power to be exercised as a “de facto” unitrust. In fact, it is highly likely that most of the adjustments are thought of in terms of a percentage of the value of the trust, but is that the same thing as a unitrust? Certainly not on the face of it. Where the trustee has a power to adjust income, including the power to adjust from principal to income and from income to principal, it is essentially something quite different from a requirement or rule that a certain percentage of the value of the trust is income, regardless of what the trustee thinks about it. One thing is essentially a power, with all of its flexibility and the virtues and deficits that go with it. The other, the unitrust, is a method, with all of its predictability and the virtues and deficits that go with it. It is one thing to have to live by a rule, and quite another to have the power to make the rule, or so it seems to this writer.

But there is a stronger argument to be made on behalf of this position, and that is that the trustee could petition the court for an advance determination under Section 105(d) of the reasonableness of a prospective adjustment. And that prospective adjustment to the income of trust would be to adjust principal to income, or income to principal, as necessary to form an income interest that is equal to a unitrust interest calculated as 4% of the value of the trust fund averaged over a three year period, such prospective adjustment to be made for as long as the trust shall continue, or until the trustee were to again petition the court for a determination of the reasonableness of a change to that method of adjustment. Now that is certainly getting a lot closer to our goal of having a state unitrust statute, as it would be an court approval of a method of exercising the power to adjust under a state statute that would be equivalent to a unitrust, wouldn’t it?

Much as I might like to find that authorization within the Uniform Act that would pass muster with the I.R.S., I must admit to a real skepticism, based upon a few distinctions. First, even if such a court proceeding were brought and approved, the trustee would still have the power to adjust differently from the unitrust method, since the advance determination under 105(d) simply said that such a method would be a reasonable exercise of the power to adjust. The court is not authorized under the statute to mandate that method of adjustment. So if the trustee is still free to exercise the power to adjust in a manner different from a unitrust, then it seems to this author that the court hasn’t actually approved a conversion to a unitrust, and if it has, then it
is not pursuant to the more or less plain words of the Uniform Act, even with the addition of the more expansive comments added to Section 105.

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

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

G. DRAFTING AND PLANNING ADAPTATIONS TO THE NEW REGULATIONS

1. First, What Are My Choices?

The theme of all of these materials is that we ought to be planning and drafting differently in the future than we have in the past. As drafters we ought to be intentional about ascertaining the goals of our clients, and, in connection with those goals, what type of trust will work best to achieve those goals. Because of the proliferation of state statutes addressing the problems involved with drafting a trust that directs the trustee to hold the principal and pay the income, those of us who practice in states with total return legislation have a number of choices in our practices, including the old reliable:

a. Do Nothing. Hold the Principal and Pay the Income. If we stick to our old ways and draft as we always have, but we live in a state with the power to adjust or the power to convert to a unitrust, we could arguably just continue to write trusts that produce the problems that were the reason for these remedial statutes. Then, if there is a problem, the power to adjust or the power to convert to a unitrust will bail us, the family and the trustee out of the problem. The author submits that this is still the least effective choice, even if your state statute is a good one to allow the power to adjust and/or the power to convert to a unitrust. But it is no longer easy either. The situation does not really allow you to literally “do nothing.” Let’s look at the considerations involved.

(1) First, You’ve Got to Explain the Law to the Client. Perhaps one of the biggest impediments to using the old style “income” trust and allowing the state statute to fix the problems is that you probably need to explain the law to the client.363 This is

363 See Sloan, supra n. 300, at 45.
always a difficult task, but if the planner is forced to explain both the consequences of a direction to pay the income, in terms of dollars and cents and the power to adjust and the power to convert to a unitrust if the problems arise, it may be a difficult process indeed.

(2) Then You Should Document the Decision. Once this is discussed, the client’s wishes should likely be reflected in the document, and must be reflected in the document if the power to adjust or the power to convert to a unitrust is to be excluded from operation on the trust. If this is done, the planner should take some care to make sure that she can document the discussion and disclosure. Eliminating the power to adjust and/or the power to convert to a unitrust could well be a very expensive proposition in the long run for the client’s family and the trustee. Conversely, there should be documentation of the explanation to the client if the power to adjust and the power to convert are intended to be available to the trustee.

(3) Then Choose Your Trustee Accordingly. Independent Trustee Needed. If the power to adjust or the power to convert to a unitrust are intended to apply to the trust, the trustee must not be the beneficiary of the trust, since these powers are not considered to be safe to be exercised by an interested party. Some state statutes allow an interested trustee to convert to a unitrust, but only by petitioning the court or appointing a disinterested party to make the decisions. This is probably the biggest problem with taking this passive approach to the total return issue, since so many spouses are appointed as trustees of trusts. Instead, one must use an independent trustee to hold these powers, and removal and replacement powers must be carefully circumscribed as well. If the trustee is to be given these powers, they should know that they will have them and need to be comfortable exercising them if need be. This should not be too much of a problem if we are generally going to be using an independent trustee, which in most cases is a professional trustee.

b. Be Intentional. Decide Upon the best Choices and Discuss these with Your Client. Rather than relying upon your state total return statute, the better choice is to consider the most appropriate alternatives for the client’s situation, and for the client’s likely choice of trustee, and the client’s goals, and discuss designing the distribution provisions for your trusts proactively, reflecting your best judgment of the best available choices, and then explaining these choices to your clients. In many, if not most of the situations, your best choices may be a unitrust or a discretionary trust, as these trusts provide the unique characteristics of predictability (for the unitrust) and flexibility (for the discretionary trust) to deal with the client’s needs. The advantages and disadvantages of these types or trusts are discussed in detail in the remaining materials.

c. If a Unitrust is Chosen, Does State Law Have Adequate Definition of Income? If a unitrust is chosen for a marital trust, your state law is critical in determining whether the unitrust amount will be considered to be paying all of the “income” for marital deduction purposes.

(1) If Not, Insert “Net Income” if Greater. If your state does not have a unitrust definition of income, the trust should provide for a payment of the net income at least annually, if the net income is more than the unitrust amount.

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(2) **If Not, no QDOT Unitrust is Possible.** If your state law does not have a unitrust definition of income, a QDOT Unitrust is not possible, although the power to adjust should provide relief, where it is available.

(3) **Even if You Have a Supportive State Statute, Draw Within the Lines.** If your state statute allows a 3-5% unitrust payout as income, drafting a unitrust outside of those limits could be a problem. A 2% unitrust is unlikely to qualify for the maritaltrust deduction, even though 2% is a healthy amount of “income” these days. You can “cure” this to some degree by adding the “net income” provision, noted above.

(4) **Will a 3% Marital Qualify in a 4% State?** If, like many states, your state law has a 4% default definition of income for a unitrust, it is probably not safe to draft a marital unitrust with a 3% payout. For those states, which like Pennsylvania, have a default rate of 4% but grant the court the power to set a different rate, there needs to be a supplementation of the statutory support to deal with this issue, as suggested above. Otherwise, the rate may not be “pursuant” to a state statute.

d. **Deal With the Capital Gains and Ordering Issues.** It would be wise to include the capital gains inclusion in DNI and ordering provisions in your governing instruments, both to provide support for the ability of the trustees to include capital gains in DNI, and also to alert the trustee to the issue.

(1) **Consider Granting the Trustee the Discretion to Include Capital Gains as Part of Principal Distribution.** By adding an express provision that gives the trustee the power to consider realized gains to be a part of a principal distribution, you will be sure that the trustee has that power, since the power must only be in applicable local law or the governing instrument. This is a “deeming” power under 1.642(a)-3(b)(2) and thus must be exercised consistently.

(2) **Or Consider Granting the Trustee a Separate Power to Include Realized Capital Gains to be Included in Fiduciary Accounting Income.** For a unitrust, this power must be exercised consistently. For an “income” trust, it must only be exercised reasonably and impartially to be respected for tax purposes. If this is added, however, care must be exercised to make sure that if there are interested trustees that the power is constrained by the usual ascertainable standards, such as “health, education, maintenance and support” in addition, so as not to make the trust taxable in the estate of the trustee!

(3) **Add an Ordering Rule for A Unitrust to Add Predictability and Efficiency.** The author generally suggests that unitrusts add an ordering rule so as to protect the corpus of the trust from depletion by taxes, and to produce simplicity and predictability for the trustee. Generally, it is best to add this sort of an ordering rule as is set out in the model documents earlier in these materials and in the Appendices. For a unitrust, capital gain must either be a part of DNI or not. It cannot be switched back and forth under any circumstances, since the amount of the unitrust payment is not affected by this tax ordering. As a result, the author always inserts an ordering provision in his unitrust documents, and generally inserts them as well with respect to discretionary distributions. If your state has authority for such an ordering
rule, as many states, such as Delaware and Pennsylvania do, there should be no question that the ordering rule will be respected. If your state has no such authority, but doesn’t prohibit it, an explicit ordering rule is likely to be respected as well as a matter of tax policy, and in reliance on Examples 4 and 11 in the Final Regulations. However, if the “and” in the Regulations concerns you, you can always include a power to the trustee to consider capital gains to be a part of DNI in its discretion.

(4) Sample Discretionary Powers. In general, the author has taken the approach of “deeming” or “sourcing” unitrust amounts and any other discretionary “principal” distributions as having been made from “net accounting income” or “net income determined as if the trust were not a unitrust”, then from ordinary income that is not a part of net accounting income, then from short term gains, then long term gains and then from the principal of the trust. This is viewed as generally advisable and makes life simpler for the trustee who does not have to determine the tax character of the distribution. Particularly with respect to a distribution of ordinary income that is not composed of qualifying dividends under JGTRRA, this may also lower the tax on the income as contrasted with the compressed brackets available to the trust. However, if the planner wants to give the trustee more flexibility (or yet another thing she has to figure out, depending upon your view of trust life), or is concerned that there isn’t enough state law support for an ordering rule, one might consider the following:

(a) Power to Include Capital Gains in Fiduciary Accounting Income for a Trust that is not a Unitrust

The corporate trustee shall have the power to allocate all or any part of realized capital gains from the sale of trust assets to income, or to principal, or partly to income and partly to principal. The foregoing power, if exercised, shall be exercised reasonably and impartially so that the income shall constitute a reasonable apportionment of the total return of the trust.

(b) Power to Include Capital Gains in Fiduciary Accounting Income for a Unitrust

The corporate trustee shall have the power to allocate realized capital gains from the sale of trust assets to the unitrust amount, provided that if such power is exercised, it shall be exercised consistently, and shall not be in excess of the unitrust amount over the amount of distributable net income determined without regard to this power.

(c) Power to “Deem” Realized Capital Gains as part of DNI.

The corporate trustee shall have the discretion to consider discretionary principal distributions as being paid from realized capital gains from the sale of trust assets which are allocated to principal, provided that if such
discretion is exercised, it shall be treated consistently on the trust’s books, records and tax returns as a distribution to the beneficiary.

XI. A TOTAL RETURN UNITRUST COMPUTER MODEL - THE NEED FOR ROAD TESTING - UNDERLYING ASSUMPTIONS

A. THE NEED TO ROAD TEST THE TOTAL RETURN UNITRUST

To give our trust model a real-world test, the author favors a test similar to a consumer's test of a car. On a theoretical basis we have already kicked the tires and examined its specifications. However, the trust should be critically examined during various historical periods and particularly when the stock market has provided a bumpy and winding road. It is critical to back test the total return unitrust using actual historical markets, because real historical markets are far more challenging than the assumptions used in most software illustrations of trust return, which constantly assume a steady linear return which is the same year in and year out. While it is impossible to predict the future returns of the market, it is safe to say that this is the one type of market we will never have, one in which there is no volatility or variability of return. Thus, while "past performance is no indication of future results", back testing is a fair way to test different trust models and distribution methods since it tests the way they react when markets go up and down. And it is in the nature of the markets to go up and down. While the future performance of the markets is not known, the way in which the TRU reacted in historical markets, should fairly predict the way the TRU will react to a market of that type whenever it occurs. This is particularly valid for the TRU based as it is on the mathematics of return, not on the composition of return.

B. UNDERLYING ASSUMPTIONS OF THE TOTAL RETURN UNITRUST COMPUTER MODEL

Just as the most important terms to a life insurance illustration or prospectus may be in the footnotes, any model designed to test real world trust and investment results should be examined critically for its underlying assumptions.

1. Investments

The model uses the Standard & Poor's 500 index as the equity proxy and the Intermediate Government Bond Index for the fixed-income proxy. For the bond portfolio particularly, one could make a variety of assumptions, including a laddered Treasury or municipal portfolio, but the index is used to be sure of the consistency of our data and to minimize the number of our assumptions.364

364 For example, the choice of a fixed-income investment, the length of the ladder, if a laddered structure were used, the investment quality required, etc.
2. **Rebalancing Portfolio**

The model rebalances once a year, to maintain a consistent asset allocation. While most managers will rebalance less frequently, it is a neutral assumption.

3. **Tax Rates**

The modeling which follows in these materials uses a flat, combined federal and state income tax rate of 38%. Given the compressed tax brackets for trusts, the combined federal and state income tax rate for a trust that reinvests income is likely to be at least this high, prior to the effect of JGTRRA. The model uses the same tax rates for individual beneficiaries, even though it will be high for some and low for others. For capital gains tax purposes, it uses a 22% rate, derived from a 20% federal bracket and a 2% net state tax bracket, which takes into account the deductibility of the state income taxes.\(^{365}\) For states with higher tax rates, like New York and California, the returns would be reduced somewhat, but the reduction in return will occur across the board to all types of trusts, regardless of their method of distribution. While JGTRRA produces very significantly different tax rates and results to the current beneficiary, presumably for the next five years at least, the base historical calculations and studies have not been recalculated with the JGTRRA rate assumptions throughout, despite the fact that the author has revised his computer program to provide that analysis as needed. The reason for not revising these results is that they are likely to be too optimistic for several reasons:

a. Historical dividend rates were much higher than they are today, and as “qualifying dividends” are treated to a 15% tax rate, the historical results using these prospective rates would likely be too optimistic.

b. JGTRRA changes to rates for qualifying dividends and long term capital gains are not permanent.

c. Near term future rates of return for stocks may be lower than historical rates of return because of lower dividend rates and higher than average price/earnings ratios, suggesting that greater conservatism in computer modeling may be preferable.

Some comparative analysis in addition to that offered earlier in these materials will, however, be undertaken for analysis purposes with the JGTRRA rates as well.

4. **Trustees' Fees**

Trustees' fees of 1% per year are assumed to cover management fees for all trust duties. While this cost may vary, this projection is reasonable.\(^{366}\)

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\(^{365}\) The model does not account for the pre-JGTRRA reduction of the capital gains tax rate to 18%, which will apply to assets held over five years. See former I.R.C. §1(h)(2)(B). The model also ignores the limited offset of ordinary income in years of income reinvestment by capital losses and the trust income tax exemption of $100 or $300, because even though the model starts with a $100,000 trust for illustrative purposes, the typical trust is likely to be much larger. In such cases, these small numbers would have minimal effect.

\(^{366}\) A $1 million trust at PNC Bank, N.A. would have trustees' fees of $10,000, or 1% of the total. A much larger

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5. Turnover Rates

Unless otherwise indicated, we have assumed an index-like 5% minimum turnover rate to maintain a diversified portfolio similar to the S&P 500. The turnover reflects company additions, deletions, and weighting changes. Actual turnover rates for index funds may vary widely, but those representing the S&P 500 are likely to be 5% or below.\textsuperscript{367} Even though the model assumes that a fairly active portfolio has a 30% turnover ratio and a very active portfolio has a 60% turnover ratio, actual turnover ratios are reported at much higher levels, some exceeding 300% a year.\textsuperscript{368} The average turnover rate of mutual funds has been rising steadily, and is now over 80%.\textsuperscript{369} In computing capital gains and losses in the portfolio, the model assumes that the trustee sells a "vertical slice" of the portfolio at the turnover rate illustrated in these materials. In other words, if the total gain held in the portfolio represents one-half of the portfolio market value, then one-half of the turnover represents capital gains. On a fund by fund basis, the portion of capital gains recognized might be somewhat smaller than the turnover ratio because managers might tend to have a propensity to sell their losers, not their winners, but eventually it should even out. Real-world effects of capital gains can be measured readily enough, but only on a fund-by-fund basis, such as the Vanguard Index 500 Fund and the Fidelity Contrafund:

For example, the Vanguard Index 500 fund had just a 4 percent turnover in its portfolio in 1996 on its way to a 22.9 percent gain. The actively managed Fidelity Contrafund, by contrast, posted a 21.9 percent gain but had a turnover of 223 percent. That hyperactive trading saddled the Fidelity shareholders with a tax liability equal to nearly 10 percent of the fund's per-share price versus less than one-half of 1 percent of the price of a Vanguard share.\textsuperscript{370}

This model uses 5%, 30%, and 60% turnover rates as proxies to represent an index fund, a relatively actively managed mutual fund, and a high turnover mutual fund, respectively.

6. Costs of Purchases and Sales

We have assumed a 1% round trip for a purchase and sale, that is ½% cost on a sale and ½% cost on the purchase. This would be a very low assumption for retail brokerage rates, but a relatively high one for an institutional investor, which might commonly trade at five or six cents per share. A tax conscious institutional investor, or an individual investor using low cost, low turnover index or tax managed funds, would have a leg up on our assumptions.

\textsuperscript{367} See Mutual Funds You Can Live With, CONSUMER REP., May 1997, at 18. In 1998, the largest S&P 500 index funds showed a turnover of 6%, while there was turnover of 8% of the companies, due primarily to merger activity. Index funds reflecting the total stock market such as the Wilshire 5000 have even lower turnover, such as the Vanguard Total Market Index Fund, with a 3% turnover in 1998. See Vanguard U.S. Stock Index Funds Prospectus, April 30, 1999, at 28.

\textsuperscript{368} Strong Growth Fund showed a 321% turnover ratio in 1996. See Mutual Funds You Can Live With, supra note 367, at 19.

\textsuperscript{369} See Bogle, supra note 37, at 25.

\textsuperscript{370} See Mutual Funds You Can Live With, supra note 367, at 15.
7. **Timing of Turnover and Pruning for Distributions**

For simplicity, the model assumes that all turnover and distributions occur at the end of a calendar year. Turnover is far more likely to occur throughout the year and distributions are more likely to be made quarterly. However, these assumptions would considerably complicate the model. This model also assumes that a trust pays taxes immediately after the close of the tax year. Obviously, quarterly tax estimates must be paid throughout the course of the year. In part to offset the simplifying assumptions that distributions and other expenses do not occur until the end of the year, no reinvestment return (a normal component of total return) is assumed during the year.

8. **Pruning for Taxes and Distributions**

The model assumes that pruning of securities to pay out distributions or tax payments requires separate securities sales in addition to the normal trust portfolio turnover. Although this complicates the model, it more likely conforms to real-life trust conditions. The model also assumes that turnover from selling one stock for investment reasons corresponds with purchasing another stock.

9. **Capital Gains Taxation to Beneficiary or Trust**

The computer model assumes that the IRS will treat the distribution of taxable income of the total return unitrust basically in accordance with the rules governing charitable remainder unitrusts - the distribution drawing out ordinary income, then short-term capital gains, then long-term capital gains. This follows our income allocation provision of our model trust, which states that the distributions are to be made from those sources in that order. The Final Regulations make this a very reasonable assumption. The same assumption is used on the other trust models apart from the unitrust, such as the index payout trust, the TRU-Cap Unitrust and the No-drop Unitrust. While the assumption that a consistent ordering will be respected in these instances is somewhat less clear, it is nonetheless likely, in light of the examples in the Final Regulations specifically allowing discretionary distributions to be treated this way where the trustee has power to include it or not as a matter of state law and the governing instrument.\(^{371}\) Either these distribution methods which are variations on a theme will either be a part of income or a part of principal, and in either case there is support in the Final Regulations for including the capital gains in those distributions to the extent that the distributions exceed traditional income.

**XII. ROAD TESTING THE TRU**

A. **SELECTING A COMPARISON PERIOD**

The period from January 1, 1973, to the present is a good period to begin our study for two reasons. The first reason is that 1973 and 1974 accounted for the worst stock market performance in modern history. During 1973 and 1974 stock prices declined 17.4% and

\(^{371}\) Treas. Reg. 1.642(a)(3) ex. 2.

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29.7%, respectively, a 42% composite decline during that two-year period. The second reason is
the similarity between the dividend and interest yields at that time and the yields of today. The
Standard & Poor's 500 dividend yield was at an average of 2.86% in 1973, while intermediate
governments bonds were approximately 6.5%. While today’s yields of 1.73% for the S & P 500
and 4.22% for a 10 year Treasury 372 are significantly lower, they provide the same challenge of
balancing income and growth. During the nine years which followed 1973, interest rates and
inflation were tremendously volatile. However, the next seventeen years provided overall a
favorable financial market especially with 1995-1999, the best five stock market years in history.
Top off that great bull market with the terrible three year bear market of 2000-2002, and end it
with one year of market recovery in 2003, and we’ll have a very challenging period to test the
TRU!

This period should not, however, be confused with a period which is neutral for testing
purposes, but rather one which is a worst-case scenario for a total return unitrust invested entirely
in equities. It is designed that way to see how things might turn out if we adopt a TRU approach
with a very aggressive 100% equity portfolio at the very worst time, and then stop the testing
period at the bottom of another major bear market

The importance of testing worst case scenarios is underscored by the recent bear market
of 2000-2002. One simply does not know when the next downturn or upturn will be, so it is
important to be comfortable with the way a trust design and a trust portfolio may react in such
markets.

B. COMPARING THE INCOME RULE TRUST TO THE TRU

Now that we have selected our worst case period for study, we will assume a hypothetical
$100,000 portfolio which is created for a surviving spouse. We will model total return trusts
with distributions of 4, 5 and 6%, reflecting a moderate to very high need for income. To
compare the TRU with the income rule trust, we will study the results two ways:

1. Equalizing our Initial Payment From an Income Rule Trust and a Total Return
Trust but Allowing Different Asset Allocations

In our first comparison, we will model the TRU with an all-equity portfolio, which would
often be a best case, but during this time period will be a worst-case scenario. At the same time,
in determining the asset allocation of the income rule trust, we will select the asset allocation
which at that time (the beginning of 1973) would have been required to produce the income rule
trust payout equivalent to the TRU in the first year. For example, in order to make a 4% payout
in an income rule trust, a 60% equity and 40% fixed-income portfolio would have been required
at the beginning of 1973. In order to yield a 5% payout from an income rule trust, the asset
allocation would have been 33% equity and 67% fixed income. To yield 6%, an income rule
trust at that time would have allowed only 6% equities and 94% fixed income. Since the asset
allocation is the only tool available to the trustee to satisfy the income need of the beneficiary,
this is not an unrealistic way to approach the comparison. In the real world of trusts, the income
need of the beneficiary drives the asset allocation of the income rule trust, not the investment

advisor! Let's see what happens when we model these competing approaches. See Table 3 which follows.

Looking at the table of results, the all equity 4% TRU versus the 60/40 income rule trust provides a striking comparison. The TRU of course gets clobbered in the first two years with a market value decline to $55,051 while the more conservative portfolio does better at about $71,000. Yet the 4% TRU over this thirty year period has only four years in which the distribution declines, including 2002. It touches bottom in 1976 and increases every single year for the following twenty-five years. By itself this is a remarkable record given the highly volatile period which was selected. The ending market value of the 4% TRU is $447,561 versus $280,976 for the 60/40 portfolio, arguably the classic trust portfolio. But note also that the income rule payout was subject to eleven years of declines rather than just four. Most telling of all is the fact that in 1984 the income rule payout generated $7,829 and in 2002 it generated only $6,573. During this eighteen-year period, the trust beneficiary had a decrease in income of 16%! In 2002 the TRU was distributing four and a half times as much as the traditional income rule trust. It is no wonder that so many of our trust beneficiaries are complaining about their income, and in an unfortunately large number of cases, suing their trustees.373

It is only fair to note that during the period of the '70s and early '80s, the income rule trust paid out substantially more income. But these were also periods when total return for the portfolio was often negative and "real" return after inflation was drastically negative throughout that period. The beneficiary of the income rule trust was receiving all of the total nominal return from that portfolio from 1973 through 1982 and much of the principal in real terms. There was nothing left of the return to protect the principal from inflation. Portfolios in the '70s were "over productive" of income and the income rule trust allocated the returns entirely to the income beneficiary.

It is also fair to note that the TRU distribution declines significantly in 2003, based upon the market values in 2000, 2001, and 2002, to $24,383, and decline further in 2004, because of the loss of the 2000 year end value, but even so, the distribution will be a multiple of its traditional competitor, and its market value is likely to be much higher as well.


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THE MORE "INCOME" YOU NEED-THE MORE YOU NEED THE TOTAL RETURN UNITRUST!

Table 3: Head to Head Uphill - TRU Versus Income Rule Trust in Most Difficult Comparison Period

<table>
<thead>
<tr>
<th>Allocation</th>
<th>100% Equity</th>
<th>60% Eq/40% Fl Income</th>
<th>100% Equity</th>
<th>33%Eq/67% Fl Income</th>
<th>100% Equity</th>
<th>6% Eq/94% Fl Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dec 1973</td>
<td>4,000</td>
<td>80,438</td>
<td>3,998</td>
<td>88,004</td>
<td>5,000</td>
<td>79,433</td>
</tr>
<tr>
<td>Dec 1974</td>
<td>3,609</td>
<td>55,051</td>
<td>4,187</td>
<td>70,970</td>
<td>4,486</td>
<td>53,437</td>
</tr>
<tr>
<td>Dec 1975</td>
<td>3,140</td>
<td>71,646</td>
<td>4,121</td>
<td>83,866</td>
<td>3,881</td>
<td>68,707</td>
</tr>
<tr>
<td>Dec 1976</td>
<td>2,762</td>
<td>84,982</td>
<td>4,289</td>
<td>94,608</td>
<td>3,360</td>
<td>80,781</td>
</tr>
<tr>
<td>Dec 1977</td>
<td>2,822</td>
<td>75,162</td>
<td>4,570</td>
<td>85,445</td>
<td>3,382</td>
<td>70,744</td>
</tr>
<tr>
<td>Dec 1978</td>
<td>3,091</td>
<td>76,084</td>
<td>5,109</td>
<td>83,839</td>
<td>3,671</td>
<td>70,848</td>
</tr>
<tr>
<td>Dec 1979</td>
<td>3,150</td>
<td>85,768</td>
<td>5,610</td>
<td>87,728</td>
<td>3,706</td>
<td>79,158</td>
</tr>
<tr>
<td>Dec 1981</td>
<td>3,605</td>
<td>98,200</td>
<td>7,629</td>
<td>89,974</td>
<td>4,160</td>
<td>89,538</td>
</tr>
<tr>
<td>Dec 1982</td>
<td>3,900</td>
<td>112,883</td>
<td>7,263</td>
<td>102,411</td>
<td>4,471</td>
<td>102,258</td>
</tr>
<tr>
<td>Dec 1983</td>
<td>4,261</td>
<td>132,331</td>
<td>6,954</td>
<td>110,945</td>
<td>4,856</td>
<td>119,089</td>
</tr>
<tr>
<td>Dec 1984</td>
<td>4,579</td>
<td>134,136</td>
<td>7,827</td>
<td>111,580</td>
<td>5,181</td>
<td>119,737</td>
</tr>
<tr>
<td>Dec 1985</td>
<td>5,058</td>
<td>169,760</td>
<td>7,611</td>
<td>132,342</td>
<td>5,685</td>
<td>150,421</td>
</tr>
<tr>
<td>Dec 1986</td>
<td>5,816</td>
<td>192,464</td>
<td>6,567</td>
<td>146,135</td>
<td>6,487</td>
<td>169,835</td>
</tr>
<tr>
<td>Dec 1987</td>
<td>6,618</td>
<td>193,726</td>
<td>6,993</td>
<td>143,018</td>
<td>7,333</td>
<td>169,646</td>
</tr>
<tr>
<td>Dec 1988</td>
<td>7,413</td>
<td>215,316</td>
<td>7,742</td>
<td>150,397</td>
<td>8,165</td>
<td>187,080</td>
</tr>
<tr>
<td>Dec 1989</td>
<td>8,020</td>
<td>270,480</td>
<td>7,985</td>
<td>175,403</td>
<td>8,776</td>
<td>233,437</td>
</tr>
<tr>
<td>Dec 1990</td>
<td>9,060</td>
<td>248,269</td>
<td>8,563</td>
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</table>

Number of Periods with Negative Change in Distribution:

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<th>5</th>
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<th>8</th>
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<td>2</td>
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<td>2</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>

Number of Periods with Negative Change in Distribution > 10%:

| 2 | 2 | 2 | 2 | 2 | 3 |

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If we were to graph the income distributions and ending market values of a 5% TRU invested 100% in equities with an income rule trust invested in 1973 so as to produce the same net income at the beginning-the middle comparison on the above table; one can see the differences in results:

Predictably, throughout the bear market of the 1970s, the income rule trust beneficiary does better with significantly more income distributed from a largely bond portfolio during this high interest rate and high inflation rate period. But once the bear market is in retreat, and the bull market takes over, there is simply no comparison between the two, with an ending distribution in 2003 from the all equity TRU at approximately six times the distribution from the largely bond portfolio, despite the tremendous drop in the TRU distribution in 2003, due to the drop in values in the bear market. Interestingly, the income from the income rule trust actually declined more than the TRU in 2003 in relative terms, declining 22.45% compared to the TRU’s decline of 20.24%. You can’t see it in the graph because of the scale which shows the income from the traditional trust to be too small to see its ups and downs clearly. In fact the income from the bond-heavy traditional trust has decreased significantly even in nominal terms during this 30 year period. One is struck also with the significantly smoother distribution produced by the all equity TRU distribution for most of the 31 year period because the three year smoothing rule makes the ride smoother than the interest rate market, which during some periods shows very substantial volatility. That smoothness broke down in 2003 and 2004, where the sharp bear market of 2000-2002 coupled with the sharp bull market from 1995-1999 produced overall the greatest period of volatility in history. But there is still be no comparison with the largely bond portfolio, the income for which continues to decline up to the present.
A graph of the market values of the two trusts is equally striking, with the TRU all equity portfolio protecting the interests of the remainder beneficiary far better throughout the majority of the period of study, despite the loss of almost 50% of its market value in the first two years.

![Worst Case Scenario (1973-2003) Total Return Unitrust vs. Income Rule Trust - Year End Market Values](image)

The recent bear market is clearly in evidence in the last three years, but the market value even at the end of 2002 is still almost twice the market value of the “conservative” portfolio, at the bottom of the recent bear market, and this is the closest the traditional trust gets to parody with our TRU trust. So even starting the TRU at the worst possible time in recent history and then stopping it at the bottom of the next bear market isn’t enough to allow its income rule counterpart to compete effectively. Over the long run, the TRU and equity investing is the clear winner.

From the early 1980's on, the income beneficiary of the income rule trusts suffered in all three of the scenarios illustrated on Table 3. With a typical asset allocation of 60/40, the nominal income from an income rule trust actually declined by 29% from 1984 to 2003. And from 1973 to 2002, there was over a 65% real decline in spendable income adjusted for inflation during this thirty year period, despite an unprecedented bull market during much of the last decade.

2. But do not be Deceived - Inflationary Bears are Harmful to Investors and Other Living Things

On the surface Table 3 looks like pretty good absolute performance during that period for the 4, 5, and 6% TRUs. But despite the fact that they hit bottom between 1976 and 1977 and rise
steadily after that, we must keep in mind that from 1973 through 1981, we had pernicious inflation totaling 103%. Not one of the TRUs nor one of the income rule trusts increased the payout by as much as inflation during this bear market, and the TRU trusts imposed a diet on their beneficiaries during this famine of real return. During this bear market period, the TRU beneficiary would have suffered considerably from this inflation. The difference is that the TRU beneficiary diets during famine and feasts during plenty, more sensible and prudent than the income rule trust that often does the opposite. The pattern of the 1970s was not repeated with our last bear market, because we had low interest rate and low dividend rates and low returns as well, which is better for the income trust, in a manner of speaking. And the tremendous volatility of the great bull market followed by a substantial bear market actually hurt the TRU in this market because the smoothing rule attempts to dampen the damage to the income beneficiary. But clearly the fruits of using a better investment mix and a better method for determining spending are a much higher ending balance and a higher total net return due to the effects of dollar averaging in most markets.

3. **Comparison of Net Total Return Between Total Return Unitrust Versus Income Rule Trust**

In examining Table 3, one might conclude that the TRU with all three payout amounts has a higher total net return than the income rule trust, but because of the widely differing payouts throughout the course of the time frame studied, one cannot easily tell. For this purpose, we have prepared the following chart of net *after-tax returns*. This comparison was compiled by treating the last year of the trust as a distribution year for termination. During the final year, the market value of the trust is sold and the capital gains taxes are paid in full on the increase in value.³⁷⁴

³⁷⁴ Selling all trust assets and fully paying capital gains tax will result in an understatement of the TRUs benefit because the TRU produces greater capital gains resulting in greater capital gains taxes and because the gains could continue to be deferred, utilizing additional funds from capital only as necessary to meet the beneficiary's needs. These returns were computed by present valuing the irregular net income streams and adjusting the discount rate until the present values were equalized.
The big message here is that with the income rule trust, for each percent of additional payout desired, we lose about an extra percent in total net return because the only instrument we have for adjusting how much the beneficiary receives is our asset allocation and the more the beneficiary needs, the more we are forced to invest in those investments (fixed-income investments) which are least able to afford it.

You will note also that the TRU also loses total return with a higher payout which is a natural result of the loss of reinvestment return which is really a normal component of total return. However, this method of measuring return is certainly no distortion because it more realistically computes return based on the need to actually consume some of the investment in order to live, much more like the real world than the standardized total return computation.

The moral of this story is clearly that the more income you need, the more you need the TRU trust and equities. It is also noteworthy to observe that the differences in real returns after inflation are much more striking. During the period 1973 through 2003, inflation averaged 4.9% so that for a 60/40 portfolio, the real net return was 1.5% for the income rule trust and a 2.9% return for the total return unitrust. The TRU had almost twice the net real return to the beneficiary. It is even more striking for the 33% bond, 67% equity portfolio which shows a net total return of .6% versus the TRU at 2.7%. Were we to consider the portfolio with only 6% equities, we would find a negative real total return. This theme will recur over and over again.
4. Road Testing the TRU While Equalizing Asset Allocation - Do Unitruts do it Better?

The key feature of the total return unitrust is that the asset allocation is independent of the distribution. No factors other than risk and return and the tolerance of the trust and its beneficiaries to put up with such risk and return need be considered in investing the TRU. Because the return from stocks over long periods of time is much greater than it is for bonds, it stands to reason that our asset allocation will be higher in stocks for total return trusts in general and total return unitruts in particular. But what if it were not? What if we tested the TRU against an income rule payout while holding the asset allocation constant?

Table 4 (which follows) provides a detailed comparison showing the distributions and the market values for the 1973-2003 period for three different investment mixes: 80% equity and 20% fixed income; 60% equity and 40% fixed income; and 33% equity and 67% fixed income. One very significant trend you will see by comparing the pairs of trusts is that the market value is larger with the TRU for each and every year and each and every asset allocation after the first year. This is because the income rule payout is not decreased no matter how much the market value of the portfolio goes down, as long as the income stays where it is or increases. This feature of course is a two-edged sword since the current income beneficiary of the TRU will hurt during a high inflationary bear market such as the one we are illustrating here.

The graph of distributions which follows shows rather clearly the superior smoothness of the TRU distributions. But note that the income rule trust pays out more to the income beneficiary for the majority of the period using the same asset allocation. Since we are modeling an inflationary bear market, this would be true even if we used a higher rate unitrust to compensate. The income rule trust with a 60/40 mix will outspend a 5% unitrust until 1987. But that spending has a significant price in total return and safety of the overall trust.

If we measure the net total after-tax returns from these different asset allocations, using the same methodology of cashing out the portfolio in the final year and paying the capital gains tax, we find the TRU generates more total net return by 19 to 33 basis points. See the Differential table below Table 4 which follows.
Unitrusts Do It Better!
Total Return Trust vs. Income Rule Trust - Distributions
(60% Equity / 40% Fixed Income)

$20,000
3.998% Total Return Trust

$2,000
$
$4,000


TRT 2003 =15,947
TRT-1973 =3,998
IRT 2003 =5,562
IRT-1973 =3,998

Distributions

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Unitrusts Do It Better!

Total Return Trust vs. Income Rule Trust - Year End Market Value
(60% Equity / 40% Fixed Income)

TRT

<table>
<thead>
<tr>
<th>Year</th>
<th>Market Value</th>
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<tr>
<td>1974</td>
<td>$600,000</td>
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</table>

IRT

<table>
<thead>
<tr>
<th>Year</th>
<th>Market Value</th>
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</thead>
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<td>$0</td>
</tr>
<tr>
<td>1974</td>
<td>$100,000</td>
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</table>

TRT-1973 = 88,004
IRT-1973 = 88,004
TRT 2003 = 388,168
IRT 2003 = 321,208

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SI-168-RBW
## Table 4: Head to Head Uphill - Total Return Trust Versus Income Rule Trust in Most Difficult Comparison Period

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<thead>
<tr>
<th>Allocation</th>
<th>80% Eq/20% FI</th>
<th>80% Eq/20% FI</th>
<th>60% Eq/40% FI</th>
<th>60% Eq/40% FI</th>
<th>33% Eq/67% FI</th>
<th>33% Eq/67% FI</th>
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<td>Rule</td>
<td>End</td>
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<td>Payout</td>
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<td>4,891</td>
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<table>
<thead>
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<th>Number of Periods with Negative Change in Distribution:</th>
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</thead>
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<tr>
<td>5</td>
</tr>
<tr>
<td>2</td>
</tr>
</tbody>
</table>

Number of Periods with Negative Change in Distribution > 10%:

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SI-169-RBW
DIFFERENTIAL IN NET TOTAL AFTER-TAX RETURNS WITH IDENTICAL INVESTMENT MIXES BETWEEN 1973 - 2003

<table>
<thead>
<tr>
<th>Investment Mix (Equity/Fixed)</th>
<th>Difference in Basis Points (in percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>33/67</td>
<td>18.9</td>
</tr>
<tr>
<td>60/40</td>
<td>23.8</td>
</tr>
<tr>
<td>80/20</td>
<td>27.3</td>
</tr>
<tr>
<td>100/0</td>
<td>33.1</td>
</tr>
</tbody>
</table>

This is actually a very large difference when we consider that we are using the same investment mix and we are talking about net after-tax return. If we took out inflation, the return on the 60/40 mix would be 1.5% of which the difference is compared with 1.3%, a 16% difference!

Further, it is perhaps surprising that the volatility of the distributions is significantly lower for the TRU than it is for the income rule trust. But this is because interest rate volatility has no effect on the distribution from a TRU and interest rate volatility exceeds the market value volatility that results from variability of return over a period of time because of our smoothing rule.

While the income rule trust tends to pay out more in an inflationary bear market, thus deferring the pain to the income beneficiary, such a result seems to make no sense in the context of allocating return between the current beneficiary and the remaindermen. Why should the income beneficiary receive more than all of the real return? The TRU, on the other hand, makes the current beneficiary and remaindermen suffer and celebrate together. This is in the long run beneficial in fostering good relationships where the total return impacts both the current beneficiary and the remaindermen in an equal fashion, cementing the trust triangle of trustee, current beneficiary and remaindermen. If the current beneficiary must be put on a diet, it makes more sense to do it in lean times than in times of plenty.

But this is only true if the intent of the grantor is to allocate risk and return fairly between the current and future beneficiaries. In some cases, perhaps frequently, the grantor would really prefer that the current beneficiary's distribution be protected from inflation, even if that would have deleterious results on the risks to the remaindermen. For this purpose we must look carefully at a comparison of the TRU with the indexed payout trust.

C. COMPARING THE TRU WITH THE INDEXED PAYOUT TRUST -- A LIMITED BUT IMPORTANT ALTERNATIVE

1. Selecting a Time Frame to Examine the Indexed Payout Trust

A suitable "rough road" to examine the indexed payout trust would clearly be the same course as we used for the TRU, and for the same reason. The period 1973 through 1982 was one in which inflationary pressures and its companion “stagflation” reflected both stagnant growth in the economy and substantial inflation. In this environment, an inflation indexed trust would be of great value to the current beneficiary, provided that it did not deplete the trust entirely.
Professor Dobris,375 Bill Hoisington376 and others377 have noted the considerable utility of an indexed payout trust if the interests of the current beneficiary are primary. Table 5 which follows shows the results for an indexed payout trust using the same all-equity portfolio and initial payouts of 3, 4, 5, and 6%, and taking into account taxes and expenses.

From this analysis, it appears that using an indexed payout trust would have actually worked well at the 3% level, largely depleted the trust over a 30 year period at the 4% level, depleted the trust entirely after 18 years at the 5% level, and exhausted itself in less than thirteen years at a 6% level. Still, the indexed payout trust lasted a dozen years even with the high initial payment of 6% and beginning at the worst possible time from the point of view of inflation and the markets, and this might well be longer than the life expectancy of an elderly beneficiary.

One should note also that the indexed payout trust allows the trustee to invest for total return, although the risk and return characteristics differ with this form of trust as between fixed income and equities. If the goal in an indexed payout trust is to minimize the danger of complete depletion of the trust, an optimal mix will include a much higher proportion of fixed income, although during this time frame at a 5% payout indexed for inflation, there is no investment mix of S & P 500 stocks and intermediate government bonds which would have preserved the fund up to the present time.

375 DOBRIS, supra note 11, at 22-38.
376 HOISINGTON, Modern Trust Design, supra note 11, at 5-10.
<table>
<thead>
<tr>
<th>Year</th>
<th>3% Market Value</th>
<th>4% Market Value</th>
<th>5% Market Value</th>
<th>6% Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec 1973</td>
<td>3,000  81,443</td>
<td>4,000  80,438</td>
<td>5,000  79,433</td>
<td>6,000  78,428</td>
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<td>Dec 1974</td>
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<td>5,440  52,478</td>
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<tr>
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<td>6,104  65,171</td>
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<td>5,225  79,117</td>
<td>6,532  73,262</td>
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<td>Dec 1977</td>
<td>4,107  73,862</td>
<td>5,477  67,112</td>
<td>6,846  60,361</td>
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<td>Dec 1978</td>
<td>4,386  73,414</td>
<td>5,847  64,833</td>
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<td>Dec 1979</td>
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<td>6,090  88,337</td>
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<td>10,150 52,244</td>
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<td>6,891  112,673</td>
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<td>11,485 50,499</td>
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<td>7,153  111,024</td>
<td>9,537  76,013</td>
<td>11,921 41,002</td>
<td>14,306 5,990</td>
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<td>7,716  152,986</td>
<td>10,287 94,264</td>
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<tr>
<td>Dec 1987</td>
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<td>10,404 88,175</td>
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<tr>
<td>Dec 1988</td>
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<td>Dec 1994</td>
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<td>13,725 79,411</td>
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<tr>
<td>Dec 1995</td>
<td>10,568 307,837</td>
<td>14,091 93,807</td>
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<tr>
<td>Dec 1996</td>
<td>10,837 361,609</td>
<td>14,449 99,687</td>
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<tr>
<td>Dec 1997</td>
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<td>14,929 116,643</td>
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<td>Dec 1998</td>
<td>11,387 573,060</td>
<td>15,182 133,018</td>
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<tr>
<td>Dec 1999</td>
<td>11,570 669,120</td>
<td>15,427 143,396</td>
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</tr>
<tr>
<td>Dec 2000</td>
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<tr>
<td>Dec 2001</td>
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<td>16,377 81,540</td>
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<td>0     0</td>
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<tr>
<td>Dec 2002</td>
<td>12,473 364,138</td>
<td>16,631 46,058</td>
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<td>0     0</td>
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<tr>
<td>Dec 2003</td>
<td>12,770 449,607</td>
<td>17,027 41,530</td>
<td>0     0</td>
<td>0     0</td>
</tr>
</tbody>
</table>

YEARS TO DEPLETION OF AN INFLATION INDEXED PAYOUT TRUST WITH 5% PAYOUT FOR THE PERIOD 1973-PRESENT

<table>
<thead>
<tr>
<th>Percentage Equity/Fixed Income</th>
<th>Years to Depletion</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% Equity</td>
<td>18 yrs</td>
</tr>
<tr>
<td>80% Equity / 20% Fixed Income</td>
<td>19 yrs</td>
</tr>
<tr>
<td>60% Equity / 40% Fixed Income</td>
<td>20 yrs</td>
</tr>
<tr>
<td>40% Equity / 60% Fixed Income</td>
<td>21 yrs</td>
</tr>
<tr>
<td>20% Equity / 80% Fixed Income</td>
<td>21 yrs</td>
</tr>
<tr>
<td>100% Fixed Income</td>
<td>20 yrs</td>
</tr>
</tbody>
</table>

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The methodology of payment affects not only our returns, but also our choice as to an optimal investment mix. The total return unitrust, with a smoothing rule to help with the corrections in the equity market, tends to encourage the use of equities because of its performance characteristics. This is also true with an indexed payout trust, if the goal is to keep the corpus and income up with inflation, but not if the goal is to avoid depletion. If you want to do both (and who doesn't?), this presents a problem.

D. IF INDEXING, LOWER PAYOUT RATE AND SHORTER TERM ARE SAFER

This discussion suggests that if the payout rate from the trust is relatively low, then the trust can afford to have it indexed over a long period of time. The 3% payout illustrated in Table 5 works well even starting in 1973. However, the payout was fairly close to the starting S&P 500 dividend yield which on an historical basis has generally kept up with inflation anyway in an all-equity portfolio, as discussed in more detail later in these materials. A higher payout will work, but would be prudent only if the duration of the trust, implicitly the life expectancy of the beneficiary, is not too long.

A planner might also use an indexed payout trust for a relatively short period, for example, when a parent intends a child to receive an "allowance" to provide basic support but not to discourage initiative. If the period is short enough and the payout is low enough, this approach may best meet the clients' goals. The primary thesis of these materials is that trusts must be drafted so that the trust portfolio can be invested for total return, which is best achieved through the use of the TRU or a fully discretionary trust. Nonetheless, sometimes an inflation indexed payout trust may be justified and more desirable.

Indexing the payout is obviously dangerous, but it is also costly in terms of net total return. We can measure that cost by comparing the net after tax returns of a 3% and 4% indexed payout trust with a 3% and 4% TRU over our difficult test track of 1973-2001. The differences are far greater than those found with the income rule trust:

Net After Tax Return to Beneficiary of Trust With All Equity Investment Mix from 1973-2003

Liquidating Portfolio at End of Period and Paying Capital Gains Taxes

<table>
<thead>
<tr>
<th></th>
<th>3%</th>
<th>4%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Return Unitrust</td>
<td>7.95%</td>
<td>7.80%</td>
</tr>
<tr>
<td>Indexed Payout Trust</td>
<td>7.39%</td>
<td>6.37%</td>
</tr>
<tr>
<td>Net Loss of Return</td>
<td>.56%</td>
<td>1.43%</td>
</tr>
</tbody>
</table>

The indexed payout trust increases its payout in high inflation periods when the stock and bond markets are at their worst to a much greater degree than the income rule trust. The results show up in substantial loss of net total return from the trust even if the trust does not deplete itself.

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E. USE OF FULLY DISCRETIONARY TRUSTS SHOULD BE EXPANDED

A trust which gives an independent trustee full discretion with no standards, or one which gives a non-independent trustee the power to distribute any amount of income or principal based upon ascertainable standards such as "health, education, maintenance, and support" will also give the trustee the ability to invest for total return. It will also afford the trustee maximum flexibility to adapt distribution and investment policies to the changing needs of the family. And it allows the trustee to reinvest all returns if the beneficiary can afford it. This will be extremely valuable in the context of a marital and credit shelter trust scenario as discussed more fully in the estate planning section of these materials. However, the fully discretionary trust is problematic when there is discord in the family and whenever the family does not have absolute confidence in the trustee - its very flexibility will work against the trustee.

XIII. HOW MUCH CAN A TRUST AFFORD TO PAY OUT AND (PERHAPS) KEEP UP WITH INFLATION?

A. TAXES, EXPENSES, AND INFLATION - ENEMIES OF THE FAMILY TRUST!

In the real world of trusts, taxes, expenses and inflation are our enemies. In this section of these materials we will examine just how big an effect these three factors have on our ability to pay out a "reasonable" return and still be able to preserve the real value of what is there. The author’s first article on this subject utilized a computer model which did not take into account the effects of taxes and expenses on the investment results. Since then we have refined the model significantly to take into account these enemies of the family trust—taxes and expenses. Updating the figures through 2003, here is how the figures would compare, starting out with a $100,000 all equity trust and paying out 5% per year to the beneficiary. Even adjusted for inflation, and even at the end of a severe three year bear market, the value of the trust is $528,749, well over five times the initial starting value even adjusted for inflation. After taxes and expenses, however, the value is pared down to $166,408, less than one third as much, but significantly, still a 66% increase over the inflation adjusted value of the trust over the 78 year Ibbotson period.
Appendix 2 available by request shows the detail of the TRU performance from 1926 through 1998 with all of the details and transactions that go into the spreadsheet analysis for anyone wanting to see all of the figures calculated to reach these results.

Note also that this TRU, diminished as it was by taxes and inflation, is an all-equity trust with a 5% turnover rate. **With a turnover rate of 30%, and a 50/50 portfolio, the ending value of a 5% TRU would have been $279,592 through 2003, a real decrease of 72%!**

Very few trusts will last as long as the 1926 through 2003 period. From 1960 to 2003, using a starting period employed in the Sanford Bernstein study discussed later in these materials, the initial starting value of $100,000 would grow to $556,727, which sounds good enough until we adjust it for inflation, to find that by the end of 2003, the inflation adjusted value had dropped to $88,756. As discussed later, this would be a very unfavorable starting and stopping point for a fair analysis, because 1960 was at the end of a great bull market of the 1950s, and of course while 2003 was a good year, it did not recover the losses of the bear market of 2000-2002. Selection of starting and stopping points is critical in any historical analysis, and this period would have been difficult indeed for any trust. So also would the period of 1973 through 2003, and during this period, the initial value of $100,000 would have grown to $414,230, which sounds good until inflation adjusted, it drops to $95,516. Just for perspective an income only trust with a 60/40 investment mix paying out only the income from 1973-2003 would have a total of $321,208, and adjusted for inflation $74,066. So particularly the more recent periods of investment have been very challenging regardless of the methodology of investment and distribution, but equities and the TRU clearly give the trust a fighting chance! Appendix 3 and 4, **

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378 However, the use of dynasty trusts to optimize generation-skipping transfer tax savings may increase the planner's stable of long-term trusts.

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available by request, show the details of each calculation year for the periods 1960 through 1998 and 1973 through 1998. The author has not updated these lengthy Appendices simply out of a concern for the environment.

B. DISTRIBUTIONS MAINTAIN “REAL” LEVELS AND LAG MARKET VALUES DUE TO THE SMOOTHING RULE

During the longest test period, the market values seem to have kept up with inflation, but have the distributions? During the seventy-eight-year period starting in 1926 and ending in 2003, distributions increase by 1872%, a 92% "real" increase. The 1960 through 2003 showed a 542% increase in distribution, and a real increase after inflation of 2.3%. The 1973 through 2003 modeling showed an increase of 377%, and a real increase after inflation of 10.1%. One might ask how it could be that the distributions have kept up with inflation whereas the market values did not for the most recent periods through the end of 2003? The answer to that is fairly simple—the three year smoothing rule allows the increase in the distribution to lag in bull markets and lag in bear markets as well. As a result, the distributions in 2003 take into account the market values of 2000, 2001 and 2002. Taken as a function of the prior year end value, the distribution in 2003 is 6.9% of the value as of December 31, 2002, while in 1998 distribution is 3.98% of the 1997 year end value. So in a strong bull market, or in a strong bear market, the three year smoothing rule makes a lot of difference. In this author’s opinion, in the real world of trusts, it is a very good difference. This factor also increases returns during a bull market (by distributing less than the stated percentage while the market advances) and reduces them in a bear market (by paying out relatively more when the market is in decline), but eases the volatility in both types of markets to the current beneficiary. In light of the unprecedented volatility of 1995-2003, if anything we need more smoothing, and certainly not less.

C. TAXES AND EXPENSES INCREASE VOLATILITY

The volatility of the distributions is significantly increased by factoring in real taxes and expenses. During the seventy-one-year period modeled in the author’s first article, there were thirteen years in which the distribution declined. Factoring in these modest costs and expenses and, perhaps, rather immodest taxes results in an increase in volatility. Now nineteen out of seventy-three years through 1998 show a decrease in distribution. An examination of after-tax distributions reveals an increase in declining years to twenty-one out of seventy-three years. Based on this same analysis, from 1973 to 1998, the number of down years for distributions rises from three to five, and after taxes, from three to seven.

D. EVEN WITH LOW TURNOVER AND AN ALL-EQUITY PORTFOLIO, 5% IS A SENSIBLE MAXIMUM FOR LONG-TERM PAYOUT

What conclusions can be drawn from these results? Taxes, costs, and inflation are a very difficult triple threat if the current beneficiary needs a 5% distribution. For this reason, the data and model suggest that if in designing a long-term trust the goals are to protect both the current beneficiary and the remaindemen from inflation, then 5% is probably the most the trustee can distribute and still have a reasonable chance of fulfilling these objectives. And remember this is
with an all-equity portfolio which a relatively small proportion of trusts may be able to tolerate. For most trust portfolios, a 3% or 4% distribution rate is more sensible.

Clearly, during some significant periods the model will not fulfill these goals. Note that 1960 through the end of 2003 and 1973 through the end of 2003 contain relatively difficult periods in which to test these theories. The 1950s, when inflation averaged 2.1% and returns from common stocks were very high - an average total return of 17.5%\(^{379}\) per year for the decade - would have been much easier. It would also be easy if the model used only the 1981 to 1999 period when the total return on equities averaged 17.9%. However, this would not have been a fair test of the model and process.

E. PAYOUT RATES AND ENDING TRUST VALUES - A SMOOTH PROGRESSION.

Varying the payout of our unitrust illustrates the way that the payout can affect the market values and the smoothness of distributions. Table 6 which follows shows a TRU with a 100% equity portfolio and a 3%, 4%, 5%, and 6% payout rate from 1960 through 2002.

<table>
<thead>
<tr>
<th>Year</th>
<th>3% Payout</th>
<th>Market Value</th>
<th>4% Payout</th>
<th>Market Value</th>
<th>5% Payout</th>
<th>Market Value</th>
<th>6% Payout</th>
<th>Market Value</th>
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<td>4,000</td>
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<td>113,433</td>
<td>5,797</td>
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<td>112,815</td>
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<td>112,098</td>
<td>7,046</td>
<td>104,514</td>
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<td>121,217</td>
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<td>137,895</td>
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<td>107,099</td>
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<td>102,688</td>
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<td>138,969</td>
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<td>139,680</td>
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<td>111,514</td>
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<td>96,554</td>
</tr>
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<td>75,067</td>
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<td>4,973</td>
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<td>96,533</td>
<td>5,653</td>
<td>81,059</td>
</tr>
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<td>4,719</td>
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<td>89,679</td>
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<td>118,960</td>
<td>4,752</td>
<td>99,279</td>
<td>4,787</td>
<td>81,863</td>
</tr>
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<td>4,900</td>
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<td>5,155</td>
<td>99,404</td>
<td>5,147</td>
<td>81,079</td>
</tr>
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<td>4,986</td>
<td>135,165</td>
<td>5,203</td>
<td>111,021</td>
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<td>89,679</td>
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<td>203,976</td>
<td>4,990</td>
<td>170,477</td>
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<td>139,353</td>
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<td>Dec 1981</td>
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<td>184,910</td>
<td>5,677</td>
<td>153,563</td>
<td>5,830</td>
<td>124,723</td>
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<td>5,500</td>
<td>212,727</td>
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<td>6,252</td>
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<td>249,385</td>
<td>6,664</td>
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<td>6,767</td>
<td>164,598</td>
<td>6,465</td>
<td>129,081</td>
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</table>

\(^{379}\) Derived from IBBOTSON ASSOCIATES, supra note 21.

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<table>
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<tr>
<th>Year</th>
<th>Payout 1</th>
<th>Payout 2</th>
<th>Payout 3</th>
<th>Payout 4</th>
<th>Payout 5</th>
<th>Payout 6</th>
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</tr>
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<td>252,733</td>
<td>7,126</td>
<td>206,713</td>
<td>7,187</td>
<td>164,685</td>
<td>6,809</td>
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<td>7,148</td>
<td>319,388</td>
<td>7,834</td>
<td>260,153</td>
<td>7,853</td>
<td>205,920</td>
<td>7,386</td>
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<tr>
<td>Dec 1986</td>
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<td>362,685</td>
<td>8,959</td>
<td>294,032</td>
<td>8,920</td>
<td>231,244</td>
<td>8,326</td>
</tr>
<tr>
<td>Dec 1987</td>
<td>9,348</td>
<td>367,204</td>
<td>10,145</td>
<td>295,469</td>
<td>10,031</td>
<td>230,500</td>
<td>9,293</td>
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<td>Dec 1988</td>
<td>10,493</td>
<td>410,753</td>
<td>11,329</td>
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<td>11,128</td>
<td>253,742</td>
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<td>Dec 1989</td>
<td>11,406</td>
<td>518,536</td>
<td>12,232</td>
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<td>16,769</td>
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<tr>
<td>Dec 1993</td>
<td>16,982</td>
<td>628,920</td>
<td>19,298</td>
<td>478,376</td>
<td>18,081</td>
<td>352,135</td>
<td>15,854</td>
</tr>
<tr>
<td>Dec 1994</td>
<td>18,693</td>
<td>618,145</td>
<td>21,406</td>
<td>478,707</td>
<td>19,702</td>
<td>358,858</td>
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<td>Dec 1995</td>
<td>18,978</td>
<td>630,531</td>
<td>19,425</td>
<td>498,490</td>
<td>20,014</td>
<td>352,135</td>
<td>15,854</td>
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<td>Dec 1997</td>
<td>24,420</td>
<td>1,262,553</td>
<td>24,569</td>
<td>941,289</td>
<td>22,427</td>
<td>678,999</td>
<td>19,148</td>
</tr>
<tr>
<td>Dec 1998</td>
<td>30,756</td>
<td>1,562,471</td>
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<td>1,157,469</td>
<td>27,874</td>
<td>829,563</td>
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<td>Dec 1999</td>
<td>38,075</td>
<td>1,817,403</td>
<td>37,810</td>
<td>1,337,113</td>
<td>34,059</td>
<td>951,676</td>
<td>28,692</td>
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<td>Dec 2000</td>
<td>46,424</td>
<td>2,172,764</td>
<td>45,812</td>
<td>1,145,812</td>
<td>41,004</td>
<td>807,397</td>
<td>34,320</td>
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<td>Dec 2001</td>
<td>49,526</td>
<td>1,309,364</td>
<td>48,539</td>
<td>942,045</td>
<td>43,144</td>
<td>655,323</td>
<td>35,858</td>
</tr>
<tr>
<td>Dec 2002</td>
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<td>955,352</td>
<td>45,666</td>
<td>676,291</td>
<td>40,240</td>
<td>462,588</td>
<td>33,150</td>
</tr>
<tr>
<td>Dec 2003</td>
<td>38,375</td>
<td>1,176,778</td>
<td>36,855</td>
<td>824,026</td>
<td>32,088</td>
<td>556,727</td>
<td>26,111</td>
</tr>
</tbody>
</table>

As illustrated in Table 6 over this long period of time, the lower payouts have caught the higher payouts by virtue of the compounding effect of reinvested returns. Note also, that a 3% payout is twice as smooth as a 5% payout, at least as measured by the number of negative changes in a distribution from 1960 through 2001. Clearly then, the lower the payout, the safer and smoother it is. The less we spend, the more we will have.

It is interesting to note that the progression of market values is almost linear and almost predictable, as contrasted with the indexed payout trust which is far more sensitive to the initial payout value. In other words, the TRU is a great deal safer and has a greater margin for error than one in which the payout is unrelated to total return and unrelated to market value. The following bar chart shows this even more clearly.

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The increase in market value for every 1% decline in spending rate is approximately 1% times the number of years in the period, with a 52% increase between 6% and 5%, a 48.5% increase between 5% and 4%, and a 43% increase between 4% and 3%. My hypothesis as to why it is not exactly the same is that the lower rates keep more of the taxes inside the trust, so there is a diminishing return in the results of the reduction in payout rate. Note also that the result for each reduction of 1% is compounded, so the rule of thumb is only valid for 1% differentials. No doubt there is a mathematical equation that could be developed to predict this, but the reader will have to be satisfied with the above observation for now!

F. HOW MUCH POWER IS THERE IN TOTAL RETURN INVESTING – REVISITING THE REAL INCOME RULE TRUST.

Earlier in these materials, the author graphed the results of an actual income rule trust over the last 15 years to illustrate just how this problem affects real trusts and real families. Let’s take another look at the same data with a different scale used so that we can see what might have happened if the trust had been a TRU and had been invested entirely in equities throughout this period. First, here is the data previously produced, but using a smaller scale for comparison purposes.
If the trust had been drafted as a total return unitrust and invested entirely in equities, with the same starting income yield as the income trust, the results would have been startlingly different for all concerned.
The distribution in 2002 would have been almost four times as large, and the market value still over 40% higher, even after three very poor market years. What is more surprising perhaps is the smoothness of the distributions given the all equity investment of the trust. The TRU distribution declined for the first time in 2002, and in 2003, it will decline substantially further, as it is based upon the 2000, 2001 and 2002 values, but still the trust would have produced much, much more money for the beneficiary than its alternative. And in all likelihood, the trust would have contained some bonds for safety, such as the 80/20 mix illustrated below, and while it would have dampened the performance, it would have dampened the volatility as well. Overall, this real world example clearly puts an exclamation point on the power of total return investing, and the efficacy of the Total Return Unitrust.  

![Total Return Trust (1988 - 2002) 80% Equities/20% Bonds](image)

Over 3 Times the Income--35% More Market Value

380 We have in fact converted the above trust to a 4% TRU under the Pennsylvania unitrust conversion statute, and have begun a transition to an 80/20 portfolio, which we hope over the long term to be more beneficial for both the current beneficiary and the remaindermen. We therefor have no more “real” income trust data after 2002!

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XIV. HOW DOES TURNOVER AFFECT REAL RETURNS - THE CASE FOR LOW TURNOVER, TAX EFFICIENCY AND INDEX FUNDS IN TRUST INVESTING

A. SIGNIFICANT TURNOVER, EVEN AT TODAY’S LOW LONG-TERM CAPITAL GAINS RATES, IS A MAJOR OBSTACLE

What happens if the trust turnover jumps from an index-like 5% to a 30% turnover rate, mimicking a modestly active managed portfolio? From 1926 through 2003, a $100,000 all-equity portfolio paying out a 5% unitrust amount would have grown to $986,446. This is 42% less than the identical model with a 5% turnover, which had an ending value of $1,710,350. At 60% turnover, paying out 5% leaves the trust with an ending market value of $716,087, 58% less than the 5% turnover model. Over shorter periods of time, the results are only slightly less striking. From 1960 through 2003, with 30% turnover in the portfolio, the model ends with a market value of $379,535 versus $556,727 with a 5% turnover. At 60% turnover, the market value falls to $309,051.

Table 7 which follows compares the distributions and market values using turnover rates of 5%, 30%, and 60% for a 5% total return unitrust with an all-equity portfolio for the period 1973 to 2003.
### TABLE 7

**COMPARISON OF 5% UNITRUST PAYOUT FOR THE PERIOD 1973-2003**

**ILLUSTRATING 5%, 30%, AND 60% TURNOVER—100% EQUITY PORTFOLIO**

TURNOVER INCREASES TAXES AND DECREASES RETURNS

<table>
<thead>
<tr>
<th>Year</th>
<th>5% Turnover</th>
<th>30% Turnover</th>
<th>60% Turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Market</td>
<td>Distribution</td>
<td>Market</td>
</tr>
<tr>
<td></td>
<td>Value</td>
<td>Value</td>
<td>Value</td>
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<td>5,000</td>
<td>79,433</td>
<td>5,000</td>
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<td>53,437</td>
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<tr>
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<td>3,360</td>
<td>80,781</td>
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<tr>
<td>Dec 1977</td>
<td>3,382</td>
<td>70,744</td>
<td>3,354</td>
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<tr>
<td>Dec 1978</td>
<td>3,671</td>
<td>70,848</td>
<td>3,631</td>
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<tr>
<td>Dec 1979</td>
<td>3,706</td>
<td>79,158</td>
<td>3,657</td>
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<td>Dec 1980</td>
<td>3,679</td>
<td>99,572</td>
<td>3,620</td>
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<td>4,377</td>
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<tr>
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<td>4,741</td>
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<td>Dec 1985</td>
<td>5,685</td>
<td>150,421</td>
<td>5,502</td>
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<tr>
<td>Dec 1986</td>
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<td>Dec 1988</td>
<td>8,165</td>
<td>187,080</td>
<td>7,550</td>
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<td>Dec 1989</td>
<td>8,776</td>
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<td>7,967</td>
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<td>9,836</td>
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<td>Dec 1991</td>
<td>10,549</td>
<td>262,299</td>
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<td>Dec 1992</td>
<td>11,802</td>
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<td>12,341</td>
<td>275,350</td>
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<td>30,477</td>
<td>600,373</td>
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<td>Dec 2001</td>
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<td>487,421</td>
<td>24,422</td>
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<tr>
<td>Dec 2003</td>
<td>23,866</td>
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Negative Changes

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Negative Changes > 10%

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SI-183-RBW
An even more revealing way of looking at this is to examine how much one can distribute from a trust annually at different turnover rates and still have the same market value of the trust at the end of a long period such as from 1973 to 2002!

**EQUIVALENT PAYOUT TO MATCH ENDING MARKET VALUES WITH DIFFERING TURNOVER RATES (100% EQUITIES) (1973-2003)**

<table>
<thead>
<tr>
<th>Turnover Rate</th>
<th>5%</th>
<th>30%</th>
<th>60%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payout equivalents</td>
<td>5%</td>
<td>3.85%</td>
<td>3.2%</td>
</tr>
<tr>
<td></td>
<td>4%</td>
<td>2.7%</td>
<td>2.0%</td>
</tr>
<tr>
<td></td>
<td>3%</td>
<td>1.6%</td>
<td>.8%</td>
</tr>
</tbody>
</table>

Just for fun, let’s do the same analysis after JGTRRA to see how much difference it might make?

**EQUIVALENT PAYOUT TO MATCH ENDING MARKET VALUES WITH DIFFERING TURNOVER RATES (100% EQUITIES) (1973-2003)**

**POST JGTRRA**

<table>
<thead>
<tr>
<th>Turnover Rate</th>
<th>5%</th>
<th>30%</th>
<th>60%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payout equivalents</td>
<td>5%</td>
<td>3.8%</td>
<td>3.2%</td>
</tr>
<tr>
<td></td>
<td>4%</td>
<td>2.7%</td>
<td>2.1%</td>
</tr>
<tr>
<td></td>
<td>3%</td>
<td>1.6%</td>
<td>1.0%</td>
</tr>
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</table>

Now the really curious among you might say—how much of that differential is due to turnover costs and how much is the pure tax effect? Let’s assume that in the lowest tax Post JGTRRA environment there were no turnover costs at all except the taxes, how much does turnover cost then?

**EQUIVALENT PAYOUT TO MATCH ENDING MARKET VALUES WITH DIFFERING TURNOVER RATES (100% EQUITIES) (1973-2003)**

**POST JGTRRA-NO TURNOVER COSTS!**

<table>
<thead>
<tr>
<th>Turnover Rate</th>
<th>5%</th>
<th>30%</th>
<th>60%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payout equivalents</td>
<td>5%</td>
<td>4.0%</td>
<td>3.7%</td>
</tr>
<tr>
<td></td>
<td>4%</td>
<td>2.9%</td>
<td>2.6%</td>
</tr>
<tr>
<td></td>
<td>3%</td>
<td>1.9%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

So even with all of that going for it, turnover is a really big problem that would keep us from reaching our goal of market value preservation unless we are willing to accept a minimum of 20% less income at the 5% payout level, or as much as 37% income at the 3% level. The much higher effect at the lower distribution level results from the fact that the trust pays more of the capital gains taxes in the trust at the 3% payout than at the 5%, but either way the tax man cometh!
Given the amount of difference this amount of turnover engenders in net returns, one would think that a mutual fund with turnover of 60% would be the exception. However this is not the case. The average mutual fund portfolio turnover in 1997 was 85%.\(^{381}\) How could it be that something so important would be as neglected an issue as the tax effect from this amount of turnover? John Bogle suggests an answer:

The tax issue is the black sheep of the mutual fund industry. Like a cousin who can't get their life together or an uncle who drinks too much, taxes are kept out of sight and out of mind. But investors cannot afford to turn a blind eye to this issue. For it is the fund shareholder who pays the taxes on a mutual fund's income dividends and on any capital gain distributions generated by the fund's constant staccato of portfolio sales, and - at least in the recent bounteous bull market - by the realization of enormous taxable capital gains. The dichotomy is that a portfolio manager's performance is measured and applauded on the basis of pre-tax return - never mind that the Internal Revenue Service confiscates a healthy share of it. Few portfolio managers spend their time agonizing over the tax consequences of their decisions.\(^{382}\)

Worse yet, the author's computer modeling above assumes that investment management would take taxes into account at least to the extent that all of the capital gains are long term. Actually, about one-third of the fund gains are realized on a short-term basis, which would of course make the effects even greater.\(^{383}\) In the Post JGTRRA world, where short term gains are taxed at the maximum tax rate of the trust, and the long term gain is taxed at 15%, short term gains should be anathema to the professional investor in a taxable trust. Unfortunately, this may still be a while in coming.

B. POWERFUL ARGUMENTS FAVOR INDEXING FOR TRUST PORTFOLIOS

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

In order to properly understand the compelling logic and mathematics involved in index fund investing, one must look at the aggregate results of active and passive investors. First, in order to examine a particular market such as the market of the S&P 500 or the Wilshire 5000, we must divide the market participants into two groups, those who invest in index funds and those who are active managers of the funds. Clearly, the index funds investors as a group will earn the gross market rate of return - no less and no more except to the extent of any “tracking error” in the index fund. Active managers will vary from the norm - some earning a higher than the market return and some earning a below-market return. But in the aggregate, the active managers will also earn the average market return. This is so because subtracting the index fund investors from the market will leave an equivalent market return for the remaining participants.

\(^{381}\) Bogle, supra note 37, at 26.
\(^{382}\) Id. at 279.
\(^{383}\) Id. at 284-85.
So without considering management costs and the costs of buying and selling, and without considering the costs of capital gains taxes, active management on average will always equal the average market return in the market in which the active managers participate. However, since the active managers incur additional costs, both in management and in brokerage costs and in capital gains taxes, actively managed funds in the aggregate will always be below the market averages by the amount of their additional costs and the substantial taxes discussed previously which are generated by active management. As a result - practically as well as theoretically - an index fund is like the hypothetical children who live in Lake Woebegone. They are all above average!

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

The concept of the superiority of investing in the market itself to active management goes back a long time. But recent history is extraordinarily compelling. Over the preceding decade, 85% of institutional investors underperformed the return of the S&P 500, largely because of costs. Anyone taking a serious look at the question today must clearly refer to John Bogle's most recent book, Burton G. Malkiel's seminal work *A Random Walk Down Wall Street* and Scott Simon's recent book devoted exclusively to index mutual funds. These three books collectively examine the theory and practice of indexing versus every other method of investing: active mutual funds, selecting funds by Morningstar, technical analysis, newsletters, the folly of market timing and other specific issues related to indexing.

But the most persuasive argument that index funds outperform their mutual fund counterparts is simply the historical record. The S&P 500 index has outperformed equity mutual funds for periods ending December 31, 1997 for five years, ten, fifteen, twenty, twenty-five, thirty, forty and fifty years. While the over performance of 5% per year over the last five years of that period is the highest differential, the most impressive figure is the fifteen-year period from December 31, 1982 through December 31, 1997 in which the S&P 500 index averaged 17.2% and the average equity mutual fund averaged 13.2%. If we were to measure growth and value funds versus the broader Wilshire 5000 Index over the period of fifteen years ending June 30, 1998, we have a closer contest with the average fund net return of 14.1% while the index averaged 16.0%. But that still allowed only 33 of 200 funds to beat the index.

But what about the recent bear market, surely a fierce bear market will show them indexers! Surely when things are going badly, the mindless index fund will falter badly or

---

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


386 BOGLE, *supra* note 37.


389 BOGLE, *supra* note 37, at 112, Table 5.1.

390 *Id.* at 125, Figure 5.5.
somehow fall apart. But that has not proven to be the case. The Vanguard 500 Index fund did underperform its peers in the year 2000, placing itself in the 61st percentile in 2000, but has outperformed the average managed large capitalization fund in 2001, 2002, 2003 and so far in 2004—being in the top 13% in 2004! And it is in the top half as of August 20, 2004 for the last week, month, year, 3 years, 5 years and 10 years.

Virtually all of the advantage can be explained by the differential in costs and expenses of the actively managed fund. If we added back in these dollars that disappear into the pockets of others, the returns would be virtually equivalent.\(^{391}\) And these figures do not take into effect the additional substantial effect of taxes on an actively managed portfolio. The rate of return of an S&P 500 index fund versus the average mutual fund for the ten-year period ended June 30, 1998 would have given the index fund the advantage of 3.3% before taxes, but 4.2% after taxes.\(^{392}\) Looked at another way, if one could afford to pay out 5% from a trust and have a reasonable prospect of keeping up with inflation, the loss of 4.2% would allow one to pay out only .8% diminishing the trust beneficiary's income by 84%.

3. \textit{Indexing Eliminates all Non-Market Risk}

An index fund which contains all or virtually all of the securities in a particular market index will have only the risk that is present in that market. Based on the Morningstar risk assessments, an S&P 500 index fund or a Wilshire 5000 index fund has shown less risk than the average equity fund.\(^{393}\) Conceptually it is clear that a managed fund is going to have more than just the market risk because the manager will be betting on certain segments or certain stocks within a category of stocks to do better than the market itself. This provides a considerable opportunity for additional risk that is not related to the market as a whole. On the other hand, a pure index fund is the market and has no other risk involved. This is the theoretical basis for the lower risk as actually measured and reflected in the above statistics.

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

A thorough reading of the Uniform Prudent Investor Act or the Prudent Investor Rule in the \textit{Restatement of Trusts} emphasizes factors which clearly favor index fund investments for trustees. A number of the duties imposed as a prudent investor are easily satisfied with the index funds but create difficulties for active investors.

\textit{(a) The Duty of Diversification}

The trustee must take into account that it has the duty to diversify the investments of a trust "unless, under the circumstances, it is prudent not to do so."\(^{394}\) Within a particular market, clearly the index fund is the superior method of achieving diversification, since in a pure index fund, all of the securities in that market are reflected in the index fund. In some index

\(^{391}\) Id. at 126, Figure 5.6.
\(^{392}\) Id. at 286, Table 13.1.
\(^{393}\) Id. at 131, Table 5.2.
\(^{394}\) \textit{RESTATEMENT (THIRD) OF TRUSTS} § 227(b).
funds the portfolio may be a representative sample of those securities rather than all of them. This would introduce some statistical non-market risk in such funds. Indeed any error one way or the other is called "tracking error" and is a defect for an index fund if it is of any size. An S&P 500 index fund will typically own all 500 of the large-cap companies comprising the index. Index funds representing the Wilshire 5000 are understandably more likely to own a statistically selected sample of the index than the entire index. This tremendous diversification rids the trustee of one of its most welcome but thorniest problems; that is, how to deal with the security which grows too much for comfort.

While a trust portfolio may begin with, say, 20 stocks, each with 5% of the portfolio funds, as time goes on, some will go up and some will go down. Eventually, the trustee will be forced over time to deal with its "winners." If one of the stocks grows three or four times faster than the average (and one of them probably will do so), the trust will inevitably end up with one stock representing 15% or 20% of the investment portfolio. At that point, the portfolio is no longer nearly as diversified and has significant non-market company specific risk, owning too much of that one stock because of its superior performance. The trustee then has the difficult choice of deciding whether to sell and pay the capital gains taxes or continue to allow the overachiever to become a larger and larger portion of the portfolio. This never happens with an index fund because not only does it start with a far more diversified portfolio, the fund automatically adjusts its holdings to continue to reflect the index. As a result, the trustee never has to face this very common but perplexing problem.395

(b) The Duty to be Cost Conscious

Typically, the use of index funds is the lowest-cost method of obtaining and maintaining a diversified portfolio. They minimize annual operating expenses because they retain computers in the place of highly paid stock pickers and market timers employed by active funds.396 The transaction costs are minimized because stocks are sold only when necessary to match the index changes. And commission loads are rarely charged for index funds which are usually sold directly to the public rather than through stock brokers or other commissioned sales people. All of this fits in very well with the duty to contain costs under the Prudent Investor Rule.397 Luther Avery and Patrick Collins of San Francisco focus on the trustee's duty to avoid unreasonable or inappropriate costs in an ACTEC Notes article on the subject.398 As that article details, controlling those costs may require a reasonably sophisticated understanding of what all those costs may be and how to spot and avoid them.

395 And just because you have one big winner does not mean that the portfolio has outperformed the market averages. In most cases it will not as a whole do so, leaving the portfolio with uncompensated risk.
397 Id.
(c) **The Duty to Consider Tax Consequences**

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

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

As noted previously, approximately 92% of the return in a portfolio results from the decision as to asset allocation, and only 8% on all other factors including timing and stock selection. As noted in Brinson, Singer and Beebower's seminal work, active management at all levels seems to have little net effect!

While active asset allocation contributed a net under performance of 26 basis points, and security selection contributed a gain of 26 basis points, neither figure is statistically different from zero. Active management not only had no measurable impact on returns, but . . . it appears to have increased risk by a small margin.\(^{399}\)

Utilizing index funds, the trustee can expend its efforts on the factors that produce the greatest proportion of return; that is, the selection of markets and the proportions in which the trust will be in those markets. Index funds are available to cover virtually any potential stock or bond market.\(^{400}\) This gives the trustee the ability to spend most of its time on the decisions that are most important, a policy that should make both dollars and sense.

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

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

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399 See BRINSON, et al., supra note 31, at 44.
400 With the exception perhaps of the municipal bond market which has too much state-to-state variation and individual variation to succumb easily to indexing.

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the competition year after year with such an approach. Even if it did not, it seems difficult to see how the trustee could be held liable for earning a market return, as long as the asset allocation was sensibly matched to the needs of the trust. For the active manager, the duty to justify additional costs and taxes could well be a difficult one to bear, a point made by Scott Simon in his book: *The Prudent Investor Act: A Guide to Understanding*:

First, while the Prudent Investor Act allows both active and passive styles of investing, there is implicit in the duty to minimize costs the following two-prong test to justify an active investing strategy:

1. First, are the extra costs of active management substantial (and by that we must include management costs, direct and indirect costs, and taxes)?

2. An, if so, are they justified by realistically evaluated return expectations?

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

**XV. HOW MUCH SLEEPING GOOD (FIXED-INCOME INVESTMENT) CAN WE AFFORD?**

**A. FIXED INCOME AFTER TAXES AND INFLATION - A VANISHING RETURN**

One of the most startling contrasts revealed by the modeling of trust portfolios after taxes and expenses is the widening split between fixed-income investments and equities. Almost everyone knows that, historically, equities have provided a better total return over long periods. But what happens when we account for taxes, expenses, and spending? You may recall that a 5% payout from a $100,000 portfolio invested entirely in equity securities would have left a total of $1,710,350 at the end of 2002. How about a total return unitrust using intermediate government securities during that same period? The all fixed income model leaves us with only $39,096, a 61% loss, even before adjusting for inflation.402 See bar chart on the following page.

The fixed-income model actually depleted the trust to approximately 40 cents on the nominal dollar and less than 4 cents on an inflation adjusted basis. Examining the 1960 to 2003 and 1973 to 2003 periods, the results appear less striking because nominal pre-tax bond returns were far closer to stocks. The ending market value, paying out 5% from 1960 through 2003, is up moderately from $100,000 to $132,483. From 1973 to 2003, bonds seemingly fared best of all, allowing nominal growth from $100,000 to $157,167,403 and distribution growth from

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402 Appendix 5 (available by request) shows the detailed calculations of such a fixed income model from 1926 through 1998.
403 Appendices 6 and 7 (available by request) shows the detailed calculations of such a fixed income model from 1960-1998, and 1973-1998.

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$5,000 to $7,765, a 55% increase. However, with inflation requiring an over 300% increase, the real distribution is reduced to 36 cents on the dollar.

B. HOW MUCH DIVERSIFICATION INTO FIXED INCOME CAN WE AFFORD?

The question is how much "sleeping good" with the less volatile fixed-income portfolio can we stand in a long-term trust?

![Graph 1: Stocks vs. Bonds -- The Long Term Difference! Ending Market Value of 5% Unitrust (1926-2003)]($1,710,350)

To answer this question, we designed our computer program to model a unitrust where the portfolio allows a blend of fixed income and equities. The model assumes that the trustee re-balances the portfolio to the proper investment mix every year.\(^4\) Graph 1 which follows indicates the percentage payout from a unitrust from 1926 to 2003 that could be made at each level of investment mix and still have a corpus that keeps up with inflation at the end of the period. The straight line sloping downward is the amount of accounting income, after thirty-five basis points of trustees' fees, generated by the investment mix in today's investment market.

The answer is that the more sound sleep we want with additional fixed income, the less we can afford to pay out from the trust on a systematic basis and have a reasonable expectation of keeping up with inflation. Phrased differently, the more we need, the less safe we can afford to be.

Taken to an extreme, safety becomes the most "unsafe" investment! An all fixed-income trust portfolio could not keep up with inflation even if all of the returns are reinvested! It would require a *contribution* of over \(\frac{1}{2}\) of one percent per year. The trust cannot afford to pay its beneficiary anything at all!

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\(^4\) This assumption produced numerous transactions and a far more complicated model with multiple spreadsheets that are too large to put in an appendix.
Equities have a higher return over long periods of time than fixed income. That margin is clearly increased if we take taxes and expenses into account. Intuitively, then, it is clear that we should be able to spend far more from a trust if it has more equities in it and spend less from a trust if it is invested more heavily in fixed income. Yet the accounting income available in the current market from the same investment mix is exactly the reverse of this conclusion. And unfortunately, these are exactly the instructions that we give to the trustee in an income rule trust.

As surprising as Graph 1 might be for the 1926 to 2003 period in showing the direct relationship between the amount a trustee can afford to spend and the percentage of equity in the trust portfolio, it seemed likely that graphing the same function for the periods of 1960 to 2003 and 1973 to 2003 would result in a significantly flatter curve. The flatter curve would theoretically reflect the relatively better performance of the fixed-income markets during the more recent periods.

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As Graph 2 illustrates, while the more recent periods are a bit flatter and a bit lower, these three long term periods are strikingly similar! It appears that nominal fixed-income returns from the 1960s and 1970s through the present time have been markedly higher only because of the higher rate of inflation throughout these periods.

These higher nominal returns on bonds were entirely consumed by a higher rate of inflation and taxes during the periods from 1960 on. In fact, the graphs starting in 1960 and 1973 through 2003 are significantly under the graph from 1926 through 2003. This means that the net total returns for that investment mix, taking into account taxes, expenses and inflation, were higher from 1926 through 1960, even including the Depression, than they were from 1960 to the present time. That is surprising, but that is the tremendous compounding effect of inflation and taxes.

Equally important and surprising is the fact that all three of these curves are as close together as they are. This implies that the markets themselves, at least in those three very long periods, sifted through very efficiently to provide a level of return that is quite consistent and seemingly dependent primarily on our asset allocation into equities versus fixed income. So risk and return are related.

Significantly, the S&P 500 yields at the starting points of these three periods were also quite different. In 1926 the S&P 500 yield was 5.41%; in 1960 it was 3.26%; and in 1973 it was 2.86%. But over very long periods of time, these initial yields do not seem to have much relevance in determining how much one would be able to spend on a unitrust basis and still be...
able to keep up with inflation over the long term. One should not push this point too far, because higher yields generally imply a cheaper market under most circumstances and lower yields may imply a more expensive market. This will clearly have implications for future returns in the shorter periods of up to ten years.  

But we must also remember that we are writing trusts, many of which will not go into effect until sometime in the indefinite future, at the death of the grantor or testator, and we often expect the trust to survive both bull and bear periods. Accordingly, it is sensible to look at these long term historical studies to make our decision on a rate of distribution, rather than trying to relate it to a present day prognostication.

But what about all of this must we conclude? The most striking point is that the income rule trust approach is not just wrong - it is backwards! Apparently the income rule directs the trustee to pay out the right amount at only one point on the entire graph - the point of intersection. At all points to the left of the intersection, the income rule trust tells the trustee to distribute too much, and at all points to the right, it tells the trustee to distribute too little. But, because of the slope of the income line, the higher the income need, the less likely the trustee of an income rule trust will invest in the securities that can afford to provide the distribution the beneficiary needs.

C.  A CAUTIONARY NOTE

As good a summary as Graph 1 may be in describing what one would have been able to pay from a trust over a long period of time and still have a reasonable prospect of the trust corpus and distributions keeping up with inflation, there is absolutely no certainty to it—no law of the universe that says it has to work out. It is just true that on average and in the majority of time periods of history, it has worked that way. A great deal depends upon when one starts and stops the study. The 1926-2003 study period included the extraordinary period from 1995 to 1999. The S&P 500 produced a total return of 238% from 1995-1999, and inflation would only bring that down to a real return of 204.6%. The 2000-2002 bear market, however, has largely taken the “froth” out of the previous bull market returns, so that Graph 1 may be a sensible indicator of what one might be able to spend out of a given asset allocation. However, it is wise to heed the cautions of those who think that equity returns may be damped for some time to come as compared to our historical norms, and count on a bit less than that graph might imply. A similar analysis stopping at the end of the most recent prior bear market ending in 1994 underscores this. See the following graph.

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405 Professor Malkiel points to the strong correlation between current dividend yield and future ten-year rates of return as well as a strong correlation with price/earnings ratios. Malkiel, supra note 387, at 389.
Does Graph 3 mean that we really could afford only 1.5% or 2% payout to a beneficiary to preserve the value in a sixty-forty investment portfolio? That is certainly what happened for these shorter periods, but these periods were selected with beginning points designed to make them at least pessimistic, if not worst-case scenarios. The year 1960 was chosen because in a well-known Sanford Bernstein study the authors did not believe that the 1950s should be included. The 1950s in their view represented a period of growth and low inflation that would not likely be repeated. Ironically, the Sanford Bernstein study ended in 1994, just before the most recent resurgence of the bull market through 1999 in which we enjoyed compound total return of 24.96% after inflation from 1995 through 1999—better than any five-year period in the 1950s. The 1973 period was selected as a worst-case scenario for testing our TRU because of the 42% decline in market value of the equity markets over the following two years. It is, therefore, not surprising that if we start our period at the worst times and end it before the best times, our results will undershoot the long term averages.

Interestingly, the long period 1926-1994 graphed above is almost identical with the full period 1926-2003, so one can argue on a total real return basis, the market has reverted fully to the mean.

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407 On a price earnings basis or price to book basis, there is support for the proposition that the market is still at a high level. Time will tell!
If one were to graph the results of all of the rolling 20 year periods since 1926, interestingly, the average results are generally more sanguine than the graphs through 2002, though very similar in shape.

The reason for this difference between the long term ending results and the 20 year rolling period averages is that the graph through 2003 ends after the 2000-2002 bear market, and those years bear considerable influence on the ending market values. The average results of the rolling periods, on the other hand, only show an effect of the bear market in three of the last four rolling periods ending in 2000, 2001, and 2002, and 2003 so it affects them in only 4 of the 78 rolling periods. It is also well to note that having an acceptable average result does not indicate that you are likely to have a good result, because the averages have an upside bias caused by the fact that the market value of a trust portfolio can go up more than it can go down, since the value cannot go below zero. Hence some of the periods that had very good results bring the average result up significantly, but the average result or better will be achieved in a minority of the rolling periods. For example, a payout of 7.3% with 100% equities gives an average inflation adjusted value equal to the starting value, but it matches the starting value in only 49% of the periods. This means that the likelihood of preserving real value should be taken into account, and

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not just the average result. We will see this more clearly when we graph all of the results of rolling periods in the next section of these materials covering estate planning with total return trusts.

Averages aside, the author strongly suggests selection of a total return trust percentage that is significantly lower than the long-term historical norms for the expected investment mix, provided that the beneficiary can stand the more conservative payout. For example a 4% payout for an 80/20 mix is reasonable, in the author’s opinion.

XVI. ESTATE PLANNING WITH TOTAL RETURN TRUSTS

A. TAKE TRU AIM - THE TRU ALLOWS THE ECONOMIC BENEFITS TO BE DIVIDED IN ACCORDANCE WITH GRANTOR'S INTENT

Strangely, at least if one views the matter from a perspective other than as a trusts and estates professional, our trusts do not prescribe how much is to be distributed to the current beneficiary or the remainder beneficiary in the traditional trust. We typically simply state the trustee is to hold the principal and pay the income. And what the income may be will depend on the investment environment at the time the trust goes into effect and the manner in which the trust is invested. And we typically do not prescribe how the trust is to be invested. In fact, we often spend a number of pages in the typical trust or will making it as clear as possible that we want the trustee to be able to do whatever it thinks is the best thing. Now all of that might be confused with flexibility, were it not for the fact that most trust documents do not describe the goal of the trust either.

Consequently, in theory at least, the trustee is left adrift at sea and the economic value that flows to the current beneficiary and the remaindermen is likely to be dependent upon which direction is chosen. If the trust is invested primarily in bonds, the majority of the economic benefit will flow to the current beneficiary, while if the trust is invested primarily in equities, the majority of the benefit may be divided more evenly depending on the period of time during which the current beneficiary retains an interest. Other more innovative styles of trusts such as an indexed payout trust will prescribe the amount that the current beneficiary is to receive, but the proportion of the entire economic benefit flowing to the current beneficiary will depend in part on how the trust is invested and in part upon the future return from those investments. Because the current beneficiary’s return is determined by the instrument and a factor which is not directly related to the return from the trust, inflation, the portion of the economic value passing to the current beneficiary and the remaindermen will depend entirely on future returns and future inflation, something that cannot be predicted by the grantor or testator, and perhaps most critically, the time that they are put in operation, implicitly in an estate planning context, the time of the client’s death.

In Jonathan R. Macey's extraordinary\textsuperscript{408} work *An Introduction to Modern Financial Theory* prepared for the American College of Trust and Estate Counsel Foundation, Professor

\textsuperscript{408} What is extraordinary about it is not what is said, but that he says it as simply and readably as he does. It is an extraordinary primer for lawyers or other trust professionals seeking to peek in the window of financial theory.

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Macey points to the revisions in the law which would allow the trustee to try to allocate returns in accordance with the settlor's probable intent:

In forthcoming revisions to the law, trustees should not be compelled to allocate trust earnings simply on the basis of the form that an investment payout happens to take. Rather, trustees should be permitted to allocate a trust's capital appreciation to income beneficiaries and dividend income to remaindermen where doing so is consistent with the settlor's probable intent. For example, suppose that a settlor creates a trust in 1990 with a corpus of $100,000. A trustee who invests in a diversified portfolio of high yield junk bonds may provide the income beneficiary with a handsome return, but inflation may erode the value of the remainder interest. Trustees should be able to right this imbalance by reallocating some of the interest income to the remaindermen. Similarly, a trustee who invests in a high tech firm that pays no dividends yet enjoys a spectacular increase in market values should be permitted to allocate some of the capital gains to the income beneficiary.409

The foregoing clearly points to the concept behind Section 104 of the UPAIA. Professor Macey then discusses Professor John Langbein's suggestion that we should encourage the settlor to express his or her intent with a simple checklist of alternatives that might include the following:

(1) All accretions of value beyond the nominal principal would go to the income beneficiary and the nominal principal would be preserved for the remaindermen.

(2) The trustee would be required to retain sufficient trust earnings to preserve the constant dollar purchasing power of the trust corpus for the remaindermen, or

(3) The trustee could add to the corpus of the trust a fixed percentage basis and to pay the rest out to the remaindermen.410

The thought that the testator or settlor should consider and prescribe how much of the economic benefit might go to the current beneficiary and the remaindermen is a valuable insight. Would the use of a fixed percentage unitrust with a smoothing rule allow the settlor or testator to prescribe just how much of the economic benefit would pass to the current beneficiary and the remaindermen? As we will see, the TRU builds very well on this insight.

A unique characteristic of a unitrust is that the portion of the present economic value that passes to the life beneficiary and the remaindermen will vary only with the payout rate and the duration of the interest. It will not depend in any way upon the future investments returns. And this is so for two reasons. First, the distribution and remainder interests share the same fate. If the value of the trust goes up, so does the distribution, and if it goes down, so does the current

409 MACEY, supra note 27, at 78-79.  
410 Id. at 79-80.
beneficiary's distribution. The second reason which keeps the division of economic benefit constant is that in order to evaluate the present value of a future stream of payments, one must discount it by a rate appropriate given the risk and return characteristics in the market. If one assumes the discount rate is equal to the actual future return on the funds, the proportion of economic benefit passing to the current and remainder beneficiary will remain the same agnostic to the future rate of return. The following is a graph of the economic value to a life beneficiary of a TRU based on current age and distribution rate. Here we have graphed a 2%, 4% and 6% TRU at two ages: At age 50, perhaps the average age for an inheritance by a child, and the other at age 75, perhaps the average age of a surviving spouse.

While the change in the present values of the current interests is not a linear function, it is clear that the portion of the economic interest passing to the current beneficiary will be largely proportional to the payout rate at a given age of the beneficiary. The real value will of course be based upon some unknowns such as actual life span. We are simply using the life expectancy of a current beneficiary. But by using a total return unitrust, we really are allowing the settlor or testator a much greater hand in focusing how much of the benefit goes to the current beneficiary and the remaindermen. This, it seems to the author, is a logical extension of Professor Langbein's point of view. And no other distribution rule will affect this result - only the total return unitrust, because the current interest changes along with the value of the trust estate.

![Graph of Present Economic Value to Life Beneficiary of TRU Based on Age and Distribution Rate](image)

**B. TRU DESIGN BOOSTS TAX PLANNING LEVERAGE TO A WHOLE NEW LEVEL -PAINLESSLY!**

This ability to focus economic benefit where we wish has some very powerful extensions into the estate planning field. To see how this might work, we can use a case study. Successful

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Sylvester and Supportive Sally are both about 50 years of age in 2004 when they come to the planner with the following assets:

<table>
<thead>
<tr>
<th></th>
<th>Successful</th>
<th>Supportive</th>
</tr>
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<tbody>
<tr>
<td>Cash and securities</td>
<td>$2,500,000</td>
<td>$450,000</td>
</tr>
<tr>
<td>Residence</td>
<td>$350,000</td>
<td></td>
</tr>
<tr>
<td>Life insurance</td>
<td>$250,000</td>
<td>$50,000</td>
</tr>
<tr>
<td></td>
<td>$2,750,000</td>
<td>$500,000</td>
</tr>
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Total assets $3,600,000

Sly has been financially successful, and typically earns $180,000 per year. But if Sly were to die, that support would have to come from his trust investments. At this point our planning would immediately be focused in a different direction than we are accustomed. Specifically the inquiry would be directed to Sally’s income needs if Sly were to die. Let us assume that Sly and Sally, perhaps with the help of a financial planner, determine that Sally’s family income needs would be reduced by $40,000 in the event of Sly’s death (representing the marginal costs of Sly’s living expenditures), and that her social security would be about $30,000. That would leave her with an income need of $110,000 from Sly’s estate assets. In order to minimize the potential tax burden to their children, we would expect to form a marital and credit shelter trust.

Note that in the traditional trust estate plan the question of what the surviving spouse's income needs might be might not come up at all and if it did, the estate planner would only be able to say that the income and, if necessary, the principal, would be available to Sally. Indeed such a discussion would be an unhappy one if it occurred at all because in order to generate the $100,000 Sally needs in 2004, the trusts would have to be invested in at least 75% fixed income, leaving no more than 25% to be invested in equities. That of course would startle any professional trustee and indeed would probably doom Sally to a substandard lifestyle for the rest of her life.

Inflation would eat away at Sally's income for the rest of her life, gradually eroding the purchasing power of the income. Such a small proportion of equities would never be able to make up for the three quarters of the trust portfolio that cannot grow at all. And because she would be such a young widow, this would be truly disastrous.

But with a TRU, we can plan things differently. Suppose we divide the estate as we normally would at that time into a marital and residuary trust with a marital trust of $1,200,000 and the credit shelter trust of $1,500,000. Suppose further that we would satisfy Sally's income needs by paying out 5.5% from the marital trust and 3% from the credit shelter trust. Of course if we lived in a non-unitrust state, we would also have to pay out the income if it were greater than the 5.5% in the marital trust to be assured of our marital deduction, but that would be fairly academic at the present time. This combination of TRU trusts would give us exactly the $110,000 needed by Sally. Now this is by no means a guarantee of the income, because over time it will depend upon changes in their net worth and income needs, as well as the market performance after Sly’s death, but at least we are able to aim at addressing the family’s income needs! And because our trusts are not tied to a payout based on income, we could invest the
credit shelter trust entirely in equities. That is the trust where we will prefer to get our growth. And the marital trust, from which we will be making a much higher payout, should be invested more conservatively, perhaps half in bonds and half in stocks. Overall, this would give us an asset allocation of 75% equities and 25% bonds, a sensible place to start at least.

If we did this, how might the trusts have turned out in comparison to our old standard income rule approach? To answer this question, we might select a particular historical period to see what kind of results we might have produced with the different approaches, but to get the broadest view of whatever history may have to teach us, we may wish to examine all of the historical periods of a comparable duration. In this case, since Sally’s life expectancy is a bit over 30 years, we might examine all of the historical 30-year market periods and see what the average results might have been.

The average or expected increase in the value of our 100% equity credit shelter trust paying out 3% over all of the 30 year periods would be from $1,500,000 to $9,706,000. The 5.5% marital trust, invested 50/50 in stocks and bonds, because it had a higher payout and was more conservatively invested, would have increased over the average 30-year period only modestly from $1,200,000 to $1,921,300. Had the trustees invested the funds in the traditional manner in order to produce income of $100,000 in an income rule trust, we would have ended up with an average 30-year period total in the marital and credit shelter trusts of $3,527,900. Graphically, we might illustrate these results as follows:

![Ending Market Values--Average 30 Year Period](image)

5% turnover rate; 1% expense rate

And these good results would look even better if we consider that the majority of the value would be in the credit shelter trust where it will not be taxed at Sally's death. If the marital

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trust were taxed at 50%, the balance remaining to their children would be $2,743,922 with the traditional income rule trust, and $10,666,650 after tax with the TRU combination illustrated above. This would lower the tax burden in the second estate from 22% of the estate to 7.6% because we have focused our economic benefit where it will do the most good. But we do not need to stop there. We can focus our economic benefit even more by raising the marital payout percentage from 5.5% to 7.5% and making the credit shelter trust fully discretionary, so that none of the credit shelter trust would have to be paid out during Sally's lifetime. This would have allowed the credit shelter trust to build up to an average 30 year ending market value of over $16 million while the marital trust would have been worn down to an average value of $627,450 compared once again to the $3.5 million total with the income rule trust combination.

Note that there are several reasons why the results here are so much better using the TRU plans. First and foremost is the fact that the asset allocation required to generate the necessary income with the traditional income rule trust will ruin the investment results in virtually any long term period. The TRU trusts can be invested with a sensible asset allocation despite the relatively high income need. Secondly, by reinvesting the equities in the credit shelter trust, we are tilting the asset allocation even further towards equities over the period of the analysis. This increases the trust returns on average considerably. The third factor is that with the higher payout in the marital trust, we will tend to decrease the relative payout as compared to a lower payout trust with the same asset allocation, since the payout will grow (if at all) more slowly with the higher payout.

To truly level the playing field, however, we would have to pay out additional funds from the marital trust in addition to the distribution amount because while the 7.5% payout marital trust would have started out at the same level of distributions as the income rule trust, the payout...
is high enough that it would have depleted the marital trust during many long periods of time if compared to our income rule trust alternative. To equalize these payouts, we would need to select a particular period. If instead of examining the composite results of all of the 30-year periods in history, we took the most recent 30 year period from 1974-2003, and if we were to equalize the after tax income to Sally with the TRU trust plan compared to the income rule trust approach, we would end up with the following results, after taxes in Sally’s estate:

<table>
<thead>
<tr>
<th>After Tax Distribution to Children After Equalization</th>
<th>Combined Marital &amp; Residuary Trusts $2,700,000 1974-2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>$8,871,305</td>
<td>$3,442,869</td>
</tr>
</tbody>
</table>

In after-tax returns to the remaindermen we produce over two and ½ times the net available from ordinary income rule trusts without sacrificing one dollar of net after-tax income to Sally. This is the logical extension of focusing economic benefit.

In our estate planning we should focus as much of the economic benefit passing to the credit shelter trust as possible towards the remaindermen while we focus as much as necessary from the marital trust to the surviving spouse. This optimizes our ability to invest for total return, while satisfying the human needs involved, and leveraging of the tax credits all at the same time. All of this is the direct result of being able to focus economic benefit.

As good as this plan seems with a Marital TRU and a fully discretionary trust for our Credit Shelter, the changes brought about by the Economic Growth and Revenue Reconciliation Act of 2001 make us rethink our process. With the size of the Credit Shelter changing dramatically over the coming years, how can we be sure that this plan will be a comfortable one for a surviving spouse? Having a comfort level with a fully discretionary Credit Shelter at $1,500,000 does not imply that the surviving spouse will be comfortable with a $2,000,000 fully discretionary Credit Shelter in 2006, or a $3,500,000 Credit Shelter in 2009!

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Enter the concept of what the author has named the "Ordered Unitrust" in which the overall distribution rate is held constant as a function of the market value of both the marital and the credit shelter trusts, but in which the entire TRU payout is directed from the Marital TRU. This gives us the best of both worlds - the distribution of a predictable percentage of the entire trust estate, and the full economic benefits that we have found to be extremely valuable, without relying on the trustee's discretion for the base payout desired for the spouse. An example of such an ordered Marital and Credit Shelter TRU plan is in Form 3 in Appendix 11 at the end of these materials.

C. WHAT IS THE RIGHT RATE?

What rate is optimal for the life tenant in a long-term TRU? As noted above, the “right” rate obviously most critically depends upon whom the settlor wishes to receive the majority of the economic benefit. And, as we see, it may be tremendously important to try to focus our benefits to maximize the benefit of the applicable credit amount and the GST exemption. But what if the primary goal is for the life beneficiary and not the amount remaining in the trust for the remaindernmen?

The answer to that question, important as it is, requires another. How much does the beneficiary truly need given the facts known to the drafter at the time the plan is created? In deciding what the beneficiary may need, the settlor and the drafter should consider that the lower the rate, the more secure the trust will be, the more the income stream will grow. Let us take a look once again at the table showing the unitrust payouts from a 3, 4, 5 and 6% portfolio invested 100% in equities between the period 1960 through 2003 (see Table 6 on the following page).

One notes a number of things in comparing these payouts. First of all, they clearly converge over time. The lower payouts grow faster than the higher payouts and eventually catch up if the period is long enough. By the thirty-fifth year of this forty-four-year period, the 3% payout has caught and surpassed the 5% and 6% payouts by shear force of compounding. At the same time, the distribution is smoother with only half as many negative changes in a 3% payout as in a 5% payout. To see this better, let us take a look at the 3% unitrust and the 6% unitrust distributions graphed against one another.

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Low Payout Rates Grow Faster!
3% TRU vs. 6% TRU - Distributions (1960-2003)

It isn’t at all obvious, but the relative decline in the recent bear market is less for the 3% TRU than the 6% TRU, the 3% TRU declining 22.5% from 2001 to 2003, while the 6% TRU declined 27.5%. And the same would have been true if we were to measure the decline during the ’70s in these two trusts, during which the 3% TRU experienced a 20.8% decline between 1973 and 1976 while the 6% payout declined 28% during the same period and 32% before the decline is reversed. The mathematics of this is simple enough.

The conclusion is that lower is safer and better if it can sensibly meet the beneficiary's need.

TABLE 6
COMPARISON OF RESULTS FOR UNITRUST PAYOUTS OF 3%, 4%, 5%, AND 6% FOR THE PERIOD 1960-2003 AFTER TAXES AND EXPENSES - 100% EQUITY PORTFOLIO - IN THE LONG-RUN THE LOWER THE PAYOUT RATE THE BETTER

<table>
<thead>
<tr>
<th>Year</th>
<th>3% Market Payout</th>
<th>4% Market Payout</th>
<th>5% Market Payout</th>
<th>6% Market Payout</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec 1960</td>
<td>3,000</td>
<td>96,238</td>
<td>4,000</td>
<td>95,233</td>
</tr>
<tr>
<td>Dec 1961</td>
<td>2,944</td>
<td>117,879</td>
<td>3,905</td>
<td>115,651</td>
</tr>
<tr>
<td>Dec 1962</td>
<td>3,141</td>
<td>103,039</td>
<td>4,145</td>
<td>100,077</td>
</tr>
<tr>
<td>Dec 1963</td>
<td>3,172</td>
<td>121,958</td>
<td>4,146</td>
<td>117,380</td>
</tr>
<tr>
<td>Dec 1964</td>
<td>3,429</td>
<td>136,925</td>
<td>4,441</td>
<td>130,823</td>
</tr>
<tr>
<td>Dec 1965</td>
<td>3,619</td>
<td>148,299</td>
<td>4,644</td>
<td>140,707</td>
</tr>
<tr>
<td>Dec 1966</td>
<td>4,072</td>
<td>127,472</td>
<td>5,185</td>
<td>119,783</td>
</tr>
<tr>
<td>Dec 1967</td>
<td>4,127</td>
<td>152,064</td>
<td>5,218</td>
<td>141,710</td>
</tr>
<tr>
<td>Dec 1968</td>
<td>4,278</td>
<td>162,184</td>
<td>5,363</td>
<td>149,981</td>
</tr>
<tr>
<td>Dec 1969</td>
<td>4,417</td>
<td>141,995</td>
<td>5,486</td>
<td>130,089</td>
</tr>
<tr>
<td>Dec 1970</td>
<td>4,562</td>
<td>140,746</td>
<td>5,624</td>
<td>127,731</td>
</tr>
<tr>
<td>Dec 1971</td>
<td>4,449</td>
<td>154,458</td>
<td>5,437</td>
<td>138,969</td>
</tr>
<tr>
<td>Dec 1972</td>
<td>4,372</td>
<td>176,953</td>
<td>5,291</td>
<td>158,107</td>
</tr>
</tbody>
</table>
But what if we abstracted further so that we did not know what the need was in order to apply our rule of choosing the right rate based on need, keeping in mind our mantra that “lower is better?” Is there some limitation on the rate we might choose from the current beneficiary’s point of view for a long period of time?

One way to approach this would be to take a look at the after-tax income to the life beneficiary at the end of a long period (perhaps comparable to a middle-aged beneficiary's life expectancy) and see what rates would produce the highest after-tax income at the end. If the rate is "too high," then by the last year a lower rate surely would have caught up and surpassed it. Clearly if the rate chosen over a long period of time produces the highest possible after-tax income at the end of the period, then at least it was not too high for the current beneficiary. Of course it may not have been high enough, but that is best addressed as part of our first question: What is the need?
To take a look at this, let us graph these after-tax distributions in the year 1998 from the period 1960 through 1998 with two alternative portfolios: A 100% equity portfolio and the second a 65% equity/35% bond portfolio.

One notices several things about this graph. The first of course is that the 100% equity is paying out much more money at the end of the day than the 65/35 portfolio. This of course should come as no shock. The second point is that with both of the portfolios, the rate that produces the highest after-tax income at the end of this long thirty-eight-year period is near 4%. But we know that the four-year period from 1995 through 1998 was extraordinary, even unprecedented. So we should construct the same graph from 1960 through 1994.
Towards an Optimal Rate (1960-1994)
Final Year After-Tax Distribution from a Total Return Trust as a Function of Payout Rate

Perhaps not intuitively, the rate which produces the highest income at the end of the period is actually higher ending in 1994 suggesting a 4% rate for all equity and a 4-1/2% rate for a 65% equity, 35% bond portfolio. The "optimal" rate is higher here for two reasons. First, the longer the period, the better the trust performs at a lower payout rate, and the higher the return during the period the faster a lower payout will catch up. That is why this four-year period makes so much difference in these graphs with a tremendous four-year performance by the equities from 1995 to 1998.

Looked at this way, one can make the argument that between 4% and 4-1/2% is not "too high" at least from the point of view of the current beneficiary. Two additional caveats need to be added at this point. First, we are only at this juncture looking at the upper limits of what we think may be optimal for the current beneficiary, not the remaindermen. Obviously, lower is better for the remaindermen. Then too, if the capital gains tax is paid entirely by the trust rather than shared with the current beneficiary, a somewhat lower payout rate would be indicated, perhaps a quarter percent.\(^{411}\) Still, this does give us some guidance on what may be "best" for the current beneficiary. *Remember that if the income is the greatest in the last year from a given payout rate, a lower rate would have produced less dollars in each and every prior year of the period since a lower rate always compares most favorably at the end of the period.*

\(^{411}\) A larger differential would apply if the trust were funded with low basis securities, perhaps as much as 60 basis points even if the turnover rate were 5%.

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D. ASSET ALLOCATION CRITICALLY AFFECTS SUSTAINABILITY OF THE TRU RATE - TWICE THE EQUITIES MAY ALLOW TWICE THE PAYOUT!

While this point has been made many times in many ways throughout these materials, in the context of setting a rate, it is critically important to understand that if the goal is to protect the trust estate and the distribution from the trust estate from future inflation, then the amount which one can afford to pay out is directly related to the asset allocation and consequentially the risk tolerance of the investor. To illustrate this, let us take a look at the case of Substantial Samantha and Little Lyle whose estate assets appear as follows:

<table>
<thead>
<tr>
<th>Estate Asset</th>
<th>Substantial Samantha</th>
<th>Joint</th>
<th>Little Lyle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Municipal Bonds</td>
<td>$ 2,000,000</td>
<td>$ 500,000</td>
<td></td>
</tr>
<tr>
<td>Stocks</td>
<td>23,000,000</td>
<td></td>
<td>2,500,000</td>
</tr>
<tr>
<td>Residence</td>
<td>1,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vacation Residence</td>
<td>500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$25,000,000</strong></td>
<td><strong>$2,000,000</strong></td>
<td><strong>$3,000,000</strong></td>
</tr>
</tbody>
</table>

Samantha and Lyle are perfectly willing to give away some of their property and so you suggest perpetuities trusts (or perpetual trusts if you live in one of the increasing number of states to do away with the rule against perpetuities.) 412 To maximize the benefit of the GST exemption, of course, we might suggest that they skip the first generation entirely or at least use a fully discretionary principal trust so that the children could use as small as possible an amount from these trusts. However, Samantha and Lyle do not want you to do that. They want the children to have a significant benefit from these trusts during their lifetimes. And they wish to take advantage of the GST exemption as early as possible. You will suggest no doubt that they make lifetime gifts since this makes the best use of their applicable credit amount as well and should allow the trust to grow during their lifetimes. But what if the children are unlike their parents and are very risk averse so that they would be uncomfortable with more than a 50/50 portfolio? How would this interplay with the selection of a rate for the TRU trust for their children and issue? If we were to examine the effect of different payouts and asset allocations on each other, we might suggest that a 4% payout with an all-equity portfolio be compared with a 2% payout with a 50/50 portfolio. The graph which follows shows market values of that trust from 1960 through 2003 with an initial market value of $1,500,000.

Looking over the market values of the two trusts, one is tempted to conclude that the two trusts protect the principal value roughly equally throughout the period and that they protect it rather well. A close look indicates that during the period of the '70s, the all-equity trust dipped and stayed somewhat below the more conservative payout and only catches up completely by 1989. Then again in during 1995-1998, the all-equity trust forges ahead by almost 2/3rds, and the

412 Alaska, Delaware, Idaho, Illinois, Maine, Maryland, New Jersey, Ohio, Rhode Island, South Dakota, Virginia, and Wisconsin have either repealed their Rule Against Perpetuities, never had a rule, or have an "opt out" statute. See Ira M. Bloom, The GST Tax Tail is Killing The Rule Against Perpetuities, 87 Tax Notes 569, 571-572 nn. 13 and 24 (2000). Since then, Arizona repealed its Rule, and Florida (360 years), New Hampshire, Utah (1000 years), Washington (150 years), Wyoming (1000 years) have extended their perpetuities period.

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recent bear market makes this long race a tie at the end of 2002. All in all, one might conclude that the two trusts had similar characteristics from the point of view of protecting the GST exemption and consequently the grandchildren and their issue. But then let’s take a look at the distributions to the children and see how they are affected.

Here one sees clearly the price of conservatism in the investment of the trust. At no point during the entire forty-three-year history would the current beneficiary have been better off with

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the 2% more conservative payout and the more conservative asset allocation. One is drawn towards the conclusion that the current beneficiary's interest in the all equity trust is worth perhaps twice as much invested in all equities as it is with the more conservative payout, and more conservative investment mix, while the value of the remainderman's interest is unaffected, though both undergo a higher volatility, without a doubt. But in the design phase of the trust, one may need to take the conservatism of the trustee and beneficiary into account in determining what rate is appropriate, at least if we intend to have a rational expectation of meeting the goal of inflation protection, which is likely the client's goal in this situation.

So once again, asset allocation is the key.

E. CHANCES OF PRESERVING THE REAL VALUE OF A TRUST AS A FUNCTION OF SPENDING AND ASSET ALLOCATION

To consider the probability of preserving the real after tax, after expense, after inflation value of a trust over time, one should examine all of the rolling 20 year periods in modern investment history and examine the twin effects of asset allocation and spending rate on the percentage of periods in which the real value of the trust would have been maintained. First, let's look at the percentage of twenty year periods in which a trust using our now standard assumptions would have preserved the real value paying out all of the income and no principal during the 1926-2003 period.

An all bond portfolio has essentially no chance of preserving the real value of the trust over a long term period like 20 years. Indeed, the 2% success rate is entirely due to the first
rolling period in the analysis, from 1926-1945, during which period there was no net inflation, so even that very low probability of success is probably an overestimate, since a period of deflation does not seem overly likely. One can also see that the first asset allocation which has more than a 50/50 chance of success is a 65% equity/35% fixed income portfolio. A 50/50 mix has only a bit over a one in three chance of maintaining the real value of the portfolio over twenty year periods. As we will see later on, it does even worse over thirty year periods.

A second observation might be that it does not seem to make much difference in the success rate once you have at least 45% equities. This would be misleading, and is partly a function of the fact that the percentage of success in maintaining real value is a "yes" or "no" function, and does not take into account how pronounced the "yes" or "no" might be. Let's take a look at the actual ending market values of an income rule trust with an all bond portfolio to see just how big a "no" is involved here.

Now this gives you a clearer picture of just how bad a result is likely with an all bond portfolio in terms of preserving real value. And the average result of the ending market values shows a 55% average decline in value over the average 20 year period. No wonder the phrase "on fixed income" is synonymous with financial misery!

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But what would our modeling show us with respect to other asset allocations? Let's look at the ending market values from a 50/50 allocation:

HALF A LOAF IS BETTER THAN NONE
Inflation Adjusted Ending Market Values - 20 Year Periods, Income Only Distribution, 50% S&P 500, 50% Intermediate Government Bond Index, $100,000 Starting Value, 1% Expense Rate, 5% Turnover-Through 2003

The results here are clearly much better, but still not good as the majority of ending values are still under water, and the average result is a loss in value of 14%.

Now let's examine a 75% equity mix, so that we can see there is light at the end of the tunnel, if we are on the right train!
Mostly Equities-Mostly Good Result!

Inflation adjusted Ending Market Values - 20 Year Periods, Income Only Distribution, 75 % S&P 500, 25% Intermediate Government Bond Index, $100,000 Starting Value, 1% Expense Rate, 5% Turnover-Through 2003

<table>
<thead>
<tr>
<th>Years</th>
<th>End Market Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>1926-1945</td>
<td>$220000</td>
</tr>
<tr>
<td>1929-1948</td>
<td>$120000</td>
</tr>
<tr>
<td>1932-1951</td>
<td>$70000</td>
</tr>
<tr>
<td>1935-1954</td>
<td>$170000</td>
</tr>
<tr>
<td>1938-1957</td>
<td>$220000</td>
</tr>
<tr>
<td>1941-1960</td>
<td>$270000</td>
</tr>
<tr>
<td>1944-1963</td>
<td>$270000</td>
</tr>
<tr>
<td>1947-1966</td>
<td>$270000</td>
</tr>
<tr>
<td>1950-1969</td>
<td>$270000</td>
</tr>
<tr>
<td>1953-1972</td>
<td>$270000</td>
</tr>
<tr>
<td>1956-1975</td>
<td>$270000</td>
</tr>
<tr>
<td>1959-1978</td>
<td>$270000</td>
</tr>
<tr>
<td>1962-1981</td>
<td>$270000</td>
</tr>
<tr>
<td>1965-1984</td>
<td>$270000</td>
</tr>
<tr>
<td>1968-1987</td>
<td>$270000</td>
</tr>
<tr>
<td>1971-1990</td>
<td>$270000</td>
</tr>
<tr>
<td>1974-1993</td>
<td>$270000</td>
</tr>
<tr>
<td>1977-1996</td>
<td>$270000</td>
</tr>
<tr>
<td>1980-1999</td>
<td>$270000</td>
</tr>
<tr>
<td>1983-2002</td>
<td>$270000</td>
</tr>
</tbody>
</table>

The average result here is an **increase** of 18% in value over all of those 20 year periods, as opposed to an average decrease of 14% for the 50/50 trust. But note that in order to be able to afford the better results, we will need to use a trust different from the income rule trust modeled above, since the income distribution on a 75% equity mix today is about 2.2%, not enough for most income beneficiaries to live on, particularly in the case of smaller trusts.

So let us take a look at a graph of the historical probabilities of preserving real value using a Total Return Unitrust and various asset allocations and various distribution rates:
Historical Statistical Chance of Preserving Real Value of a Trust as A Function of
Asset Allocation and Distribution Rate

Percent of Rolling 20 year periods 1926-2003 in which TRU market value is preserved after taxes, expense and inflation.
Assumptions: 38% income tax rate, 22% capital gains tax rate, 5% turnover rate, and 1% expense rate.

Clearly again, the more equities we have, the greater our chances to maintain the real value of the trust, and the more we can spend while preserving our chances. Examining some of the more familiar figures, a 4% unitrust with a 60% equity mix or greater is able to maintain the real value of the trust in a majority of the rolling 20 year periods. If a 40% equity mix is chosen, in order to have a greater than 50% chance of preserving the real value of the portfolio, we have to lower our distribution rate to 1.5%. With an all bond portfolio, even if we paid out nothing, we would have only a one in seven chance of preserving the real value of the portfolio. At a payout of only 4 ½% the historical probability drops to 0%!

On the other hand, with an all stock portfolio, a payout of 6% is more likely than not to have preserved the real value, and even with an 8% payment, we have about a 40% chance, not great, but better than a more conservative, higher income producing portfolio.

A close examination of the above graph illustrates that through the majority of the range of sensible unitrust payouts, an 80% equity portfolio comes rather close to the 100% equity portfolio in the percentages of periods it achieves the goal of preserving real value. If we graph all of these results with a 4% payout, we find significant volatility in results but an average result with an increase in real value of over one third, and a 59% success rate.
One could argue that this might be a fairly sensible payout, if the asset allocation, trust expenses, turnover performance are likely to match our standard assumptions for modeling purposes. One should remember, however, that if the cost basis of the portfolio is low, and particularly if the turnover is high, the results are likely not going to be as good as those modeled. One is also tempted to compare the graph above with the 75/25 income payout trust on the prior page, and note that the results are not terribly different. This should come as no great shock to the reader at this point because the asset allocation is almost identical, and that makes the primary difference. Further, the average income return on such an income rule trust over all of the rolling periods in history is fairly close to 4%. It is only in the last 10 years or so that we have come to have such a wide divergence between the “income” produced by dividends and a 4% unitrust payout. However, to live with a 75% equity mix today sentences the income beneficiary to a 2.2% yield, so the difference today is very real! The question remains as to whether the future equity rates of returns can match those of the past with the lower dividend rates of today coupled with today’s higher price/earnings ratios.

So once again we see that asset allocation, not accounting income, is the key to what we can spend, and the key to the freedom to use that knowledge is the Total Return Trust.

F. TOTAL RETURN TRUSTS FILL THE PLANNER'S TOOL CHEST WITH THE RIGHT TOOLS FOR THE RIGHT JOB

No one type of trust fits all situations. Like the craftsman, we estate planners should consider all available tools to match the particular job in a particular family. In this section we will take a look at a difficult situation which lets us test out some old and new tools to see which ones fit the job.

1. Dealing With the High Demand - High Risk Scenario

We posit the case of Rex Ready and Willing Wilma. Rex is in the process of getting remarried to Wilma and they are negotiating their antenuptial agreement. Rex has been an
entrepreneur for many years and has involved his children by his first marriage in the business. Obviously he would like to protect that small business and also wants to satisfy the needs of his new wife, Wilma. Wilma believes that she needs to have $100,000 in income out of Rex's estate plan in the event of his death to make up for the loss of his earnings and she wants that income to keep up with inflation. Rex is seventy-eight years old, while Wilma is seventy-three. Rex has a total of $2,000,000 in assets that could be placed in the trust without including his business. What type of a trust can we offer to her? Well the first and most obvious suggestion would be to use an indexed payout trust starting at 5% of the initial fair market value or simply $100,000 indexed for inflation and see if that would do the trick. Unfortunately, if at the time of Rex's death, we experienced a period of high inflation and a bear market like we did starting in 1973 the trust may be entirely depleted during Wilma's lifetime, thus not protecting Wilma in the long run or protecting the children's interests. The following is a chart of the market value of that indexed payout trust beginning in 1973:

![Chart of Indexed Payout Trust](image)

This would not be an acceptable risk either for Wilma or for Rex. Under this very bearish scenario the trust would be depleted in eighteen years.

2. **What About a Hybrid - A "No-Drop" Unitrust**

If the first tool doesn't work, let us take a look and see what else we might have in our toolbox to address Rex and Wilma's problem. What if we were to design a trust that would not allow the distribution to go down - a "no-drop" unitrust, but would allow it to go up if the market provided enough return? There is no theoretical reason why we could not draft such a trust. We could simply insert the following language into our form:

The distribution amount shall not be less than the distribution amount in the immediately preceding tax year of the trust except in the case of a short year, or in an adjustment year or the year immediately following an adjustment year where...
the adjustment is caused by an additional distribution from the trust as set forth below. In such case the distribution amount can decrease, but only by the amount of the adjustment or, in the case of the following year, by the distribution rate multiplied by the additional distribution as set forth below.

Might this satisfy Wilma by having no possibility that it would go down and yet the possibility that it could go up along with inflation? Guaranteeing that the trust distribution will not go down is going to be significantly safer in most scenarios than an inflation indexed payout trust, but it may not do the job that Wilma thinks it should. Again if we use the difficult 1973 starting date, let us look at the payouts from an indexed payout trust and then a no-drop unitrust each with a 65% equity, 35% fixed income conservative investment mix.

We have not set the program to pay out the “income if greater” than the unitrust amount, as this should be unnecessary in a unitrust state, on the theory that the “no-drop” feature is simply an additional amount payable to the surviving spouse. It will always be at least the unitrust amount, and with the payout set at 5%, the ordinary unitrust payout should clearly qualify as having paid out at least “all of the income” to Wilma. That is not the case with an inflation indexed payout, which will only qualify for the marital deduction by adding the familiar income if greater rule.

While the no-drop unitrust is far safer than the indexed payout trust, we see that even with the more conservative portfolio, Wilma's distribution will not have increased for a full eleven years. Of course this is because during this bear market the overall portfolio went down
significantly during this period. But there is a tremendous gap between the indexed payout she thinks she needs and what you are able to provide with a no-drop unitrust. How much might we be able to provide without exhausting the trust as compared to preserving its real value? See Graph which follows:

![Graph showing Inflation Indexed Payout Versus Unitrust Payout]

Clearly, there is some margin for error in the indexed payout trust, but not enough to get us up to Wilma's request for a 5% indexed payout. Interestingly, also, it appears that the highest payout rate would be afforded by about a 50/50 mix. This is because of the relative intolerance of the indexed payout trust for bear markets during an inflationary cycle. If our goal were to have no loss in value during this period, one would be able to pay out no more than about 2.8% with an all-equity portfolio. At 4.1% the trust is exhausted! Note also that where the goal is no loss in value, we are always better off with the highest percentage of equities, whereas when the fear is exhaustion of the trust, fixed income is necessary in the mix.

Now let us take a theoretical look at the no-drop unitrust versus the total return unitrust for the same period. See the graph which follows:

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Clearly the no-drop unitrust has a much greater margin for error so that we could offer Wilma a much higher "starting salary" if she were willing to accept more risk along with the rest of the family and the children by Rex's first marriage. In most scenarios, the use of the no-drop unitrust will not cost you a lot in terms of what you can pay out, but there is one scenario in which it would and that is a deflationary depression such as the 1930s. In that case the inflation indexed payout trust would be safer than a no-drop unitrust because the distributions would be automatically reduced during a period of deflation, and this would, relatively speaking, protect the trust corpus from depletion. Indeed, a 5% indexed payout trust starting in 1926 would have lasted until 2003 even with the "safer" 65% equity/35% fixed-income portfolio, while a “no-drop” unitrust would have been extinguished by 1953. This works primarily because of the fact that the dividend payout at the beginning was 5.41%, and dividends as discussed later have historically done an excellent job of keeping up with inflation. Critically, though, the reason it worked for this long is because the first truly awful market was one in which there was deflation rather than inflation. Notably also, the trust was extinguished in 2003.
For the foregoing illustration, we used a 65/35 mix because we thought it would be "safer". And it is safer if the risk is complete depletion in an inflationary period. The “No-Drop” with an all equity portfolio goes away 10 years sooner, in 1943. But if 5% inflation indexed payout trust had been all equity, there would have been $61,176,638 in the trust at the end of 2003! How did it get so large? The distribution on the $61 million in 2003 is $1,008,839, only 1.6% of the ending value. Now that's leverage!

3. **A Merger of Good Ideas - The TRUCAP Index Trust**

This case study highlights both the great advantage and the great disadvantage of the indexed payout trust. Once we unlink the payout from the total return earned in a trust and from its market value, we risk depletion of the trust. If we link our distribution to the market values, clearly we will fall well short of our goal in this example of keeping Wilma up with inflation. Of course, setting a goal of keeping up with inflation starting at 5% and beginning the trust in 1973 makes the goal impossible to reach, but is there something that would better blend the priorities so as to try to keep the distribution up with inflation but impose safeguards on the distribution so as to avoid depleting the trust?

The answer may lie in a hybrid between the TRU and the indexed payout trust. If we utilize a formula for our distribution which is an indexed payout but put a limit on it so that the payout must bear a sensible relation to the market value, we could avoid the risk of complete depletion of the trust during the lifetime of the beneficiary. Obviously from everyone’s point of view, depletion is the worst-case scenario. What would the distributions look like in this case study if we were to put a cap on the distribution of 10% times the average of the fair market values of the trust over the most recent three-year period?

If we do this, we will create a hybrid between the indexed payout trust and the TRU so that during "normal" or good times, the trust would distribute the indexed payout, but if the indexed payout exceeded the 10% benchmark, the trust would distribute only the 10% TRU distribution, putting a "cap" on the payout. This effectively would convert the trust from an indexed payout trust into a TRU just when the trust assets need the protection of a spending methodology that is geared to what is available. The three-year smoothing rule should be used here on the "TRUCAP" for the same reason it is in the ordinary TRU. Without the three-year smoothing rule, the trust would otherwise act as a high rate unitrust without a smoothing rule during difficult market periods. This is likely to be particularly disquieting for a trust beneficiary because of the volatility that it would produce.

Ten percent was chosen after modeling a number of other rates. The closer the cap rate is to the initial distribution rate, the more the TRUCAP index trust will resemble the unitrust, which works well in many contexts but does not adapt itself particularly well towards this difficult situation. Below is a graph of our trust using a 65% equity/35% bond portfolio from 1973 through 2003 and alternative 8%, 10% and 12% caps.
The distributions from the 10% cap rate take a middle ground between the 8 and 12% caps as one would expect. In this very difficult scenario, the 10% cap would allow the trustee to pay out the inflation indexed value for a period of six years before the trust converts itself into a 10% unitrust with a three year rolling payout. From that point on it is a 10% TRU. Obviously that is an aggressive payout, but at least in this worst-case scenario it allows the trustee to try to address Wilma’s goals without taking on very serious risk of depletion.

Now let us return to our distribution comparison and compare our new model with the indexed payout trust and the no-drop unitrust to see how it stacks up. See the graph which follows.
This may well be the best we can do for Wilma to accomplish the dual goals of keeping the distribution up with inflation and not exhausting the trust, which would of course place Wilma in even greater financial difficulty.

While the TRUCAP alternative does not appear to get all that close to our inflation protected goal, we must bear in mind that we are testing this case study in a period when the goal cannot be attained because of the combination of inflation and bear market scenarios. In any real trust we do not know whether we are going into a period like the ones starting 1973 or 1981 or 1950. We simply do not know what the future will bring and we are only back testing our models to gain insight into the way our approaches react in a variety of difficult circumstances. Before we leave this potential solution, though, let us look at the ending market values from our three models.
Clearly, the 10% TRUCAP index trust was treading water even in nominal terms throughout this period. Putting a higher cap than the 10% would increase the danger to the financial security of Wilma and the remaindermen.

Much depends on when we start our model. If we were to start in 1950 and compare these same three trusts with payouts beginning at 5%, the resulting graph is instructive.

Depending on When You Start You May Never Need the CAP!
Index Payout Trust vs. TRUCAP Index Trust vs. No-Drop Unitrust
65% Equity/35% Fixed Income; 5% Payout; 10% CAP

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In this illustration, the TRUCAP never comes into play. The 1950s were such a good economic period from the point of view of low inflation and a high equity return that the trust builds up its value so that in the 1970s, the distribution is able to keep up with inflation without distributing more than 10% of the smoothed market values from the trust. Note the significant difference in the no-drop configuration which starts to run into trouble in 1966 because that is when the S&P 500 attained its high water mark taking into account the burgeoning inflationary pressures. Because the no-drop paid out significantly more during the '50s and '60s up to that point, it would otherwise be declining in value and therefore also declining in distribution were it not for the "no-drop" rule. It takes the no-drop until 1985 to regain its upward momentum. If we graph the market values from the two trusts, we would find that the TRUCAP index trust maintained the value of the trust better than the no-drop unitrust.

At Some Starting Points Inflation Indexing Produces Superior Results

Starting as it did in 1950, a very favorable starting point, as contrasted with 1973, a very unfavorable starting point, we end up getting very different results and comparisons of our trust models. The strength of the TRUCAP index trust is that it can potentially change back and forth from the index trust to the unitrust and back again as necessary and as possible given the market and economic conditions. Let's compare the same three trusts starting in 1973 but use a 4% payout rate initially and an 80% equity/20% fixed income investment mix. See graph on the following page.

The TRUCAP index trust first acts as an indexed payout trust for eight years, then becomes a 10% TRU for the remainder of the period but approaches very closely the indexed payout goal in 1989 and attains it from 1999 through 2003. Having a trust which can morph back and forth may be very helpful in this type of difficult planning scenario.

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4.  Choosing Your Risks - The Inflation - Depletion Dichotomy

Clearly, if one is willing to accept the variability in distribution to which it is subject, a TRU trust is going to be the safest trust distribution methodology from the point of view of protecting and not exhausting the trust principal. It will be safer than a no-drop unitrust because it will be safe from depletion even in a deflationary depression. It is safer than an indexed payout trust because it is safe from depletion even in an inflationary bear market, perhaps the most likely worry today. Of course the income rule trust itself is also safe from depletion, but it is subject to all of the conflicts and limitations to investment discussed throughout these materials.

The TRUCAP index trust however is probably the vehicle of choice given the very high priority on keeping Wilma up with inflation. It will not protect the principal value of the trust in all likelihood as well as the unitrust, but since we do not know what the next economic period will look like, it provides what may be a relatively ideal hybrid between the two trusts.

Once the planner has made the decision as to which tool to use, the tool and the payout rate have important implications for the investment of the trust. Clearly where depletion is more of a problem, fixed income plays a more important role whereas if the goal is to keep the trust up with inflation, in all long historical periods, equities are the superior investment. The allocation of risk and return varies significantly depending upon our choice of distribution methodology.

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and is particularly sensitive once we stray from the path of an income interest or a unitrust interest. And the type of trust we choose must be taken into account in investing the trust as well.

5. **Asset Sufficiency and Certainty**

In the foregoing difficult case study, we sought to satisfy Wilma's need for both security and protection from inflation by inventive trust design. But we could also analyze the case study from the point of view of asset sufficiency. Wilma was 73 years old and in 30 years she would be 103. There is only a 2% possibility that she would be alive at the end of that period based on current actuarial tables. If we were to computer model a 5% inflation index payout trust for all of the 30 year rolling periods starting in 1926, there would have been 19 of the 30 year periods in which Wilma would have run out of money using a 65/35 asset allocation. Interestingly, using a 100% equity portfolio, there would have only been 16 failures, rather than 19, so again, the longer the period, the better stocks compare with the alternative. But clearly, in either case, an unacceptable number of failures. But if we did the same thing with a 65/35 asset allocation and a 4% payout she would have run out in only four of the 49 periods, a 92% success rate. If we lowered the payout rate to 3-1/2%, the trust would not have been exhausted in any of the 49 periods with starting years from 1926 through 1973.\(^\text{413}\) So the probability of being able to use an inflation indexed payout will vary quite directly depending on its payout. If additional capital were required, life insurance could be added to change the odds of success as follows:

<table>
<thead>
<tr>
<th></th>
<th>5%</th>
<th>4%</th>
<th>3-1/2%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wilma's Success Rate:</td>
<td>61%</td>
<td>92%</td>
<td>100%</td>
</tr>
<tr>
<td>Insurance needed to fund trust</td>
<td>0</td>
<td>$500,000</td>
<td>$860,000</td>
</tr>
</tbody>
</table>

The additional insurance need is simple enough to compute. We simply work backwards from the required income, dividing it by the payout rate, to arrive at the capital required. The difference between the capital required and the capital available is the amount of additional life insurance needed to increase our odds to a level of comfort. While no approach will produce a 100% guarantee, one of the most important tools that can be used is simply to increase the available trust assets with life insurance so that the payout rate can become safer and more secure.

Also interestingly, life insurance underwriters tend to assume much higher payout abilities in establishing limits upon life insurance coverage, or, stated differently, they assume a much smaller need for insurance than seems to be supported by the historical financial data. The

---

\(^{413}\) The average ending market value of all of the periods represents a loss of 18% on an inflation-adjusted basis, and the ending market value of the trust would have lost real value in 71% of the 30-year periods. If we were to eliminate the “income if greater” requirement were the trust not intended to qualify for the marital deduction, and reduce the payout rate to 3%, the results would actually be relatively good. With a 65/35 asset allocation, the trust would have preserved real value in 59% of the periods, and the average ending market value would have been up 19%. A 3% inflation adjusted payout with 100% equities would have done, on average, very well indeed, with an 86% success rate in preserving inflation adjusted market value, and an average ending market value increase of 130%.

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foresgoing computations are made for academic reasons, and not for the purpose of selling life insurance, but the truth is that it takes a lot of money invested prudently to produce a reasonable stream of income for a lifetime. Insurance underwriters should acknowledge this fact. *It is sensible to assume that a 73 year old will need 29 times the annual income need to be relatively certain of her income stream.* This is a significant multiple of the amounts generally suggested, yet the desire of survivors to have an inflation indexed income stream is real enough, even if the logical extension of that desire is not well known.

**G. HOW TO HANDLE THREE TRUST GST PLANS**

At this point we have studied and worked with all the trust tools we need to tackle a three trust GST plan. Let us assume that Successful Sylvester and Supportive Sally, our estate planning clients discussed previously, were to come back 15 years later. Sylvester and Sally are now 65 years of age and are considering retirement. Their children are now in their thirties and they now have five grandchildren. Their assets now appear as follows:

<table>
<thead>
<tr>
<th></th>
<th>Successful Sylvester</th>
<th>Joint</th>
<th>Supportive Sally</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and Securities</td>
<td>$4,000,000</td>
<td>$0</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Residence</td>
<td>$500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life Insurance</td>
<td>$250,000</td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$4,250,000</td>
<td>$500,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$4,950,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

While Sly and Sally have seen their portfolios grow comfortably, their lifestyle has increased as well and with the children out of the house they are used to having a few of the finer things. Sly and Sally have begun making annual exclusion gifts to their children, in addition to a one-time taxable gift of $300,000 to their children. In the event of Sly's death, Sally would want to be able to continue their annual gifts to the children without feeling strapped. They inform you that they need the $180,000 in cash flow to do that and keep Sally comfortable. They also inform you that they would like to have some portion of their estate be kept safe from taxes for at least two generations. Because of this taxable gift, they may want a three-trust plan even though the applicable credit amount and the GST exemption have merged at $1,500,000 for 2004 and 2005. So you need to consider a three-trust plan, with the usual nonexempt marital trust, and a GST exempt marital trust and credit shelter trust to which the GST exemption is applied. This would give us three trusts to design:

- Credit Shelter Trust - $1,200,000
- GST Exempt Marital Trust - $300,000
- GST Nonexempt Marital Trust - $2,750,000

Using the techniques we have learned, we know that we will want to use the most aggressive investment mix and the most conservative payout regimen in the most tax advantaged

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trust, in order to focus the economic benefit entirely on the lowest generation. This could be accomplished by making the credit shelter trust fully discretionary and planning to invest the credit shelter trust entirely in equities and distributing nothing from that trust unless or until the other two trusts were exhausted. The GST exempt marital trust must of course pay out all the income, but with a somewhat tax advantaged trust, we might wish to use a three percent marital TRU and a 75/25 equity/fixed income mix. The nonexempt marital TRU should be invested the most conservatively, such as a 50/50 equity/fixed income mix with the highest payout rate, in this case a 6.25% marital TRU. These three trusts will provide a total of slightly more that $180,000 in cash flow, just what Sally wanted.

Now instead of modeling these three trusts for a specific period, we will take all of the historical periods and examine their best and worst cases and their average results to study the effects of this plan. That way we will have a better idea as to our risks and avoid any claims of "data mining". The relevant period to be examined would be twenty years reflecting Sally's remaining life expectancy. Let's look at our sample results counting all fifty-eight of the relevant twenty-year periods beginning in 1926. For the two marital deduction trusts, we will assume that we are in a unitrust state, and thus do not have to pay out the “income if greater”. The results for each of the trusts are as follows:

Total Return Trust Plan

Credit Shelter Trust - All Equity - No Payout

<table>
<thead>
<tr>
<th>Starting Value</th>
<th>Worst Case</th>
<th>Best Case</th>
<th>Average Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,200,000</td>
<td>$1,314,502</td>
<td>$19,189,723</td>
<td>$7,085,031</td>
</tr>
</tbody>
</table>

GST Exempt Marital Trust - 75% Equity - 3% Payout

<table>
<thead>
<tr>
<th>Starting Value</th>
<th>Worst Case</th>
<th>Best Case</th>
<th>Average Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>$300,000</td>
<td>$264,818</td>
<td>$2,239,524</td>
<td>$919,286</td>
</tr>
</tbody>
</table>

GST Nonexempt Marital Trust – 50% Equity/50% Bonds – 6.25% Payout

<table>
<thead>
<tr>
<th>Starting Value</th>
<th>Worst Case</th>
<th>Best Case</th>
<th>Average Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2,750,000</td>
<td>$1,289,986</td>
<td>$8,645,399</td>
<td>$3,641,718</td>
</tr>
</tbody>
</table>

Several observations about the foregoing results jump out at the reader. First, there is a tremendous variation between our worst and best cases. As one would expect, the variability of the credit shelter trust invested in 100% equities is the greatest. The average results in the three trusts illustrate quite well the expected results with the following cumulative increases in market value:

---

414 The process of digging through large volumes of data until we find some data that we find favorable, and then citing that data and only that data.

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Credit Shelter Trust | GST Exempt Marital Trust | GST Nonexempt Marital Trust
---|---|---
490% Increase | 206% Increase | 32% Increase

This of course is exactly what one intends with fifteen times the increase in the most tax favored credit shelter trust than we have to the GST nonexempt marital trust. And the methodology holds true even in the worst case which, surprise to no one, begins in 1929:

Change in value 1929-1948

<table>
<thead>
<tr>
<th>Credit Shelter Trust</th>
<th>GST Exempt Marital Trust</th>
<th>GST Nonexempt Marital Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>+9.5%</td>
<td>-12%</td>
<td>-53%</td>
</tr>
</tbody>
</table>

Even in the worst-case scenario in recorded financial history, the methodology produces a favorable result from a tax planning point of view. Interestingly, as you might suspect, a higher fixed income mix would have been optimal starting in 1929. In fact a 31% equity 69% fixed income portfolio would have given us the highest value at the end of the 1929 to 1948 period for the credit shelter trust starting with $1,200,000 - $1,807,437. 415

Had we followed a conventional plan of trying to match income with desired distribution, we would have immediately been in trouble, because we need a net yield of 4.25%. The investment mix needed would have to have been 90% fixed income as represented by a 30 year U.S. Treasury Bond at roughly 5% and 10% equities at 1.67%. Were we to use all income rule trusts, we would have produced the following:

Income Rule Trust Plan

<table>
<thead>
<tr>
<th>Credit Shelter Trust</th>
<th>GST Exempt Marital Trust</th>
<th>GST Nonexempt Marital Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Starting Value</strong></td>
<td><strong>Worst Case</strong></td>
<td><strong>Best Case</strong></td>
</tr>
<tr>
<td>$1,200,000</td>
<td>$841,945</td>
<td>$1,765,758</td>
</tr>
<tr>
<td>$300,000</td>
<td>$210,486</td>
<td>$441,440</td>
</tr>
<tr>
<td>$2,750,000</td>
<td>$1,929,456</td>
<td>$4,056,529</td>
</tr>
</tbody>
</table>

415 While bonds had the higher total return than the S & P 500 during that period (3.9% versus 3.1%), the annual re-balancing produces the highest ending balance with 31% equities. Interestingly small cap stocks had a significantly higher total return of 5.7% from 1929 to 1948.

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The average increases in value are as follows:

<table>
<thead>
<tr>
<th>Trust Type</th>
<th>TRU Plan</th>
<th>Income Rule Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Shelter Trust</td>
<td>+ 490%</td>
<td>+3.3%</td>
</tr>
<tr>
<td>GST Exempt Marital Trust</td>
<td>+206%</td>
<td>+3.3%</td>
</tr>
<tr>
<td>GST Nonexempt Marital Trust</td>
<td>+32%</td>
<td>+3.3%</td>
</tr>
</tbody>
</table>

The net to the next generation, after taxes at 48% in the surviving spouse's estate, would be as follows:

**Average Results**

**TRU Three Trust Plan**

<table>
<thead>
<tr>
<th>Trust Type</th>
<th>Pre-Tax</th>
<th>Tax</th>
<th>After Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Shelter Trust</td>
<td>$7,085,031</td>
<td>$0</td>
<td>$7,085,031</td>
</tr>
<tr>
<td>GST Exempt Marital Trust</td>
<td>$919,286</td>
<td>$441,257</td>
<td>$478,029</td>
</tr>
<tr>
<td>GST Nonexempt Marital Trust</td>
<td>$3,641,718</td>
<td>$1,748,025</td>
<td>$1,893,693</td>
</tr>
<tr>
<td>Total:</td>
<td>$11,646,035</td>
<td>$2,189,282</td>
<td>$9,456,753</td>
</tr>
</tbody>
</table>

**Income Rule Trust Plan**

<table>
<thead>
<tr>
<th>Trust Type</th>
<th>Pre-Tax</th>
<th>Tax</th>
<th>After Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Shelter Trust</td>
<td>$ 1,239,521</td>
<td>$0</td>
<td>$ 1,239,521</td>
</tr>
<tr>
<td>GST Exempt Marital Trust</td>
<td>$ 309,880</td>
<td>$148,742</td>
<td>$ 161,138</td>
</tr>
<tr>
<td>GST Nonexempt Marital Trust</td>
<td>$2,840,568</td>
<td>$1,363,473</td>
<td>$1,477,095</td>
</tr>
<tr>
<td>Total:</td>
<td>$4,389,969</td>
<td>$1,512,215</td>
<td>$2,877,754</td>
</tr>
</tbody>
</table>

Hence the average after tax results to the next generation is 3.29 times as large using the TRU three trust plan over the average of all twenty-year periods since 1926. The actual rolling period data is shown in Table 8 which follows:
<table>
<thead>
<tr>
<th>Credit Shelter TRU</th>
<th>GST Exempt Marital TRU</th>
<th>GST Non-Exempt Marital TRU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity %: 100%</td>
<td>Equity %: 75%</td>
<td>Equity %: 50%</td>
</tr>
<tr>
<td>Fixed Income %: 0%</td>
<td>Fixed Income %: 25%</td>
<td>Fixed Income %: 50%</td>
</tr>
<tr>
<td>Income Tax Rate: 38.0%</td>
<td>Capital Gain Rate: 22.00%</td>
<td>Income Tax Rate: 38.0%</td>
</tr>
<tr>
<td>Expense Rate: 1.00%</td>
<td>Expense Rate: 1.00%</td>
<td>Expense Rate: 1.00%</td>
</tr>
<tr>
<td>Turnover Rate: 5.00%</td>
<td>Turnover Rate: 5.00%</td>
<td>Turnover Rate: 5.00%</td>
</tr>
<tr>
<td>Cost of Turnover: 0.50%</td>
<td>Cost of Turnover: 0.50%</td>
<td>Cost of Turnover: 0.50%</td>
</tr>
<tr>
<td>Payout Rate: 0.00%</td>
<td>Payout Rate: 3.00%</td>
<td>Payout Rate: 6.25%</td>
</tr>
<tr>
<td>Begin MV: $1,200,000</td>
<td>Income If Greater No</td>
<td>Income If Greater No</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>20 Year Period</th>
<th>EMV</th>
<th>20 Year Period</th>
<th>EMV</th>
<th>20 Year Period</th>
<th>EMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>1926-1945</td>
<td>2,753,295</td>
<td>1926-1945</td>
<td>478,332</td>
<td>1926-1945</td>
<td>2,057,834</td>
</tr>
<tr>
<td>1927-1946</td>
<td>2,295,375</td>
<td>1927-1946</td>
<td>412,987</td>
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<td>1929-1948</td>
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<td>1929-1948</td>
<td>264,818</td>
<td>1929-1948</td>
<td>1,289,986</td>
</tr>
<tr>
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<td>1,674,947</td>
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<td>318,232</td>
<td>1930-1949</td>
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<tr>
<td>1932-1951</td>
<td>5,867,346</td>
<td>1932-1951</td>
<td>793,753</td>
<td>1932-1951</td>
<td>2,897,286</td>
</tr>
<tr>
<td>1934-1953</td>
<td>4,937,625</td>
<td>1934-1953</td>
<td>678,754</td>
<td>1934-1953</td>
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<tr>
<td>1937-1956</td>
<td>5,538,131</td>
<td>1937-1956</td>
<td>723,650</td>
<td>1937-1956</td>
<td>2,408,528</td>
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<tr>
<td>1938-1957</td>
<td>7,253,531</td>
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<td>1938-1957</td>
<td>2,866,858</td>
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<table>
<thead>
<tr>
<th>Period</th>
<th>Count</th>
<th>Year 1</th>
<th>Count</th>
<th>Year 2</th>
<th>Count</th>
</tr>
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<td>1940-1959</td>
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<td>1941-1960</td>
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<td>1941-1960</td>
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<tr>
<td>1942-1961</td>
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<td>1,435,341</td>
<td>1942-1961</td>
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<td>1943-1962</td>
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<tr>
<td>1944-1963</td>
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<td>3,537,711</td>
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<td>1,158,065</td>
<td>1945-1964</td>
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<td>1949-1968</td>
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<tr>
<td>1953-1972</td>
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<td>1953-1972</td>
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<td></td>
</tr>
<tr>
<td>1956-1975</td>
<td>3,008,119</td>
<td>466,330</td>
<td>1956-1975</td>
<td>2,055,144</td>
<td></td>
</tr>
<tr>
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<td>-----------------</td>
<td>------------</td>
<td>------------------</td>
</tr>
<tr>
<td>Average</td>
<td>7,085,031</td>
<td>Average</td>
<td>919,286</td>
<td>Average</td>
<td>3,641,718</td>
</tr>
<tr>
<td>Best</td>
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<td>Best</td>
<td>2,239,524</td>
<td>Best</td>
<td>8,645,399</td>
</tr>
<tr>
<td>Worst</td>
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<td>Worst</td>
<td>264,817</td>
<td>Worst</td>
<td>1,289,986</td>
</tr>
</tbody>
</table>

Just as in the Marital and Credit Shelter TRU plan discussed in the earlier case study, the three trust plan is also impacted by EGTRRA, as the relative sizes of the three trusts will change significantly over the coming years. Similar to our approach with Sylvester and Sally in their earlier years, an Ordered Unitrust plan can be constructed for the three trust plan in much the same way as it is for a Marital and Credit Shelter plan, with a combined unitrust amount being computed based upon a percentage of all three of the trusts, but paid entirely from the Non-exempt Marital TRU first, then the Exempt Marital TRU and lastly from the Credit Shelter TRU. This preserves the predictability of the cash flow to the surviving spouse based upon all of the

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trust assets available at death, without reliance on the exercise of trustees’ discretion in the process. The only wrinkle in the three trust plan is that it will probably be wise to retain a requirement that all of the net income earned in the Exempt Marital TRU will be paid out in addition to the TRU payout, since the TRU payout will be paid from the Non-exempt Marital TRU first, because both marital trusts must pay out the “income” for each trust to qualify for the marital deduction. Since it is likely that the 3% minimum rate approved by the Final Regulations will be more than the net accounting income earned in that trust, paying out the income from the exempt marital TRU as a bonus may well be the easiest way to make sure the trust qualifies without distributing more than desired. As such, the three trust ordered unitrust approach should produce even better leverage than the case study illustrates! The Exempt Marital Trust will be unnecessary for most plans now that the applicable credit amount and the GST exemption are the same, though the three trust plans will still be necessary for those who have used an unequal amount of the applicable credit amount and GST exemption, such as when a taxable gift is made to children, as in the above case study, or where GST exemption is used over time to cover gifts to an irrevocable life insurance trust, even though no applicable credit amount is used because of Crummey withdrawal rights. A model three trust Ordered Unitrust plan can be found at Form 4 in Appendix 11 at the end of these materials.

Let us turn back from a discussion of how to best focus our economic benefit to examining the variability of returns over long periods as a result of different asset allocations. If we were to examine graphically all the rolling periods of our 100% equities credit shelter trust with no payout and an income rule trust with the 90% fixed income, we can see that the income rule trust never matched the reinvesting all equity trust and normally fell short by a large multiple.
Clearly though the all equity portfolio has a great deal of volatility in it's results despite the fact that it was always a better plan than the income rule trust. We could control this fairly simply by adjusting the asset allocation but not changing the terms of the trust. Below is the same data but for a 75% equity and 50/50 trust for comparison:

![75% EQUITIES & 25% FIXED INCOME -- WEARING DOWN THE PEAKS!](chart.png)

Comparison of EMV of Credit Shelter Trust over 20-year period from 1926-2003.
By focusing the economic benefit with total return trusts, we can obtain better results regardless of our risk tolerance, but the fact that we are using such trusts does not eliminate the need for the trustee to assess the risk tolerance of the trust, with its need for liquidity as well as the risk tolerance of the family.

Total return trusts allow the trustee to invest aggressively, but also allow the trustee to invest conservatively while focusing and managing the return more accurately. Over long periods of time such as the twenty year periods illustrated below, one is tempted to conclude that almost all of the volatility one avoids with the more conservative portfolio is the upside volatility.
H. WHAT TO DO WITH EXISTING TRUSTS

All of the foregoing is fine, you may say, with regards to estate planning for the future, but what do we do with our existing trusts and the estate plans which have come to fruition through the death of the settlor or testator.
1. Creating Virtual Unitrusts

How do we utilize our new tools with trusts constructed before these changes into a more modern trust design? For the answer to this, we would suggest an approach similar to that utilized by the drafters of Section 104 of the new UPAIA. We should first look to the powers contained in the trust itself. To the extent that we have discretionary powers of distribution, even subject to ascertainable standards, we can utilize these powers to invest for total return as a prudent investor and still follow the terms of our document. For example, let us assume a trust which tells the trustee to hold the principal and pay the income to the current beneficiary but allows the trustee to distribute additional principal for the beneficiary's "health, maintenance, and support in his or her accustomed manner of living." In response to that, and a relatively high need on the part of the trust beneficiary, the trustee may have invested the fund 50% in stock and 50% in bonds which today would give you about a 3.0% current return. If the trustee and the beneficiaries can accept the additional volatility of a higher equity mix, they could adopt, for example, an 80% equity and 20% fixed-income allocation. This would produce, of course, far less income, approximately 2.0% currently. But let us assume that the real need in dollars is for a return that is approximately 4% of the market value. Can the trustee prudently distribute the amount needed? I should think that the trustee could do so. First, if the trustee feels a duty to impartially administer the trust and to try to protect the current value for the remaindermen after inflation, an 80% equity, 20% fixed-income mix may allow a 4% payout at least based on the majority of all long-term periods since 1926, provided that the trustee does not charge too much or cause excessive turnover. Of course we do not have a unitrust here. We have a conventional trust and the need determinations should preferably be expressed in dollar terms, not as a percentage, so we cannot truly form a unitrust in this situation, nor can we have a smoothing rule exactly, but we can respond to the need in a way which takes into account total return investing, modern portfolio theory, and long-term risk and return objectives. The downside of this is the process that must be followed to document the decisions, which are based upon the need of the beneficiary, and are often intrusive, including requests for income tax returns and budgets, which often tends to alienate the trustee and the beneficiary.

In another situation, there may be withdrawal rights that can be used helpfully for this purpose. Let us take another case study, the case of Deceased Donald who had a number of family trusts, but left a marital trust for his widow in the amount of $2 million and other tax-free generation skipping trusts of $3 million:

<table>
<thead>
<tr>
<th>Deceased Donald</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marital Trust</td>
</tr>
<tr>
<td>Residuary Trust</td>
</tr>
</tbody>
</table>

Donald and his family accumulated their wealth by holding on to equities over their lifetimes and passing them on through generations without touching the underlying investments. The problem presented is that three quarters of their entire portfolio was represented in high yielding oil stocks. This of course imposes an important diversification issue, but with Donald's death, we have an opportunity to diversify because of the step-up in cost basis of the assets which were taxable in his estate. Let us assume that the marital trust involved was an old style marital which gave the surviving spouse the right to withdraw principal at any time. What might
we be able to do to both diversify Donald's family's investments and continue to provide amply for their needs?

First, because the assets passing through his estate received a new step-up in basis under Section 1014, any of those assets could be sold without significant capital gains difficulties. The problem is, how to replace the yield of the oil stocks if we diversify? The answer is fairly simple. Implement the diversification by selling the oils which have a stepped-up cost basis, invest the proceeds of the sale of the oil stocks into a highly diversified portfolio designed to match the family's risk and return profile, but simply withdraw on an annual basis from the marital trust the amount which responds to the surviving spouse's cash flow needs. The decline in accounting income from the loss of the oil stock dividends can be easily made up for by a modest amount of "stock pruning" as we have discussed previously. And by using her new cost basis and the low capital gains tax rates, this will give his surviving spouse a higher after-tax income than would be available and a much safer investment portfolio. Once again, we can respond to a need for income by looking for flexibility in the powers of the trust itself.

2. The Need for Statutory Reform - A Unitrust Conversion Statute

Many other trusts, however, lack the flexibilities of the ones described above and for those trusts there is no relief except through the passage of the UPAIA and Section 104 or by the passage of a statute which would allow conversion of an income rule trust into a unitrust. Attached as Appendix 8 to these materials is the portion of the Pennsylvania Statute which allows a trustee to convert an income only trust into a 4% unitrust with a three-year smoothing rule under a relatively simple process unless a party in interest were to object. By allowing a simple default model of a 4% unitrust with a three-year smoothing rule, we afford trustees a relatively simple means of getting from here to there and one that everyone would be able to understand easily. It is submitted that such a statute should be considered, particularly where Section 104 is not available, as has been done in Delaware, Illinois, Iowa, New Hampshire and South Dakota, or as a supplement and alternative to Section 104 as has been discussed previously and has been adopted in Alaska, Colorado, Florida, Indiana, Kentucky (as an adjustment), Maine, Maryland, Missouri, New York, North Carolina, Oregon, Pennsylvania, Virginia and Washington.

The Final Regulations make the need for an alternative unitrust definition of income even more clear. Without adequate statutory support, the marital deduction is unavailable even for new trusts, unless the “income if greater” provision is added to the trust. It is submitted that the “income if greater” formula should be avoided if possible, as there may be markets in the future in which this formula may produce the same investment conflicts which the unitrust was intended to eliminate, or at least minimize. And in the case of the QDOT, where a distribution of “principal” is particularly “taxing”, it is completely clear that a unitrust marital is unavailable without statutory unitrust support. If the power to adjust is available, it could be used in a similar fashion, but its use in this context may be a bit more stressful than in other contexts, because of the possibility of the imposition of federal estate tax if the exercise of the power to adjust, (“generally” approved as a definition of income) were to be disapproved if exercised too aggressively in this context. One might expect that an exercise in the range of 3-5% in a manner
similar to a unitrust ought to be considered an acceptable exercise in this context as it is in a unitrust context if a unitrust statute were available.

The addition of a unitrust statute should take into account the previously discussed suggestions for changes in the various types of total return statutes available throughout the country, particularly incorporating the need to address unitrusts which are drafted as unitrusts, as contrasted with income trusts which are converted to unitrusts.

Reformation or modification of income only trusts to unitrusts has also been allowed under the supervision and with the cooperation of courts across the country. The legal basis for such a modification or reformation may be a frustration of purpose of the trust, or may be some other statute that gives the court the power to make a special allowance from principal. Increasingly, more and more trusts have been modified into unitrusts at the request of beneficiaries or as a result of litigation between the beneficiaries and the trustees because of the conflicts described in these materials. However, such reformations should in future be approached with great caution from a tax standpoint, particularly as noted below, as Treasury specifically reserved in the Final Regulations the possibility of raising the specter of loss of GST grandfathering, of a possible gift, or a sale or exchange of the income interest.

3. Cautionary Notes – GST and Valuation Matters

It is important to note that if the trust involved is grandfathered for generation-skipping transfer tax, conversion to a unitrust by court reformation may draw into question whether such a modification, because it affects the value and timing of the distribution to the beneficiary, would be construed as causing the trust to lose its grandfathered status. "Final" GST regulations were issued at the end of 2000 with respect to trust modification to attempt to clarify a variety of trust modification issues. Such a modification, according to these regulations, would not deny the trust its grandfathered status provided two requirements are met:

(a) There must be no extension in vesting of generation-skipping interests, and

(b) There must be no shifting of benefit to a lower generation.

Conversion into a unitrust does not extend the vesting of GST interests. Nor should the second requirement be a problem since the conversion into a total return unitrust will almost always raise the amount of money going to the current beneficiary. For example, when we try to convert an income rule trust earning 2% for the income beneficiary to a 4% total return unitrust, it is pretty obvious that the income beneficiary is not transferring an economic interest to the remaindemen. The income beneficiary will be getting twice as much with the court reformed TRU. Despite the fact that it seems obvious that such a transfer is not shifting an economic

416 A possible basis in Pennsylvania for example is §6102(a) of the Probate, Estates and Fiduciaries Code which allows for "An allowance from principal to one or more beneficiaries" provided that the original purpose of the trust cannot otherwise be carried out and such allowance "more nearly approximates the intention of the conveyor." 20 Pa.C.S. §6102(a).
benefit to the remaindersmen, a look at the valuation tables used by the Service interjects some doubt to this seemingly evident result. For example, an individual with a life estate at age 75 has an income interest supposedly worth 35.33% at a 4.6% section 7520 rate. A 4% TRU has a value of only 33.13% and a 2% TRU, the closest thing to what today's income beneficiary may actually receive, is worth only 18.75%. So arguably by changing an income rule trust earning 2% to a 4% TRU we have decreased the value of the income beneficiary from 35% to 33%, hence the IRS could argue that the reformation transferred benefit to the remaindersmen, even though it did not. The real problem here is that the IRS tables assume that the section 7520 rate (4.6% in this example) is the rate the income beneficiary receives. That of course if far from the truth and really points out the fact that the Service's life estate tables grossly overvalue the life interest. The unitrust tables in fact work fine but they are undervalued compared with the life estate. Currently, the Section 7520 rate is only 4.6%, and thus is coincidentally closer to reality, but that is all that it is, coincidence. The Section 7520 rate has nothing to do with the “income” in a particular portfolio. It assumes that the “income” in the portfolio is equivalent to an interest rate function, and within this premise must be the assumption that either the “income” is equal to the total return, and that the income beneficiary gets all of it, or that there is some other “principal” return, and if there is, this return is ignored completely. The Service’s valuation premise of regular income interests is fundamentally completely flawed.

In response to these worries, we could reform the trust to allow a distribution which is the greater of the income or the TRU distribution. That way the current beneficiary's interest could never be less so that there could not be a transfer of a benefit downstream. Nor is it likely that there would be a transfer of beneficial interest from the remaindersmen to the life beneficiary since their actuarial interest using the Service's tables should be unchanged.

The final GST regulations allow the unitrust or income approach, whichever is greater where the higher distribution is not shifting a benefit to a lower generation. Where there is a change in the state law definition of income to allow a unitrust payout in lieu of income, the Final Regulations under 643 discussed previously will expressly allow the change without prejudice to the GST grandfathered status. Where a reformation or modification is performed in a state without a state law allowing a unitrust definition of income, the former income or unitrust interest, whichever is greater approach allowed by the final GST Regulations would be required.

While the modification of a GST grandfathered trust in a state without a unitrust conversion statute is likely to be safe for GST purposes if the “income if greater” approach is taken, the Final 643 Regulations make it altogether too clear that it may not be safe for gift tax purposes or as a sale or exchange as discussed previously. As a result, it is likely to be simply unsafe to convert an income trust to a unitrust in the absence of a supportive state statute without a private letter ruling.

XVII. VARIATIONS ON A THEME - UNITRUST VARIATIONS - JERRY HORN'S "GIVE-ME-FIVE" UNITRUST

Jerold Horn has made several excellent suggestions for planners wishing to vary the unitrust theme in his articles on the Prudent Investor Rule.418 In his treatment of the subject,

418 HORN, supra n. 11.
Horn suggested a variation to a private unitrust model which he calls the "Give-Me-Five" unitrust. It is a logical adaptation of the "five-and-five" power by giving the beneficiary what he calls the "Give-Me-Five" unitrust model. In this model the beneficiary receives nothing automatically, and has the right, but not the obligation, to withdraw up to 5% of the value of the trust. By virtue of Internal Revenue Code Section 2041(b)(2), the lapse of that power, if unexercised, would not be a taxable transfer. This trust may be a valuable addition to our tool chest. And of course it could be used with a smaller percentage than 5% if that were desirable. It puts the freedom to choose on the beneficiary and therefore does not provide a "method" mandated by the testator. But that is not necessarily bad. It depends on where the settlor wishes to be on the continuum in-between safety and certainty on the one hand and freedom and flexibility on the other. For those drafters who already use a five-and-five power in connection with their trust planning, the income and gift tax consequences of such a withdrawable power are no stranger, but they should be evaluated before selecting this Give-Me-Five unitrust model.419

Horn's suggestion, however, should not be confused with simply adding a five-and-five power to an income rule trust however. While the five-and-five power clearly does create some additional flexibility, it leaves the trustee with the same conflict in choosing our investments and which determine investment "income." Further, 5% plus the income is too much to distribute if the withdrawal power is exercised and if one wishes to preserve the real value of the trust. The Give-Me-Five unitrust is a helpful addition to the planner's tool chest, but the five-and-five power along with income may still be problematic.

XVIII. THE GARLAND AND HERTOG - LEVINE STUDIES - TRU BUSTERS

Jim Garland and David Levine have been outspoken critics of the total return unitrust since the articles by this author and by Hoisington and Horn have brought the matter to the attention of estate planners. Indeed, Joel Dobris in his articles about spending rules and modern trust design discussed private unitrusts even earlier, but seems to have turned away from them in favor of Section 104 of the UPAIA, of which he was a Co-Reporter. Indeed the charitable remainder unitrust goes back to the 1969 Tax Reform Act and to even earlier articles suggesting the concept.420 But the dominance of total return investing today together with the historic decline in dividend yields makes unitrusts more important. And today we can couple our planning with the ability to use computers to analyze different distribution methodologies. This makes their advantages both striking and demonstrable. But before we discuss Garland and Levine's current views on unitrusts and why they do not like them, let us review their past work and academic contribution to the area.

419 HORN, supra n.11, at 46-53 (discussing the considerable tax complexities). In short, the IRS has suggested that the 5% of the trust included in the power holder's taxable income is cumulative each year, and the payment of that mandated tax may be a gift back to the trust. See id. at 52. The gift back argument in this context is eliminated by Rev. Rul. 2004-64.

A. GARLAND REJECTS INCOME RULE TRUSTS

Several important studies have addressed returns after taxes, costs, and inflation. The first of these was an article by James P. Garland.421 In his article, Garland examined various rules for determining how much to spend from endowments and trusts, including "market value rules," which direct a distribution based upon the market value of the portfolio, and the "spend all the income" default rule. Garland rejected the spend all the income rule because the rule "totally dominates the asset allocation policy."422 Such policies tend to produce the popular 60% equity and 40% fixed-income mix, which provides a reasonable flow of accounting income and some potential for growth. The difficulty, as Garland pointed out, is that during times of significant inflation, the stock portion of the portfolio cannot appreciate fast enough to balance the bond component, which does not offset inflation. Consequently, Garland concluded that the spend all the income rule "cannot tolerate even modestly high inflation."423

B. GARLAND RULE SUGGESTS 100% OF THE STANDARD & POOR'S 500 DIVIDEND YIELD AS THE BEST STANDARD FOR SPENDING FROM A TRUST

Garland criticized the use of market value spending rules because of the potential for distribution volatility.424 In his quest for what he believed to be an ideal spending rule, Garland focused on the dividends of the S&P 500 companies as a potential income stream to which one could peg the distributions from a foundation or trust.425 For a non-taxpaying foundation, he established a spending rule of 125% of the yield of the S&P 500.426 For taxable accounts, he concluded that spending 100% of the S&P 500 yield times the market value would be an appropriate spending policy that would be smooth, stable, and, for most periods, keep pace with inflation.427 Garland also pointed out that investment expenses, such as trustees' or managers' fees, should be subtracted from the distribution.428 Furthermore, he suggested that the bond yield begin with the S&P 500 dividend rate - not the interest received - and be reduced by the amount that total returns on stocks typically exceed bond returns.429

C. THE GARLAND RULE IS CONSERVATIVE, BUT UNHELPFUL IN PRESENT MARKETS

Adopting a Garland-type approach to distributions from trusts would produce a smooth, stable stream of income. Unfortunately, under today's market conditions, it would produce virtually no income. With the S&P 500 currently yielding 1.67%, the trustee's fee would in some cases eliminate the distributions altogether! Adding bonds would actually reduce our ability to

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422 Id. at 52.
423 Id. at 53.
424 Id. at 59.
425 Id. at 58.
426 Id. at 56, 58-59.
427 Id. at 57.
428 Id. at 56-57.
429 Id. at 57.
produce a stream of income because total return from bonds is typically less than from stocks. Nonetheless, recognition of the way dividend yields seem to track inflation and the smoothness of that income stream is important. In a charitable trust or endowment not subject to tax, Garland recommended spending 25% more than the accounting income by liquidating a portion of the portfolio at appropriate intervals. Even though he did not note the considerable tax advantages of that method for a taxable portfolio, the methodology is identical to the stock pruning described in these materials.

**D. HERTOG AND LEVINE CONCLUDE 5% SPENDING IS TOO HIGH**

Roger Hertog and David A. Levine of Sanford C. Bernstein & Co., Inc. also authored an important study on investment returns and spending. Acknowledging that the most powerful determinant of investment return over time is asset allocation, they demonstrated that taxes, inflation, and the need to spend some accumulated money are critical obstacles to building personal wealth. In their detailed study, Hertog and Levine excluded the 1950s, which began with common stocks yielding more than 8% and intermediate treasuries yielding 1.3%. By the end of the 1950s, that relationship had reversed itself with dividend yields less than 3.5% and bond yields at 4.5% to 5%. The authors examined a hypothetical investor with $1 million to invest, spending 5% annually from 1960 to 1994 with a portfolio with 60% in equities mimicking the S&P 500 and 40% fixed income in municipal bonds. Although their hypothetical investor's spending policy appears sensible, it is really too high because of the effects of taxes, inflation, and a 60% equity, 40% fixed-income investment mix. While the investor spent 5% and invested conservatively, taxes and inflation reduced the real value of the investor's estate by 50%. A 5% spending policy after taxes and expenses would be the equivalent of about a 7% unitrust distribution. Not surprisingly, the investor was unable to keep up with inflation.

Hertog and Levine then compared a 3% of assets spending rule with an income rule and a modified Garland rule calling for the distribution of bond income less the prior year's inflation. While the authors concluded that the 3% of assets rule was not calamitous, they believed that a modified Garland rule was the best of the three for most investment mixes, except the 20% stock and 80% bond investment mix, which produced an extremely volatile distribution. Unfortunately, in setting their comparative budgets, Hertog and Levine allowed the portfolios using an income rule and a modified Garland rule to pay out considerably less income at the beginning, which impairs the fairness of the comparisons. Although asset-based distribution formulas, like unitrusts, are somewhat self-adjusting during good and bad years, a higher rate of distribution produces greater volatility of distribution and a smaller total return over long periods.

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430 Id.
431 Id.
432 HERTOG & LEVINE, supra n. 318.
433 Id. at 16, n.2.
434 Id. at 12.
435 Id.
436 In the all-equities comparison, the authors compared the results of a 3% spending rule to those of an income rule, and a modified Garland rule, both of which had an initial payout of 2.2%. Three percent is 36% higher than 2.2%. In their analysis of the 60/40 balanced approach, a 3% unitrust payout began 20% higher than the income spending rule and 50% higher than the modified Garland rule. Id. at 13.
of time. These correlations result from a loss in the compounding effect of an initial lower payout.

E. HERTOG, LEVINE, AND GARLAND DO NOT TELL US WHAT TO DO IN A CLIMATE OF VANISHING DIVIDENDS

The difficulty with using the Garland rule or a similar rule based on the S&P 500 yield is that the yield has declined to a point which no longer represents a sensible proportion of the total return or even company earnings. Undoubtedly, if beneficiaries could consume only the S&P 500 dividend yield of 1.6% less the trustees' fees, then that minuscule return would be very smooth and stable. This is little consolation to a disappointed trust beneficiary. Nevertheless, the Hertog and Levine study is important because it reinforces the importance of taxes, expenses, and spending on return. Furthermore, their data, though described and derived somewhat differently, appears consistent with data presented in these materials.

F. RECENT UPDATES TO GARLAND AND LEVINE VIEWS THE TRUST BUSTERS!

1. An Update of Jim Garland's Views

The author has had the pleasure of corresponding with Mr. Garland over several years since the author's articles first appeared. Mr. Garland continues to disfavor unitrusts and finds them as un-useful as the author finds them useful. It is important however to note a number of points on which Mr. Garland and the author agree:

(a) The income rule trust does not work and causes over investment in bonds to the detriment of the financial health of long-term trusts.

(b) Over the long term, stocks are likely to allow the trust to spend more than bonds while retaining sufficient growth to maintain its real value in nominal and in distribution-producing capability. In a more recent article, Garland outlines his continuing concerns about unitrusts. His article chronicles the movement in favor of unitrusts and equates it to the period in the late '60s when the concept of the unitrust was born. He specifically discusses the Ford Foundation, which financed several significant studies that popularized the idea of total return investing and allowed the trustees to invest more heavily in equities. The Ford Foundation, following its own advice, invested more heavily in equities and then found itself in a dilemma as a result of the bear market of the 1970s. Indeed, as Garland points out, the real bear market of the '70s started in 1965 when the S&P 500 index actually hit its high point in inflation-adjusted dollars. It was not to regain that level after inflation until 1981. In effect, in real terms, 1966-

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437 Hertog and Levine used actual income and capital gains tax rates. Those rates are historically more correct, but, perhaps, less predictive of the future. The authors also assumed that the taxpayer had other taxable income exactly equal to the taxpayer's deductions. Furthermore, the authors approached the equation from the spending, rather than the distribution, point of view. Because of insufficient detail in their article, it cannot be determined whether the assumptions concerning the calculation of capital gains taxes or portfolio turnover are equivalent to those used in these materials.


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1981 was a fifteen-year bear market. Garland thinks today's consideration of total return unitrusts reflects the same type of fad:

“A natural but unfortunate result of a long bull market is a commonly shared belief that such a market will never end. Just as the bull market of the 1950s and 1960s spawned an interest in total return spending, so has the bull market of 1980s and 1990s spawned this interest in unitrusts.439”

While it is clearly true that the high returns from equities spawn interest in any methodology that will allow the trustee to invest for a higher total return, it is certainly not the case that this author has ever contended that the bull market was permanent. More obvious yet since we have already undergone a three year bear market since it went away, and are arguably on to the next bull market. That is why we have from the beginning taken pains to model out the results of using a unitrust starting in 1973 which illustrates the effects of a severe bear market. It is also important to note that we do not espouse a conversion of a conservative portfolio to a 100% equity portfolio, particularly where the portfolio cannot withstand the volatility. And this apparently is what the Ford Foundation itself experienced. There is nothing worse than the whipsaw of bad timing. Indeed the Ford Foundation, which was nonetheless pretty substantial with current investments of $9.8 billion according to its 2003 annual report, but likely it has still not recovered all of its 1972 value in real terms.440 If one changes the asset allocation to all equity when the market is very high and then sells out or becomes more conservative when the market is low, that really will cause a problem, but the problem is not with the unitrust. The unitrust only frees the trustee to make these decisions. It does not tell them to disregard risk and only think of return. And the Ford Foundation still used a remarkably familiar distribution rule taking into account the excise tax on private foundations and “… an internally derived formula equal to 5.8 percent of the average value of the investment portfolio over the previous 36 month period” as of 2002441 There is no reference to such a policy in the 2003 annual report, though the expenditures of $552 Million continue to appear to be in line with the prior announced policy. Apparently the trustees do not find even now that a unitrust payout is undesirable!442

439 Id. at 2.
440 See the historical data from 2002 annual report available at the Ford Foundation website at http://www.fordfound.org. Notably, this discouraging fact could not be found in its 2003 report, though it is no doubt still true, with the Foundation relatively conservatively invested with less than 50% invested in public equities at the end of 2002 and less than 55% in public equities at the end of 2003.
441 Id. See “Introduction to Financial Statements” under “Financial Information” at the Home Page.
442 Indeed in 2001, the value shrunk to $10.6 Billion, a 26% decline, and to $9.1 Billion by the end of 2002, leading one to wonder whether their timing and asset allocation were once again less than perfect. But actually, much of it was a result of additional spending opportunities. “Occasionally the foundation will exceed both benchmarks to address a unique program opportunity. In fiscal 2001 the foundation launched the International Fellowship Program (I.F.P.) and made $280 million in grants related to this major initiative. As a result, the foundation's qualifying distribution exceeded 7.2 percent of its average asset value in fiscal 2001. In fiscal 2002, the payout ratio was 6 percent.” Id. Spending foundation monies on charitable endeavors is not, after all, a bad thing. Spending trust funds on the beneficiary of the trust is not necessarily a bad thing either, even if it leads to a reduction in the real value of the trust. Trusts do not and should not exist for their own sake, but for the sake of their beneficiaries!
Garland makes several additional points in his article that should be noted:

(a) A three-year smoothing rule is supposed to protect against bear markets. This author makes no representation that a three-year smoothing rule protects against bear markets. On the contrary, a true bear market is a market that is long enough that even with the three-year smoothing rule the distributions will go down. Indeed, the TRU protects the trust by decreasing the distributions during most bear markets if it lasts longer than a year. This decrease by design is important because it protects the trust from permanent depletion. We have seen ample evidence of what happens when we do not do this.

(b) For taxable investors there is no "excess" capital gain. Garland concludes that while there is some excess capital gain there is very little:

“In practice, however, charges to trust capital - trustees' fees, investment managers' fees, and especially capital gains taxes - tend to consume most if not all of this "excess" capital gain. Our own simulations suggest that the excess capital gain for typical taxable all-equity trusts during the past fifty years essentially has been zero. We suspect that it will be close to zero in the future.”

This author respectfully disagrees, but read on. An 80% equity/20% fixed-income rule trust distributing only dividends and interest from 1926 through 2002 with 1% trustees' fees, current capital gains rates and an index-like turnover beginning with $100,000 would be worth $1,823,212 at the end of 2003. This is almost 80% more than what would have been necessary to merely kept up with inflation. But that is with an 80/20 mix. With a 60/40 mix an income rule trust has no excess capital gain from 1926 through 2003. In fact, it shows a loss of 9% in real terms. The same result would obtain with a portfolio with excess turnover or any significant degree of market underperformance. This is not a necessary result, since low cost and low turnover index funds are available for virtually all market classes. It simply requires that the trustees acknowledge that they can’t beat the market, and simply structure a highly diversified portfolio in line with modern portfolio theory. There is no doubt, however, that Garland is correct in pointing out that taxes, expenses, and excessive bond holdings make it very difficult to spend very much and preserve the real value of the trust.

(c) Unitrusts are Bets on Market Values. Garland points out that unitrusts base their spending on market values that are both unpredictable and uncontrollable, while income in the trust is something the trustee can to some degree control. The author respectfully disagrees since the inability of the trustees to deal with the income problem today is the whole purpose behind this inquiry. Trustees certainly cannot control declines in dividend yields nor can they control interest rates. They are trapped within the trust vehicle in which they must operate. Trustees can get help from Section 104 if their state adopts the UPAIA, but their “freedom” in the absence of such change is illusory. It is a “freedom” that only gets in the way of good investing in virtually any market.

443 See GARLAND, supra n. 336, at 3.
(d) **Unitrusts Will Lead to Market Timing.** Garland notes that trustees of unitrusts will be concerned about investing too heavily in equities since a bad market will force a decline in distributions. He posits that the income beneficiary may be a widow who plans to live off the trust distributions and hopes to be able to pass the trust capital onto her children. If the current distribution provides "just-enough-income" the trustee may be afraid to invest in equities because the widow cannot afford to take the cut.

This argument seems backwards to this writer. The greater danger in unitrusts would be that the trustee would become too enthusiastic with the freedom which a unitrust provides and engage in too much risk taking, followed by excessive conservatism, quite possibly what happened to the Ford Foundation. And if the unitrust gives "just-enough-income" to the widow, what would Garland propose? Unfortunately, what he proposes is a "never-enough-income" trust. The better solution that he describes is still a distribution of dividends from stock and "real interest from bonds" as proposed by Hertog and Levine and discussed below. What he proposes is that not only should the trust beneficiary be satisfied with the dividend yield of stocks, but that as to bonds, the trustees should subtract from the current bond yield the effects of inflation and expenses prior to determining an appropriate distribution from the bond portion of a portfolio. This makes logical sense, but if applied to today's 5.02% long-term Treasury Bond, it would result in some simple but hard to swallow mathematics. The beneficiary would be able to enjoy 5.02% less 1.94% (the average of the last three years of inflation) minus 1% (trustees' fees) minus 1.19% (the taxes on the retained bond interest-3.13% less 38% tax equals 1.94% needed to offset inflation) or a net yield of minus .89%. Though conservative to a fault, this would only make the situation worse for the income beneficiary and for the trustee trying to invest the trust and still produce an adequate return.

This author's bottom line conclusion on Garland's attack on unitrusts is that his system would work well were it not for the fact that the beneficiary would starve on the distribution prescribed, and starving clients are not happy clients. And a distribution method that produces starving, unhappy clients is not "ideal," no matter how smooth and theoretically sound it might be.

2. **David Levine's More Recent Positions**

Again, it is well to look at those things that we agree upon before examining those on which we do not. Levine, like Garland, agrees that equities under any sensible spending rule will produce a steadier spending stream with higher spending than bonds for "virtually all portfolios at virtually all times." A second point is that neither of us disagree with the other's back testing calculations. We disagree about the conclusions to be reached from them. Levine's original article and his more current memoranda which were distributed in connection with the proposed New York legislation, deal with spending rather than distributions. This is a natural enough distinction since he is an economist and the author is a trust and estate lawyer, but distributions are the more pertinent inquiry when discussing trusts. Distributions will always be more or even substantially more than what one can spend because of taxes.

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444 Memorandum of David Levine to Jerome Levine et al. concerning proposed unitrust legislation dated April 6, 1999 (on file with author).
Levine urges the use of what he calls the modified Garland rule in which the bond portion of the portfolio as described above, has subtracted from its yield both expenses and inflation. While theoretically sound, it would increase the difficulties for a trust beneficiary today and produce "an extremely volatile spending stream."  Indeed Mr. Levine's own data as taken from his prior article shows the excessive volatility of the modified Garland rule even for the relatively stable 60/40 "fiduciary portfolio."

![Year-By-Year Nominal Budgets (Modified Garland Rule)](image)

Even without the three-year smoothing rule, a unitrust for this period looks a lot smoother and more sensible. See the graph which follows.

Probably the strongest argument that David Levine makes against the use of a 4% unitrust as a default standard is simply that the rate of return on equities in the future will be dramatically lower than it has been for the past. He forcefully makes the case based on fundamental value economics that because of the expansion of price/earnings ratios and astronomical valuations in the stock market at that time (early 1999), he projected a total equity return of only 5.26% before inflation over the next 20 years. With a projection of the CPI at 2.4% he projects a real return of 2.8%. If he is correct about this, obviously a trust cannot hold its real value paying out more than the 2.8% minus trustees' fees and any other taxes and costs paid by the trust. This would be a very dour prognostication, and would favor heavier investments in bonds and particularly Treasury inflation protected securities. While he was early in calling the current bear market, he was clearly correct in noting that by 1999, the market was grossly overvalued. But does a bear market mean that the next 20 years will be the same? Not likely.

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445 Id. at 8.
It is certainly possible that he is correct in that the real return from stocks will be 2.8% or less in the future. If so, it will be a great reversal from the returns of the past which for the past 200 years have averaged approximately 7%. However, that argues against using a 4% rate more than against using a unitrust. Indeed, in a long and substantial bear market, over time, a unitrust will lower our spending rate and will protect the trust much better than would any other method of distribution, because other distribution methods do not automatically decrease the distribution during market declines. A severe bear market could potentially be the same scenario as we modeled in the 1970s. Such a possibility is the reason that we spent so much time examining it.

Garland and Levine place great reliance on the S&P 500 dividend rate as a polestar. With the S&P 500 current dividend yield at 1.67%, the payout ratio of dividends to corporate earnings for those companies has remained near its historic low. Despite record high earnings on the S&P 500 for 1999, dividends represented only 32% of earnings—the lowest payout ratio in the seventy years since the S&P 500 began keeping those records. And 2000 yielded an even lower ratio, just under 29%, as shown on the following graph, before it increased to just over 40% in 2001, declined to a bit under 30% in 2002 and then increased modestly to 31.8% in 2004.

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446 See Infoseek: Newscenter Article, Business Wire (October 1, 1997); S&P 500 earnings were $50.82 and dividends were $16.32 for 1999— a payout of 32.11%; (data from Bruce A. Guiot, Vice President and Director, PNC Advisors Trust Company).
Significantly, in no small part this appears to be a reflection of total return investing and tax consequences of corporate share buy-backs, which was a more favorable use of the money for investors than simply raising dividends. The graph which follows shows the S&P 500 dividend to earnings ratio. At the time of the original Garland article, the payout ratio of dividends to earnings was about 48%. In 1992, it rose to 70%, more than double the 1999 ratio. While one wonders what the payout ratio might be if all earnings were more conservatively (correctly?) stated, even if earnings were overstated on average by 10%, the ratio would still be very low on historic standards.

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447 Dividend data of $17.39 in 2003 out of $54.69 in operating earnings from Standard & Poor's Website http://www2.standardandpoors.com/spf/xls/index/SP500EPSEST.XLS.
448 See INFOSEEK, supra note 446.
Perhaps there is no perfect measure of an appropriate proportion of return to consume or distribute to the life beneficiary. If one's goal is to keep a payout reflective of increases in the beneficiary's living expenses, an indexed payout trust accomplishes this goal. This will require great care, however, to avoid exhausting the funds that support the indexed payment. If the goal is to share the return between current beneficiaries and remaindersmen, no rule is likely to be more effective than the total return unitrust.

Most importantly, neither Garland nor Levine gives us a sensible alternative to a unitrust in the current environment. The unitrust provides a unity of interest between the current and remainder beneficiaries and the trustee, protects the trust in the event of a protracted bear market, and produces dollar averaging results that increase the total return when markets go up and down as they most certainly will do.

3. **What About Dividend Growth and JGTRRA? Will the Dividend Return as the Polestar?**

Even before the passage of JGTRRA, dividends were beginning to get increased attention during our bear market because in general higher dividend yielding securities may act more defensively. To some degree, this did increase interest in dividend producing stocks, and JGTRRA will likely do so considerably more, as corporations find that returning profits to shareholders in the form of dividends will be popular whenever using the money for increased dividends is a good choice as opposed to direct reinvestment of the corporate earnings in the business. As of August 11, 2003 a total of 1101 companies have increased their dividends or initiated a dividend, significantly more that was the case in 2002.449 Interestingly, though, the market and investors have appeared to be unswayed by mere increases in dividends, and have remained more growth oriented than dividend oriented.

A Goldman Sachs study notes that of companies in the S & P 500, 275 companies raised their dividends in 2003, 40% more than in 2002.450 On the other hand, those companies that raised their dividends more than their long term trends actually underperformed for the first part of 2004.451 Clearly, while JGTRRA will encourage dividend increases, its strongest effect is probably to produce market efficiency as to the use of the money.452 Prior to JGTRRA, funds that were paid out in dividends were actually penalized by a lack of any corporate tax deduction, and taxation at the shareholder level as ordinary income, as opposed to the capital gains rate they would have paid if the funds were reinvested and eventually enjoyed as a higher sales price for the stock. With JGTRRA, the decisions made by my corporate managers can be more influenced by sound investment principles—where is the money best and most fruitfully employed; by reinvestment, by share buy backs or by dividend increase? This likely increase in the importance of dividends as a form of investment returns from stocks should have a beneficial effect on

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451 Id.
corporate finance and governance overall, despite the criticisms by some that the tax cut will inevitably reward the already very rich founders and CEO’s of companies disproportionately.453

JGTRRA is likely a very healthy event for the investing public, and will undoubtedly increase the portion of earnings that are paid out in dividends. However, it is highly unlikely that dividends will return as a polestar for value, as suggested by Garland. As shown by my previous analyses of stock pruning, growth in value can always be enjoyed on a basis that is more favorable than its stated tax rate, because of the effect of cost basis. Whatever portion of the investment gain is pruned by the investor, a part, and most frequently, a large part, of the proceeds will represent a return of cost basis, and that will continue to make the long term capital gain more favorable than the dividend, even if the tax rate is the same.

We can analyze this effect with the spreadsheets developed for Table 1 and Table 2. You may remember the comparative graph of three portfolios with an equal total return of 8%, the first with taxable fixed income, the second an equity portfolio with a 2% dividend and 6% growth each year in a pre-JGTRRA tax environment, and the third the same equity portfolio in a post-JGTRRA tax environment.

What would happen if instead of the 2% dividend and 6% growth rate we assumed to compile the above graph, we instead used 8% growth and no dividend? Will JGTRRA equalize our results, or penalize our investor for investing in a non-dividend paying stock? Let’s see:

Clearly, JGTRRA has less effect for a non-dividend producing stock than for a dividend producing stock, as the lines are much closer together in terms of after tax income. But we notice something else at the same time, do we not? And that is that the after tax income is greater, both pre and post JGTRRA for the non-dividend producing stock than for the one that pays a 2% dividend yielding stock. And we might have known that before, since, after all, we knew that the effects of stock pruning were to decrease the rate of tax to a higher proportion of capital gains and a lower portion of ordinary income, but also to defer that tax significantly, because of the use of cost basis in the stock pruned.

Let’s take a look at the comparative totals of after tax income pre and post JGTRRA for fixed income, and a stock portfolio, all with 8% total return, but with different compositions; alternative 0%, 2%, and 4% dividend rates, and corresponding 8%, 6% and 4% growth rates.

First let’s look at the comparison prior to JGTRRA:
When it comes to after tax returns, for an equity investor, if total return is held equal, then lower dividends are clearly better than higher dividends, and by no small margin! The zero dividend portfolio beneficiary receives 29% more income than the beneficiary of a 4% dividend portfolio. Clearly, JGTRRA will materially change the equation of tax benefit, but as we will see on the graph that follows, it by no means eliminates the benefit of dividend reduction, essentially the benefit of deferral of the tax until significantly later on by the gradual use of the portfolio cost basis:
Post JGTRRA The Effect of Dividends on After Tax Returns-Net After tax Income From $100,000 at 8% Total Return With 4%, 2% and 0% Dividend

<table>
<thead>
<tr>
<th></th>
<th>0% Dividend</th>
<th>2% Dividend</th>
<th>4% Dividend</th>
<th>Fixed Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Net After Tax Income</td>
<td>109,194</td>
<td>105,997</td>
<td>101,245</td>
<td>72,378</td>
</tr>
</tbody>
</table>

In fact it not only does not penalize our investor, it continues to reward her, because the taxation on the return is deferred to a larger degree because of an increased use of the stock cost basis. However, JGTRRA produces a much more level playing field for corporate decision makers to decide upon the use of corporate profits. This, it is submitted, is good tax policy, rather than virtually forcing corporate managers to avoid dividends because of the almost punitive taxation scheme which allows no deduction for the dividends and then taxes them as ordinary income.

One might logically ask whether or not the increased use of cost basis in the non-dividend producing stock will not cause increased capital gain at the end of the 20 year period, if you were to sell the entire portfolio and pay the capital gains tax. And the answer to this is “Yes”. But it is still an advantage! If one were to compare a 4% dividend yielding stock with a non-dividend producing stock, the recovery of cost basis would allow the use of a 3.6% distribution rate, which would still produce more after tax dollars for our beneficiary each and every year than a 4% distribution with a 4% dividend rate. At the end of the 20 year period, the non-dividend producing stock with the lower 3.6% distribution rate would also produce more dollars after tax if the entire portfolio is sold, netting $208,722 versus $201,245. All told, the net after tax income of our non-dividend producing model is $311,105, versus $302,491, a 3% increase. And if the portfolio were not sold, but were to receive a step up in value at the death of the beneficiary, the increase would be 8%.
The foregoing differences are not great, compared to the differences between the fixed income and stock portfolio, but they underscore the beneficial effects of both JGTRRA, and the continued advantage of growth.

G. TOTAL CHAOS, MISAPPLYING TOTAL RETURN TRUSTS

Another article highly critical of total return trusts was published in Financial Planning Magazine by Frank Croke. In these materials, Croke lumps all total return trusts together as total return unitrusts and asserts that they are being used as "one size fits all" form trusts, usually paying out 5%.

If this were true, this author would heartily agree that the use of the same type of trust for everyone would be a disservice to our clients. In response Croke advocates what he calls the "planned income trust". This planned income trust would increase the distribution by 3% or, if the CPI index increased by more than that, by the appropriate CPI increase. He then correctly points out that the income would be much smoother on an inflation-adjusted basis using this methodology. The difficulty with the planned income trust is that it is merely a somewhat more risky variation of the index payout trust, which requires a great deal of capital for a relatively low income need to be safe from depletion over long periods of time. As illustrated earlier, 40% of all of the 30 year or shorter rolling periods would result in a completely depleted trust with an inflation indexed payout of 5%, so while a unitrust payout is far more volatile, it is most considerably safer if the payout need is to approach 5%.

He also notes that total return trusts have a potential for depletion when selecting an annual payout of 8% or more. This is absolutely correct. In fact at 8-1/2%, the value of the portfolio would be preserved in only 14% of the 20 year period since 1926 That level of payout, while it may seem plausible to the investor used to bull market returns, is simply too high for long-term planning:

The concept for most laws is to provide a uniform code that will apply to all situations, but this does not apply to estate planning and should not be the controlling factor. A trust should be tailored to the individual wishes of the grantor to satisfy the family requirements. The grantor is in a better position to know what is required than either the attorney or the form trust. He needs to know that he has the authority to exercise options which will fill his requirements. To obtain the greatest benefit for a family, a trust must be tailored to the individual needs of the family.

With the foregoing, this author unqualifiedly agrees. Clearly, it is important to understand that total return trusts include much more than just total return unitrusts. And the use of the unitrust and other types of trusts which allow the client to specify the payout for the first time bring the client into the trust design process so that they can both understand what may be

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454 Frank Croke, Total Chaos, FINANCIAL PLANNING, May 2000.
455 Id. at 98.
456 More risky because it has a higher payout in low inflation times because it increases the distribution by 3% at a minimum, even if inflation is less than 3%.
457 See CROKE, supra n. 454, at 104.
available to their family member after their death and take a part in the estate planning process in a meaningful way. Using the variety of total return trusts which are available and which will become available over time to planners should enhance the ability to tailor an estate plan to the specific needs of the beneficiary while allowing the trustee to invest for total return. Such criticisms are valid against planners who simply use a form 5% unitrust without considering the needs of the client or their response to volatility. But this has never been the approach of this author. There is never a trust for all seasons. And those seeking to use any of these new forms of trust must be conversant with their economic, financial and tax consequences. An inflation indexed trust like the planned income trust may be an ideal vehicle for the income beneficiary, but the risks of depletion there must be fully considered and revealed to the client unless some device is used for attenuating that risk such as the TRUCAP described and analyzed previously.

H. SIMULATION ANALYSIS BY COLLINS, SAVAGE, AND STAMPFLI

In their interesting article published in the Real Property, Probate & Trust Journal in 2000, the authors apply a considerable dose of probability theory and statistics to analyze the effects of different distribution formulae using different payout rates and differing asset allocations, particularly employing a comparison of risk and return using a highly diversified portfolio against one which consists solely of large capitalization stocks and bonds. They employ a “submartingale” price change model that builds into it a deterministic component, recognizing that capital markets have a propensity to increase in value by at least the growth in their underlying economies, and a “stochastic” component reflecting the randomness of stock movements. The model takes into account the fact that inflation is “sticky” and does not change randomly from year to year, and the historical autocorrelation between individual asset classes and differing inflation environments. This author lacks the mathematical credentials to examine credibly the exact methodology used, and Collins, Savage and Stampfli do not, in any event, reveal the exact methodology used.

Much of the purport of the article concerns the fact that there are significant risks inherent in attaining the goals of preserving value and income stream from the point of view of the current beneficiary and the remainderman even using total return trusts. With this conclusion the author heartily agrees. Indeed, the risk of failure set forth in the Collins article is likely to be considerably understated because of some of the assumptions utilized in that study. Specifically, “[t]axes, investment expenses and other portfolio frictions are ignored.” These factors are extremely important in real world trusts.

In the author’s second article, a 5% unitrust was modeled from 1926 through 1996 with an all equity portfolio. Without these frictional costs, the portfolio ended the period at $5.2 million. Taking them into account, even using a low index like turnover of 5% and today’s lower capital gains tax, the amount remaining was $1.6 million, which is more than enough to keep up with inflation, but not by a lot. Indeed, with a 75% equity–25% bond portfolio, the

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459 Id. at 289-90.
460 Id. at 246.
461 See Wolf 2, supra note 11, at 155.

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portfolio would have declined in real terms by 6%. Without those frictional costs, the market value would have increased by over 200%. Hence, any analysis that does not take these factors into account must not be relied upon in planning for a trust that must contend with them.

A second question is whether the period during which price movements were studied and incorporated into the model, 1973 through 1998, is a sufficiently rich set of data upon which to base the simulation program. That period, for example, did not contain a time in which the economy experienced a deflationary recession or depression such as was experienced in the 1930’s. How can one be sure that such data are irrelevant for the future? Longer and broader data might be needed to reflect truly the statistical risk and return characteristics of portfolios. One must also wonder if the historical negative correlations of the U.S. markets with the highly developed markets overseas are reliable in light of the considerable and growing economic and informational exchange and interdependence of those markets. One must be very careful in examining potential results, whether by historical back testing or simulation testing to adjust for the appropriate frictional costs and to reflect expected values in inflation adjusted terms.

Collins, Savage, and Stampfli favor a flexible distribution guideline rather than a formula, with the trustee relying on the grantor’s statement of goals. They also favor the ability of ongoing portfolio sufficiency testing using a simulation model such as the one they have produced. This author agrees with the utility of the discretionary trust and the importance of the expression of the grantor’s goals in the trust document. However, this author questions the concept of ongoing sufficiency monitoring to determine the ability of the trust to support a certain set of payments to the current beneficiaries. If, for example, the portfolio were to decline by 50%, the monitoring function, without an element of forecasting, would indicate that to preserve the same probability of goal attainment, such as preserving the real value of the portfolio, the distribution would have to also go down by 50%. With the mitigation afforded by the three-year smoothing rule, this is what a unitrust does when the market goes down. The three-year smoothing rule is a beneficiary sensitive provision rather than an economics or market driven rule. A unitrust without the smoothing rule actually will do better in a poor market because the distribution will adjust downward more quickly, but it is not as beneficiary friendly. We must not lose sight of the fact that trusts must be designed to fulfill the real needs of people, not the goals of economists, mathematicians, or even estate planners!

The following graph shows a “hypothetical” bear market in which the three year smoothing rule is illustrated when a portfolio declines from $1.0 Million to $.75 Million to $1/2 million and then back again in a replication of a highly volatile market:

\[\text{SI-260-RBW}\]

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\[\text{462 See COLLINS et al., supra note 372, at 301.}\]
\[\text{464 See COLLINS, supra note 373, at 243.}\]
\[\text{465 Id.}\]
\[\text{466 The first portion of the graph is not as hypothetical as we might have liked!}\]
As you can see, the low point in the distributions is the year after this 50% decline in market value, and the instantaneous payout percentages are significantly different from 4%:

- Start Year—4%
- Year 2—4.67%
- Year 3—6%
- Year 4—3.56%
- Year 5—3.0%
- Year 6—3.67%

If a trustee could do a better job of reacting to the market illustrated above with the benefit of flexibility and computer probability monitoring, I would like to know what the better distribution pattern would be?

The Collins, Savage, and Stampfli article is a valuable addition to the literature in this field because it emphasizes the probabilistic nature of returns and attempts to describe those risks in a highly sophisticated manner.

Collins and Stampfli recently published a shorter follow up Article in the ACTEC Journal. In general, the article discourages the use of income rule trusts and encourages the use

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of discretionary trusts and distribution guidelines rather than formulae. They make, however, at least one statement that appears to be clearly erroneous:

"The net income trust structure has at least one feature that appeals to all interested parties. Absent gross negligence or fraud, it has a built in safety net: the trustee, assuming no distributions of principal, cannot execute a strategy that decreases the nominal value of [the] trust." 468

Clearly that is not the case, as it would mean that in a traditional income rule trust, the value of the trust could never go down, even without taking inflation into account. This is not true unless the trust invested in nothing but money market funds or treasury bills, with all costs being taken from the income of the trust. Obviously, an income rule trust that invests in either bonds or stocks can lose nominal and real value. Indeed, in an all bond portfolio in which a portion of the trustee’s fees or other expenses are paid from the principal of the trust, the trust is virtually guaranteed to do so. For example, a trust invested in an all bond portfolio beginning in 1960 would have preserved the nominal value of the trust for only the first five years while interest rates declined. For the rest of the 42 year period, the nominal value would not have been preserved, and it would have ended up with an 9% decline in nominal terms. In real inflation adjusted terms, that same portfolio would have declined in value by 85%!

Indeed, a 50% equity and 50% bond portfolio distributing income only will be highly unlikely to preserve the real value of the trust portfolio. Over all of the rolling 30 year periods since 1926, the following is a graph of the inflation-adjusted ending market values of such a trust with a starting value of $100,000:

468 Id. at 205.
The last 30-year period in which the classic 50/50 income rule trust preserved the real value of the trust ended in 1964! The only accurate point one can make in the quoted statement by Collins and Stampfli is that the distribution of income only from such a trust will never exhaust the trust. And that is true also of the Total Return Unitrust as well. You can wear a unitrust down, but you cannot wear it out, simply because the unitrust distribution decreases with the market value of the trust in a bear market. This is true of both the income rule trust and the unitrust, but it is certainly not true of the indexed payout trust, which the Collins and Stampfli seems to equate with total return trusts generally in their analysis. The type of analysis they suggest in the face of a high income need which must be indexed for inflation appears to this author to be valuable, particularly in the decision making process of deciding whether a particular payout is likely to be safe from depletion or whether one could afford to make a substantial estate planning gift without increasing risk of depletion to the life beneficiary to an unacceptable level. If the analysis properly takes into account the effects of taxes, inflation and expenses, such a sophisticated computer model can yield valuable insights into the choices concerning distributions from total return trusts, whether they are a function of a prearranged basic formula such as a unitrust or indexed annuity, or whether they reflect the discretionary choices inherent in the fully discretionary trust or the exercise of the power to adjust.

469 See id. at 225-27.
They end their recent article by concluding the following:

Net Income Trusts are inherently flawed and should be avoided.

Total return trusts should have discretionary rather than mandatory distribution formulae. They suggest that any strategy with at least a 90% probability of success would be legally defensible.

Commercial fiduciaries should not provide investment services to total return trusts unless they possess adequate technology to perform sufficiency monitoring. (Author’s note: such as their proprietary software).

The first point is clearly correct. The second point; that discretionary trusts with guidelines rather than formulae should be used is more a matter of opinion, and in this author’s opinion they should be used often, but their use should depend upon the a number of factors which should be taken into account with each client and client’s family. While the use of guidelines clearly will give the trustee more flexibility to respond to future situations and future markets, that very flexibility takes away the predictability of the unitrust, which is quite valuable to the beneficiary, depending upon the key question—who is the trustee? If it is an independent trustee, the guideline approach may work well, but it will create less certainty for the beneficiary, who after all does not know how the guidelines will be applied.

The concept that a 90% probability of success is defensible seems evident enough, but this author suggests that such a probability will not be present in most trust scenarios. If the goal for example is to preserve the real value of the trust over long periods of time, it is likely that a 90% probability will not be attainable without utilizing a very low payout from the trust. An 80% equity/20% bond portfolio paying out 4% would have maintained the real value of the trust in 59% of all of the rolling 20 year periods since 1926. A payout of 1% only brings the historical sufficiency to 76%. It is suggested that a 90% probability polestar is far too rigorous for the real world, though utilization of multiple asset classes would clearly help to increase the probabilities of success as suggested in Collins and Stampfli’s earlier more extensive article. Over 30 year periods, high equity funds seem to have a better chance of clearing this high bar. With an 80/20 asset allocation, the portfolio would have maintained value in 90% of the periods at a 2.7% payout level and with 100% equities, at a 3.5% level. Depending upon one’s confidence in the correlations with the multiple asset classes suggested by Collins et al, these results should be improved, if the future returns and correlations repeat themselves. The data published in that earlier article suffered from a critical defect, however, in not taking into account the factors of frictional costs; specifically taxes and expenses. True confidence levels as great as 90% are likely to be unattainable in the real world, as geopolitical, as well as economic, risks are likely incalculable for the long term. For most people, a likely success rate of 50-60% is sensible in the real world. The real key is to avoid methodologies and plans which don’t work, can’t work, or at least are very unlikely to work. And there are plenty of these to avoid!

Adequate technology should help to provide improved investment services to total return trusts, but the concept of “sufficiency monitoring” does not so clearly help the process in the ordinary course. As pointed out previously, if the trust market value goes down, it is wise to
decrease the trust distribution, which is what the unitrust does automatically, whereas the income rule trust does not necessarily decrease its distribution, but may instead increase the distribution in light of higher interest rates, and the indexed payout trust, which will increase distributions in an inflationary bear market. What the trustee would do with adequate sufficiency monitoring is not clear from the articles, but unless the monitoring involves some element of forecasting, it is not clear that it will add anything important to the unitrust mechanism that pays out more in times of plenty and less in times or want.

An accurate probability based computer program should, however, lend further valuable insights into the selection of different methods of distributions from total return trusts and the risks and benefits of rate and method selection.

XIX. SO YOU FINALLY HAVE A TOTAL RETURN STATUTE - NOW WHAT? EXPLORING THE NEXT STEPS

A. WHO NEEDS A TOTAL RETURN TRUST WHEN THERE IS NO TOTAL RETURN? WHAT GOOD IS IT IN A BEAR MARKET?

This section of the materials was originally written on July 20, 2002, with the S & P 500 closing at 847.75, and the market generally closing out its 9th losing week in a row. This broad market indicator was off 44% from its highest close on March 24, 2000 at 1528.63. The NASDAQ Composite closed at 1319.15, off 74% from its high close of 5048.63 on March 10, 2000. Rather than update the perspective, it is well to preserve it and consider the following question: Why would anyone want to consider a total return trust in general and equity investing on July 20, 2002?

To answer that question, let’s review again the results of starting a total return trust at the worst possible time—just before the onset of a bear market. Here we assume an all equity portfolio and a high 5% payout for the TRU and an income rule trust with an equivalent yield of 5% at that time, which would have required a 2/3ds bond and 1/3 stock portfolio at that time. For the next two years the market would suffer its worst decline since the depression, and an all bond portfolio would be better than all stock for 10 years. The following graph shows the distributions from the two portfolios during that worst case period.
The bottom line is that the all stock portfolio did make the beneficiary suffer during this severe bear market. Let’s look at the market values of the same two portfolios:
While the market value of the all equity TRU significantly lagged the mostly bond portfolio for a number of years, the long term results are much superior, and will likely be much superior even after the year 2002 is written into the record books. It would take a 60% decline in 2002 for the all equity TRU to come out worse than its competitor, and that is frankly very unlikely.

But we are clearly not at a point just before a bear market, we are deep in the middle of it! What would the results look like if we did the same comparison starting in 1975 - two years after the start of the severe bear market of the 1970’s? Let us compare the results of an all equity TRU paying out 5% with a 50/50 income rule trust and examine the distributions and the market values. First the distributions:
Bear Market Scenario (1975-2002)
Total Return Trust vs. Income Rule Trust - Distributions

While there was a small period in which the trust beneficiary would have been better off with the income trust and the more conservative asset allocation, that is clearly not the message these results convey, is it? Now how about a comparison of the market values?
The market values of the two trusts do not favor the income rule trust and the more conservative portfolio in any of the 27 years since 1975. Could that mean that a bear market is the best time to convert to a total return trust, with the most aggressive asset allocation? Yes, very probably the smartest thing to do is the most difficult, as it often is in this world.

But perhaps even more importantly, the total return trust does not have to be invested aggressively to make sense. The primary point of the design is to allow the trustee to invest for total return and to manage the trust most effectively, whether that means mostly stock or mostly bonds, or a mixture of the two. By utilizing the total return trust, the trustee is able to weather the storm of a bear market by investing anyway she chooses, without the same degree of pressure that the income rule trust provides.

For example, the highest return asset class during 2002 thus far has been bonds. With current interest rates very low, the trustee might very well not want to invest in the bond market despite its relative safety, while the use of a money market fund in the present market lowers the income materially, as contrasted with a bond fund. But if the distribution depends upon the total return, rather than the income return, such funds can be easily used as a total return management tool, along with any other appropriate investment. If an investment strategy is best for total return, it will be the best for both the current and remainder beneficiary.

If we had started two trusts, each with a 50/50 investment mix in 1975, one distributing on an income basis and the other a TRU, the distributions from the TRU are both smoother and more likely to increase the value of the trust, because of the negative dollar averaging of the income trust which we have discussed previously.

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So whether we are in a bear or a bull market, it is always better to be able to invest for total return, and the unitrust formulation will generally produce a smoother and steadier distribution to the beneficiary, particularly if bonds are a significant portion of the portfolio, because it eliminates interest rate volatility as a primary source of volatility.

B. WHERE WE GO FROM HERE—A DETAILED ANALYSIS IN THE CONTEXT OF THE PENNSYLVANIA TOTAL RETURN STATUTE

It may be helpful to review the question from the point of view of a specific statute in order to review the choices and the considerations in reacting to a total return statute. Obviously, the statutes are different from one another, and this will make a difference, but a more detailed analysis of these factors in the context of the Pennsylvania statute may be in order, particularly because a number of states have used the total return unitrust provisions in the Pennsylvania statute in the drafting of their own total return legislation.

1. What are the fundamental choices for the trustee?

First of all, what are our choices? Under the Pennsylvania version of the Uniform Principal and Income Act, the trustee generally has the option of either using the power to adjust or the unitrust in order to implement a prudent investment and fair distribution program. There are trust situations that are excluded from both alternatives, but with one exception, all of those situations are tax sensitive. In a nutshell, both remedies are intended to be available to all trusts
that may need them, except where the possession of the power or the conversion will or may cause a tax problem, or where the power or the conversion would contravene the grantor’s intent. With the exception of the excluded situations described below, or where there is uncertainty as to the possibility of a tax problem if the trustee were to have the power to adjust or the power to convert may allow the trustee to release one or the other or both of the options, the trustee will have both powers. If they take no action, they will have the power to adjust, but would continue to have the power to convert to a unitrust as well should the trustee decide later that the unitrust is preferable.

2. What Trusts are Excluded from the Power to Adjust or the Power to Convert to a Unitrust?

(a) For the Power to Adjust Only-No Adjustment to Reduce Marital Interest. The power to adjust protects the marital deduction with the following language:

(c). Prohibited Adjustments.—A trustee may not make an adjustment if any of the following apply:

(1) The adjustment would diminish the income interest in a trust which requires all of the income to be paid at least annually to a spouse and for which a Federal estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment.470

While literally this language could apply to a credit shelter all income trust for the spouse, it should not be applicable unless the trust is one for which the marital deduction is intended to, or has been, claimed. This has been a helpful exclusion, in that it protected the marital deduction by not allowing it to be reduced, without the necessity of court action, which would have been needed for the unitrust to require an “income if greater” proviso, until the Final Regulations were in effect. Going forward, it will be unfortunate if the limitation must be retained, since the idea of the power to adjust is not generally favoritism of the income beneficiary in most cases, but impartiality, and there are markets in which an adjustment from income to principal is appropriate, despite the marital deduction.

(b) For the Power to Adjust Only-if it may reduce the actuarial value of an income interest where annual exclusion intended. The powers are not allowed where they will reduce the actuarial value of an interest for which the annual exclusion is intended to be taken:

The adjustment would reduce the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a Federal gift tax exclusion.471

So in short the trustee may not exercise the power to adjust to reduce an income interest in a trust for which the income interest is the feature that qualifies it for the annual exclusion. While the language could be applied to include a Crummey trust, where the annual

470 20 Pa.C.S. §8104(c)(1).
471 20 Pa.C.S. §8104(c)(2).
exclusion depends not on an income interest but on the right to withdraw, it should not be so applied in the author’s opinion. 472

(c) For Both the Power to Adjust and the Unitrust—Where it Would Change an Annuity or a Fractional Payout. Where the instrument describes what the beneficiary is to receive as a fixed annuity or a fixed fraction of the trust, the granting of the power to adjust would be a clear contravention of what the grantor had in mind, since the distributable amount was a definite sum, in the case of a fixed annuity, or what amounts to a unitrust, in the case of a fixed fraction of the trust. As a result, this situation is excluded from both the power to adjust and the power to convert to a unitrust. 473 This is the only exclusion that is not based at least in part upon tax considerations.

(d) For Both the Power to Adjust and the Unitrust—Split Interest Trusts. Where the adjustment might reduce or the unitrust distribution might be paid from a charitable interest, the adjustment or conversion power is not allowed, unless both the principal and income of the trust are held for charitable purposes. The Pennsylvanian provision differs from the UPAIA language here, in that it applies the exclusion only where the charitable deduction has been taken:

An adjustment may not reduce or a unitrust distribution be taken from any amount which is permanently set aside for charitable purposes under the governing instrument and for which a Federal estate or gift tax deduction has been taken, unless both income and principal are so set aside. 474

The Pennsylvania Power to Adjust and the Unitrust are therefore available for a trust with a partially charitable remainder for which a charitable deduction was not available, or was not taken. It should also be inapplicable to a NICRUT, NIMCRUT or pooled income trust, which is helpful in the context of the Final Regulations, for which these powers will be disqualifying of tax benefits.

(e) For Both the Power to Adjust and the Unitrust—Where the Possession of the Power would Make the Trust a Grantor Trust Where it Would Not Be Otherwise. For both, if possessing the power would make someone the owner of the trust for income tax purposes, and the trust would not otherwise be, then the power is denied. 475 It is not clear how this can apply unless the trustee is a beneficiary, which is covered separately.

472 The Pennsylvania statute does not apply this to the power to convert to a unitrust, no doubt because the assumption is that the unitrust interest will increase the income interest, which in most cases it will, but actuarially, income interests are overvalued at the present time, because for valuation purposes, the income interest is assumed to pay out the Section 7520 rate, 4.6% for September, 2004. Currently, and typically, the assumption that a trust will pay out the Section 7520 rate to the beneficiary is wholly unrealistic, and normally overvalues the income interest, whereas the unitrust interest is valued based upon its actual payout, using the Section 7520 rate as the total return and the discount rate. A unitrust rate should qualify for the present interest deduction in any event. The author has successfully claimed a present interest exclusion for a 2% unitrust in the past.

473 20 Pa.C.S. §8104(c)(3), §8105(i)(1).

474 See id. §8104(c)(4), §8105(i)(2).

475 See id. §8104(c)(5), §8105(i)(3).

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(f) For Both the Power to Adjust and the Unitrust—Where the Possession of the Power would Make the Trust Taxable in Someone’s Estate. Where the possession of the power to adjust or the power to convert to a unitrust would make the trust taxable in a person’s estate, where it would not otherwise have been so taxable, the powers are denied. It is again most likely that this could apply where the trustee is a beneficiary, but this is of course of primary importance, and thus is broadly excluded.

(g) For the Unitrust—Where Conversion Would Deny the Marital Deduction. The authority to convert to a unitrust is denied where the conversion would cause a loss of the marital deduction:

If the conversion would result in the disallowance of a Federal estate tax or gift tax marital deduction which would be allowed if the trustee did not have the power to convert.

This was intended to preclude a conversion to a unitrust until the Proposed Regulations were made final and in effect, unless an “income if greater” interest is included as provided in Section 8105(g)(2). This was important since a power in a third party to effect a change in a marital trust which would disqualify the trust, may itself disqualify the trust for marital deduction purposes. This provision should now be unnecessary, but should do no harm.

(h) For Both the Power to Adjust and the Unitrust—Where the Trustee is a Beneficiary. This is the most obvious exclusion where one would be concerned with the trustee exercising this authority, when he or she is a beneficiary of the trust. This is a concern both from a tax standpoint and from the point of view of the trustee exercising a power upon which she has a considerable conflict of interest.

(i) Where a Co-trustee May Exercise Without Difficulty, the Power to Adjust and the Power to Convert is Preserved. For both the power to adjust and the power to convert to a unitrust, if one of the tax problems noted above would apply to one of the trustees, but not another, then the other trustees, presumably the disinterested trustee or trustees, may exercise the power to adjust or the power to convert.

(j) For the Power to Convert Only—If no Disinterested Trustee, the Court may Decide. If the concern is that the power may cause grantor trust status or inclusion for estate tax purposes, and/or the only trustee is a beneficiary, the trustee may still petition the court for conversion to a unitrust. For the power to adjust, there is no court process that will cleanse the discretionary power, and of course one would not want to go to court every time an adjustment was desirable anyway, whereas a petition for the court to decide on a unitrust conversion issue should cleanse the process from a tax point of view for the trustee, since it is the court, rather than the trustee, that is making the decision. Even without the court process, the

476 See id. §8104(c)(6), §8105(i)(4).
477 See id. §8105(i)(5).
478 See id. §8104(c)(7), §8105(i)(6).
479 See id. §8104(d), §8105(j)(1).
480 See id. §8105(j)(2).
requirement that current and remainder beneficiaries be given notice and may block the conversion without court action should provide in most situations an “adverse party” helpful for some situations, as in a Section 2041 power of appointment concern.

(k) Release of Power to Adjust or Power to Convert When Tax Problem a Concern. Perhaps in an excess of caution, the drafters of the Uniform Act provided that if any of the tax problems described above would, or even might apply, then the power to adjust may be released, either permanently or for a period of time, and such a release may be only the power to adjust principal to income or income to principal. They further broadened the application not only to the tax problems feared and listed in the statute, but also any concern that the power might deprive the trust of a tax benefit or impose a tax burden. This broadening was copied in the Pennsylvania statute for the unitrust as well, so the trustee can release either of these powers for virtually any tax concern.

If the trustee wants no parts of this brave new world, she will have to find a tax reason to do it, and if there is one, she can release either or both of the powers under the new act. Otherwise, the default situation will be that the trustee will have the power to adjust, if the preconditions of the power to adjust apply.

3. When to Hold and When to Fold.

If the trust is not excluded or the powers released as discussed above, the trustee will have at least the power to adjust, if by its terms it is applicable. And it is applicable if the trust describes what is or may be distributed in terms of income and if using the discretionary powers contained in the trust instrument, the trustee is unable to treat the current and remainder beneficiaries impartially, except to the extent that the governing instrument indicates that the trustee shall or may favor one or another of the beneficiaries. Stated more simply, can the trustee without the power to adjust invest the trust sensibly and distribute fairly?

(a) Factors, Factors Everywhere, But What Am I to Do? The uniform act and the Pennsylvania statute list lots of factors to take into account in making the decision to exercise either the power to adjust or the power to convert to a unitrust:

1. The size of the trust.
2. The nature and estimated duration of the trust.
3. The liquidity and distribution requirements of the trust.
4. The needs for regular distributions and preservation and appreciation of capital.

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481 See id. §8104(e).
482 Id.
483 See id. §8105(k).
484 See id. §8104(a), §8103(b).
485 The Pennsylvania statute did not include the express requirement that for the power to adjust to apply, that the trustee must invest as a “prudent investor”, a term which to some imports too much investment opinion into the equation, such as the efficacy of the “efficient markets” theory, and so forth. It is intended that the Pennsylvania power to adjust would apply to any trustee trying to invest sensibly and distribute fairly. As discussed previously, the Final Regulations do not require the language to follow the Uniform Act in lockstep.

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(5) The expected tax consequences of an adjustment.
(6) The net amount allocated to income under the other sections of this chapter 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) 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 or testator.
(8) To the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the government instrument.
(9) Whether and to what extent the governing instrument gives the trustee the power to invade principal or accumulate income or prohibits the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.
(10) The intent of the settlor or testator.
(11) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.  

Factors 6 and 7 are only contained in the section covering the power to adjust, and not the unitrust. The exclusion of item 6 is clear enough, while the exclusion of item 7 in all likelihood stems from the provisions under the unitrust section to give trustees discretion as to how to handle the listed types of assets. While the foregoing list is certainly extensive, it is not intended to be exclusive of what the trustee may consider in the process. But what are the key factors in making these determinations?

(b) Concrete Trust Factors in Selecting Candidates for Exercising the Power to Adjust and the Power to Convert to a Unitrust. In a broad sense, neither remedy is needed or appropriate if, under the terms of the trust and all of the conditions and factors the trustee is able to invest sensibly and distribute fairly. So if a trustee is not constrained in administering the trust either from a distribution standpoint or an investment standpoint, then neither remedy is needed or appropriate. So, for example a fully discretionary trust would be free to invest and distribute as the trustee deems advisable, and the power to adjust would not be needed. Since the trustee could implement a unitrust distribution methodology without a formal conversion to a unitrust, the statutory unitrust conversion would not be needed either. There are factors, however, which to the author tend to press one towards one or the other remedy.

See id. §8104(b), §8105(c).

The one situation in which it might be helpful is if the ordering rule is desirable for tax reasons, as for example if the beneficiary, but not the trust, has carryover capital losses so that a conversion to a unitrust would allow the trustee to distribute the capital gains to the trust beneficiary where they may be offset by her losses.

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Factors Favoring the Power to Adjust. The factors which might press the decision in favor of the power to adjust rather than the unitrust could include the following:

(a) Need for flexibility from year to year. If given the overall circumstances of the trust and the family, it is likely to be desirable to be able to vary the distribution from year to year, to fine tune it to the needs and opportunities presented, then the power to adjust is the better vehicle, if the discretionary powers of the trust are not sufficient to address the situation.

(b) Harmonious relationship among beneficiaries. The power to adjust, like any discretionary power, works best when everyone is on the same page. Just as a fully discretionary trust works best within the context of a happy trust family, so the power to adjust is most likely to be advisable in the long run where the trust beneficiaries are in harmony with one another, and are therefore less likely to attack the trustee who exercises a discretionary power.

(c) Where the trustee is comfortable with relatively frequent exercises of discretion. Depending upon the experience and predilection of the trustee, the trustee may be more or less comfortable with exercising discretion on a relatively frequent basis. Some professional trustees very much prefer the highly discretionary model and find that it works for them very well. Others find that the exercise of discretion impairs the relationship with the beneficiaries, and would prefer to limit discretion to where it is most needed.

(d) Where the nature of the assets, their liquidity, and the variability of their income may better suit a discretionary power. While the Pennsylvania statute does not include the nature of the assets as a factor for the unitrust conversion, it is a factor for the power to adjust, and where liquidity or sporadic cash flow needs may make flexibility more important, the power to adjust may be the better approach.

(e) A caution—Adjusting up is easy—Will you adjust down when needed? It is a relatively easy thing for a trustee to decide to adjust from principal to income if the circumstances warrant it, but with the power to adjust, there is no mechanism for lowering the distribution absent the affirmative exercise of discretion. So if in a bull market, the trustee will adjust from principal to income, will they refrain or even adjust from income to principal in a bear market? Will they have what it takes to make the hard decision? Remember the unitrust does this automatically, so distributions would have decreased in 2002, 2003 and 2004. Not a pleasant thing, but a necessary thing to preserve the trust from excessive depletion. The trustee has to decide whether it can go whatever direction is proper, whether the decision is popular or not.

Factors Favoring the Unitrust—Factors favoring the unitrust might include the following:

(a) Where there is a need for more income on a continuing basis than can be satisfied by the income, without the continuing exercise of discretionary

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distribution powers under the instrument, if available. The most obvious place where the unitrust would be the most desirable would be where the income need is significantly in excess of what can be satisfied with accounting income. If a 4% or 5% income need is anticipated for the indefinite future, the power to adjust may be the tough way to go, since it would require a virtually continuous exercise of the power, and while the statute seems to allow the needs of the beneficiary to be taken into account, it may be easier to simply convert to a unitrust.

(b) Where the beneficiaries do not get along well. The classic case here is the second family and a QTIP trust, with remainder to the children by a first marriage. While one can use the power to adjust to address the conflict, it simply puts the trustee more directly into the conflict, rather than as a sideshow to the choice of asset allocation. In these situations, and indeed in situations where there is little conflict, but the trustee would prefer to keep it that way, the unitrust would be the best answer.

(c) Where the unitrust is more desirable as the simpler, more straightforward process. In many cases, the unitrust may just be simpler than deciding when and how to use the power to adjust, and where the trustee is more inclined to a method that everyone will understand more easily, the unitrust may be the better answer. In trusts which are not of the multi-million dollar variety, the trustee may not feel as though they have the time and resources to devote to the power to adjust.

(d) Where the unitrust will allow the trust beneficiaries to plan their finances better. One real advantage with the unitrust is that it brings with it a sense of stability and understandability greater than the power to adjust. The unitrust distribution will likely be used so that at the beginning of a year, the beneficiary will know her trust “salary” for the entire year. It can easily be made payable quarterly or even monthly, and this may be of significant benefit to the trust beneficiary in her financial planning. In fact, it may encourage financial maturity in the beneficiary if the beneficiary can budget a certain amount coming in at the beginning of the year, as opposed to simply asking the trustee for the exercise of its discretion, which may encourage trust dependency.

4. The Conversion Process in Pennsylvania

The process of conversion of a trust to a unitrust may be divided into the private process, without court involvement, and the public process, with court involvement. The preference in the statutory model was to provide for the private process as widely as possible.

(a) The Private Conversion Requirements. The private conversion process is fairly simple, once the trustee decides that the trust is not excluded for tax reasons as discussed previously, and that the conversion is a good idea.

(1) Is it a good idea? The statutory phrasing for the conversion being a good idea is as follows:

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"The trustee determines that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust."^488

It is unlikely that a search of the testator’s specific intent with regards to the power to adjust or the unitrust will be fruitful in most cases, since the issue is of too recent a vintage to expect that the testator will have considered the matter for trusts that are already in effect. This will change over time, as practitioners and clients become more accustomed to dealing directly with these issues, and where a distribution of “income” is called for in a trust document, we will expect to be given some guidance as to the testator’s intent with reference to the exercise of the power to adjust and/or the power to convert to a unitrust.

(2) **Give Notice of Substance of Conversion Decision.** Once having decided this central question, the trustee is required to give written notice that he intends to release the power to adjust and convert the trust into a unitrust.^489 And not just that the trustee wishes to convert to a unitrust, but how the unitrust will operate, which would presumably include the unitrust rate (always 4% in a private conversion), the dates for distributions, the method and dates used to value trust property, any assets to be excluded from the valuation computation, and any other decisions pertinent to the operating of the trust. This is important so that the beneficiary really understands the way the trust will operate if converted.

(3) **To all sui juris current and remainder beneficiaries.** The written notice must go to all of the sui juris beneficiaries in the class of current and remainder beneficiaries, defined as all sui juris beneficiaries who

(i) are currently eligible to receive income from the trust; and

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

There must be at least one beneficiary in each of the two classes, so that the current and the remainder beneficiaries are represented in the process.

(4) **No one objects within 60 days.** If no one objects within 60 days of the notice, then the conversion is complete.

The Pennsylvania statute provides a fairly simple process for conversion in most cases. Now let’s look at the procedure for the process in court.

(b) **The Court Conversion Process.** The statute lists a number of situations where the parties must seek judicial approval for the conversion:^490

1. Where one of the beneficiaries objects within 60 days.

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488 See id. §8105(a)(1).
489 See id. §8105(a).
490 See id. §8105(b). This subsection covers the first three listed situations.
2. If there are no sui juris current beneficiaries, or no sui juris remainder beneficiaries.
3. Where the beneficiary requests a conversion, but the trustee does not convert.
4. Where the trustee suggests a rate other than 4%.491
5. Where the trustee requests that net income, determined as if the trust were not a unitrust, be distributed if greater than the unitrust amount, if needed to preserve a tax benefit.492
6. Where the trustee wishes to choose a smoothing rule other than three years.493
7. Or in order to reconvert from a unitrust, and revive the power to adjust.494

(c) Whom to notify, and what to say in the notification. The statute reads well enough in defining the current and the remainder beneficiaries. In the situation where the trust is to A for life, and then to B, the application is simple enough. But there are lots of trusts that may present a more difficult situation for application of the above notice rule. For example, if the trust is multigenerational, to Mom for life, and then to children for life and then to grandchildren outright, then if the trust were to terminate in the expected way, the grandchildren would be the remaindermen and the children would neither be current beneficiaries nor remainder beneficiaries, yet the author believes that they should receive notice. If advising a trustee, it is unlikely that there is a good reason for excluding anyone who has a vested interest in the trust, and it is likely that the statutory language will be refined to include at least those beneficiaries who would be eligible to receive distributions if those beneficiaries who are currently eligible were to die.495 This seems all the more compelling where the statute requires court approval. A proposed correction of this oversight was discussed previously496, and in the meantime, trustees would do well to treat the technical change as already having been made.

The notification should spell out the conversion decision contemplated, and that the conversion will require the release of the power to adjust, as well as the details of the unitrust operating decisions on valuation and distributions. It should note that as required by the statute, once a conversion is accomplished the trustee must invest the trust for total return, rather than separately for income and principal. And if this author were to be drafting such a notice for a trustee, it would likely contain broad language noting that while investing for total return allows the trustee to do the best it can to invest the trust prudently, there is no guarantee that a total

491 See id. §8105(g)(1).
492 See id. §8105(g)(2).
493 See id. §8105(g)(3).
494 See id. §8105(g)(4).
495 In fact the Decedents Estates Advisory Committee has proposed a revision to the statute to require notice to three classes of beneficiaries, the current beneficiary, the next beneficiary, if the current beneficiary’s interest were to end, and the remaindermen if the trust were to terminate without the exercise of a power of appointment. A sui juris beneficiary would not be required for all three classes of beneficiaries—but is required of a current beneficiary, and a sui juris future beneficiary, whether of the next current beneficiary class or the remaindermen class. This latter qualification is to avoid excessive court action for minors whose interests are effectively represented by others whose interests are aligned with them. This provision is similar to the provision used in the Maryland, Colorado and North Carolina statutes discussed earlier.
496 See text at n. 361, supra.
return strategy, or any strategy, will be effective to preserve the real or even nominal value of the trust, or to make it grow. That should be easy enough to remember in the midst of a bear market, but it should be included in the notice in this author’s opinion.497

The statute is short enough that it could be included in the notice to the beneficiary.

(d) When to Go to Court—Tax Considerations in the Conversion Process. There are two general categories of trusts that require special consideration in the conversion process because of their tax status:

The marital trust

The trust which is grandfathered for GST purposes

With the Final Regulations in effect, even these most sensitive trusts should be able to be converted safely in most cases without going to court.

(1) The Marital Trust. If a marital trust is to be converted to a 4% unitrust, no court activity should be required because of the Final Regulations. If a different rate, such as 3% or 5% is desired, then under our statute a court action is necessary. One obvious question is whether a court approved rate of under 3% or over 5% will be respected for marital deduction purposes? The Final Regulations do not give us any specific guidance on this, and indeed they tell us that a conversion not pursuant to a state statute or outside the 3-5% lines may cause a loss of the marital deduction, may constitute a gift or a loss of GST grandfathering or be a sale or exchange. One would expect that anything below a 3% payout rate should require a private letter ruling, unless it were done with an “income if greater” proviso. If it were greater than 5%, the marital deduction should not be at risk, but some other risk, as for example a possible gift by remainderman to the spouse or a possible sale or exchange of the income interest, would be a concern, rendering a private letter ruling advisable.

(2) The GST Grandfathered Trust. For the GST grandfathered trust, if the 4% default rate is desired, there should be no problem in the conversion.

(3) When a rate other than 4% is best. A 4% rate was selected because it represents a reasonable proxy for the traditional notion of “income” without tying the trustee’s hands on the investment of the trust portfolio, but that is not to imply that it is best for all situations. Clearly there are situations where the need may be higher than 4%, as for example in a trust for an elderly surviving spouse, where the discretionary powers are not adequate. At the same time, the trustee of a long term GST exempt or grandfathered trust may be best advised to use a lower rate, if adequate to meet the needs of the beneficiaries. In such cases, a court petition will be required, but as long as the lower or higher rate is acceptable to all of the sui juris beneficiaries, the court should not have a hard time with the request. If a rate of 3-5% is selected

and the statutory process followed, there should be no problem from a tax perspective. If we
were to draw outside of those lines, however, such as a 2% or a 6% rate, the Final Regulations do
not give us comfort, and a private letter ruling may be the only way to be sure that we have made
our way safely through the tangle of potential tax problems, such as the possibility of loss of
GST grandfathering, a taxable gift or a sale or exchange. And a very high rate such as 7 or 8%
might well be dangerous to all concerned, since the probabilities of maintaining the real or even
nominal value of the trust with that range of payout is not sanguine.

(4) Consider the whole portfolio of trusts for the family. Just as
modern portfolio theory instructs us to look at any one investment within the context of its effect
on the entire portfolio, a trustee may wish to look at the “portfolio” of family trusts in making its
decisions about how to treat each trust under the new Pennsylvania statute, taking into account
the needs of the beneficiaries of each trust and the tax characteristics of each trust. Clearly one
can employ the same principles that are used in the chapter of these materials covering estate
planning with total return trusts to approach the decisions in an existing set of family trusts. For
example, if a family had a marital and credit shelter trust, the use of the unitrust conversion or
the power to adjust on the marital trust to enable a higher payout from that trust would be more
desirable than increasing the payout from the credit shelter trust, which might best be left to
grow as much as possible, both by choice of asset allocation and by choice of application or non-
application of the power to adjust or the power to convert to a unitrust. The statute might easily
be used to provide a more aggressive investment mix and a lower payout from the credit shelter
and a more conservative mix and a higher payout from the marital trust. And this type of
approach can be just as easily adapted to the GST exempt and non-exempt trusts employed in
other plans.

(5) What to include in a court petition to convert. Judge Drayer of
the Montgomery Pennsylvania Orphans’ Court Division issued a preliminary memorandum to
the Bar of that county as to what he might expect in a petition to convert. As one of the most
highly respected Pennsylvania jurists in this field, his suggestions may be instructive:

1. How and when the trust was created (a copy should be attached)
2. Facts supporting venue.
3. How funds received (gift, award by prior adjudication etc.)
4. Description of dispositive provisions of the trust.
5. Term of the trust.
6. Beneficiaries currently eligible to receive income, and those who
would be eligible if current beneficiaries were to die, and those, in
the absence of the exercise of any power of appointment, who
would receive any principal if the trust were to terminate and
distribution were to occur as of the time of the filing of the petition.
7. Current market value of the principal
8. Current accounting income and yield without the application of the
power to adjust.
10. Averments of facts in support of proposition that the conversion
will enable the trustee to better carry out the purposes of the trust.
11. Copies of notices sent to beneficiaries should be attached.
12. The reason or reasons why court approval is necessary.

One of the reasons stated in the memorandum why court approval might be necessary is a lack of a sui juris beneficiary in either class of current beneficiaries and remaindermen. The definitional section 8102 in the Pennsylvania statute provides broadly that a sui juris beneficiary can include a minor represented by his or her parents, an agent for incapacitated person or a guardian appointed for either one. It appears unlikely that this breadth of representation will hold with the judiciary, particularly since the parents of a minor may well be in a different class of interest in a trust, and a related agent may often have a conflict of interest in these situations, so it may be unwise to rely upon such representation. This may suggest that in some of these cases literally within the statute, the trustee will be better advised to obtain the court order, unless there are other indisputably sui juris members of each required class.498

(e) The fine points – Trustees’ discretionary decisions. There are a number of points where the trustee is given discretion under Section 8105(e) of the Pennsylvania statute. Each is discussed briefly:

(1) Provisions for prorating a unitrust distribution for a short year. Simply using the unitrust rate times the fair market value of the trust assets at the time of conversion may be an attractive alternative, particularly if the unitrust conversion occurs during a bear market such as the market from 2000-2002. The statute requires the use of a 3-year smoothing rule, but one would expect that this discretionary power for a short year might allow the distribution to be based on the initial starting value at the time of conversion. This would have the advantage of not using historical values which are not there anymore in the trust. The smoothing rule is not as helpful at the beginning of a unitrust regimen, through conversion, where the current beneficiary's income stream is typically being increased anyway, though it would work well enough during a bull market period.

(2) Frequency of Payments. The trustee can choose whatever is most comfortable for the trustee and the beneficiaries, whether quarterly or monthly. Liquidity and cost considerations aside, monthly distributions are often favored by beneficiaries.

(3) How Contributions or Distributions other than the Unitrust Amount Affect Calculations. The forms set forth in these materials have adjustment language that allows the three-year smoothing apparatus to operate reasonably in light of additional contributions to the trust or material distributions. Other approaches could deal with only such contributions or distributions which are material to the calculations.

(4) Frequency of Valuation. The calculations in these materials assume an annual valuation, though rolling valuations on a quarterly basis would make the

498 A correction of this matter has been suggested by the Decedent’s Estates Advisory Committee of the Joint State Government Commission which would not allow such problematic representation of a child by a parent under circumstances of a proposed unitrust conversion.
distributions smoother in theory, if less predictable. Most beneficiaries would prefer to know
their income in advance for an entire year, rather than having it vary quarter to quarter.

(5) **Selection of Valuation Dates.** We have used the beginning of
the year as the valuation date in our forms on the theory that it is nice to know where one stands
at the beginning of the year, and because the use of the first day of the year allows three values to
be available more quickly than using the last day of the year. This may not be possible under the
statutory language in Section 8105(d) which requires the values to be averaged

over the lesser of:

(i) the three *preceding* years; or

(ii) the period during which the trust has been in existence. (emphasis
inserted)

Consequently, for conversions, the last day of the year may be the valuation date that is most
easily used and administratively helpful, though the date of conversion could be retained as the
valuation date for that year in the year following, if desired.

(6) **How frequently to value non-liquid assets and whether to
estimate their value.** If non-liquid assets are included in a unitrust, it is important to be
practical in the valuation method and process. That is the reason for the reference to an estimate
of value. It would be unduly burdensome to require an appraisal of real estate every year just to
compute the unitrust distribution in most cases, unless the value were to be ascertained
frequently for some other purpose. If there are many non-liquid assets in the trust, the unitrust
may be less than ideal in any case.

(7) **Whether to omit from calculations trust property used or
occupied by the beneficiary.** Where the beneficiary is able to get the use of the property as for
example living in a piece of residential property, it may make the most sense to simply exclude
that property from the unitrust calculation, since the use of the property may be the equivalent of
the income or unitrust interest within the context of “use” property. This could be the case with
tangible personal property as well, but the variety of the circumstances led the drafters not to
require a particular method, but to give the trustee discretion as to how to treat these “use” type
assets.
XX. FREQUENTLY ASKED QUESTIONS AND ANSWERS

A. ISN'T A FULLY DISCRETIONARY TRUST PREFERABLE TO A TRU BECAUSE OF ITS FLEXIBILITY?

This is a question which Susan Porter of U.S. Trust raises in response to unitrusts. And this point was also made in the course of an exchange in the North Carolina Bar Association publications in response to a pro-unitrust article by Mark B. Edwards. The usefulness of the fully discretionary trust has been pointed out earlier in the article, particularly in combination with the TRU if any income is truly needed and relied upon by the beneficiary. A fully discretionary trust is often superior to a TRU wherever the forcing out of any amount of funds from the trust may be disadvantageous. This would most often be in the credit shelter trust or in a dynasty trust for example. Indeed by combining the usage of a total return unitrust with a discretionary trust we can focus the economic benefits the way we wish much more accurately than with an income rule trust.

The ordered unitrust, discussed earlier, avoids this criticism in the context of the typical marital and credit shelter trust arrangement, while preserving predictability, if that is a more important goal than flexibility.

The author uses fully as many discretionary trusts as total return unitrusts in his practice, but there is no one trust for all circumstances. It would be a major error to conclude that any trust will work well for all of the great variety of situations with which we as estate planners are faced. The fully discretionary trust, despite its usefulness, will be unacceptable to many people who do not have sufficient confidence in the trustee to invest all that power in the trustee. How do they know that the trustee will exercise it in a proper way? In many situations, the use of a unitrust to address the beneficiary's income needs will help give the beneficiary the confidence to accept a fully discretionary trust elsewhere, or perhaps, to accept a trust at all.

B. DOESN'T A FIVE-AND-FIVE POWER ACCOMPLISH THE SAME THING?

If a beneficiary has a five-and-five power in an existing income rule trust, it may be very helpful in the context of being able to produce a higher yield for the trust beneficiary. Clearly the beneficiary can simply exercise his power rather than pressure the trustee to invest more in bonds to produce more income. But a distribution which is based on income plus a five-and-five power still produces the same conflict about how much the income should be. This is the difference between simply adding a five-and-five power and Jerry Horn's Give-Me-Five unitrust which, in the author's opinion, is a superior model. Even a total return unitrust might encounter this problem if rates escalated sufficiently if the document provides for the payment of income if greater than the distribution amount in order to qualify for the marital deduction. This problem is largely eliminated by the Final Regulations, which should not require this language

501 Even a total return unitrust might encounter this problem if rates escalated sufficiently if the document provides for the payment of income if greater than the distribution amount in order to qualify for the marital deduction. This problem is largely eliminated by the Final Regulations, which should not require this language

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system, it is a power. Fundamentally, many of these issues involve who is in charge and who makes the decision about what a trust distribution ought to be. Just as beneficiaries are often concerned about an independent trustee's discretion in a fully discretionary trust, so a settlor of a trust who sets up a trust to guard against the beneficiary outstripping his assets and income should have concerns that the five-and-five power would only facilitate the beneficiary doing so more quickly. There can be little debate that withdrawing 5% plus the accounting income from a trust would likely severely deplete its real value over time.

C. ARE TRUs A GOOD CHOICE FOR TRUSTS CONTAINING CLOSELY-HELD BUSINESS INTERESTS, LLCs OR FLPs?

While conceptually they can hold such business interests, the TRU is a response to a problem that may not exist in a family owned business where the family may well have control over the stream of distributions from the business entity. It is primarily designed to be in response to the need for trustees to invest for total return in the financial markets and to satisfy their duties of impartiality as between the current beneficiary and the remaindermen without disappointing both. They are clearly not designed with this type of asset in mind and other types of trusts should be considered.

XXI. MODERN TRUST DESIGN - ONLY THE BEGINNING

The development and implementation of the types of trusts described in these materials, the total return unitrust, the indexed payout trust, the no-drop unitrust, the TRUCAP index trust, the "Give-Me-Five" unitrust, and the fully discretionary trust are by no means exhaustive of the trust possibilities. The author has discussed the use of a number of other new methods for defining trust distributions which would allocate the risks of future investment between the current beneficiary and the remaindermen differently. We as estate planners need to continue to expand our tool chest with additional types of trusts that are more and more tailored to satisfy the human needs of our clients while not impeding the investment goals of the trusts. Variations and limitations on the distribution rules provided by the indexed payout trust or the unitrust might fruitfully be used in some situations and match with precision the settlor's concerns about the future. After being stuck in a rut for literally hundreds of years in writing trusts that direct the trustee to "hold the principal and pay the income", there is no reason to expect that the ingenuity of lawyers in crafting new trust vehicles will stop now that we have broken out of our income cocoon. Estate planners should instead continue to develop new and favorable designs for trustees and beneficiaries.

RBW/la.09/21/04

in states with a unitrust definition of income.

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XXII. APPENDICES

APPENDICES 1-7
AVAILABLE BY REQUEST
§ 8103. Fiduciary duties; general principles.

(a) Allocation.--In allocating receipts and disbursements to or between principal and income and with respect to any matter within the scope of this chapter, the following shall apply:

(1) A fiduciary shall administer a trust or estate in accordance with the governing instrument, even if there is a different provision in this chapter.

(2) A fiduciary may administer a trust or estate by the exercise of a discretionary power of administration regarding a matter within the scope of this chapter given to the fiduciary by the governing instrument, even if the exercise of the power produces a result different from a result required or permitted by this chapter. No inference that the fiduciary has improperly exercised the discretionary power shall arise from that fact that the fiduciary has made an allocation contrary to a provision of this chapter.

(3) A fiduciary shall administer a trust or estate in accordance with this chapter if the governing instrument does not contain a different provision or does not give the fiduciary a discretionary power of administration regarding a matter within the scope of this chapter.

(4) A fiduciary shall add a receipt or charge a disbursement to principal to the extent that the governing instrument and this chapter do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) Discretionary power.--In exercising a discretionary power of administration regarding a matter within the scope of this chapter, whether granted by the governing instrument or this chapter, including section 8104 (relating to trustee’s power to adjust) and section 8105 (relating to power to convert to unitrust), a fiduciary shall administer a trust or estate impartially based on what is fair and reasonable to all of the beneficiaries, except to the extent that the governing instrument clearly manifests an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this chapter is presumed to be fair and reasonable to all of the beneficiaries.

[Uniform Act Comments Not Included-may be found at http://www.law.upenn.edu/bll/ulc/ulc_frame.htm]

Pennsylvania Comment: Section 8103. The additional words at the end of section 8103(a)(2) are taken from the California version of the Uniform Act. Calif. Probate Code § 16335(a)(2).
Section 8103(b) contains an impartiality standard. This does not require that the trustee treat the income beneficiary and the remainder beneficiary equally, because most creators of trusts intend the trustee to favor those generationally closest to them.

§ 8104. Trustee’s power to adjust.

(a) Adjustment.—Subject to subsections (c) and (f), a trustee may adjust between principal and income by allocating an amount of income to principal or an amount of principal to income to the extent the trustee considers appropriate if:

(1) the governing instrument describes what may or must be distributed to a beneficiary by referring to the trust’s income; and

(2) the trustee determines, after applying the rules in section 8103(a) (relating to fiduciary duties; general principles), that the trustee is unable to comply with section 8103(b).

(b) Considerations.—In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee may consider, among other things, all of the following:

(1) The size of the trust.

(2) The nature and estimated duration of the trust.

(3) The liquidity and distribution requirements of the trust.

(4) The needs for regular distributions and preservation and appreciation of capital.

(5) The expected tax consequences of an adjustment.

(6) The net amount allocated to income under the other sections of this chapter 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) 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 or testator.

(8) To the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument.

(9) Whether and to what extent the governing instrument gives the trustee the power to invade principal or accumulate income or prohibits the trustee from invading principal...
or accumulating income, and the extent to which the trustee has exercised a power from time to
time to invade principal or accumulate income.

(10) The intent of the settlor or testator.

(11) The actual and anticipated effect of economic conditions on principal and
income and effects of inflation and deflation.

(c) Prohibited adjustments.--A trustee may not make an adjustment under this section if
any of the following apply:

(1) The adjustment would diminish the income interest in a trust which requires
all of the income to be paid at least annually to a spouse and for which a Federal estate tax or gift
tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power
to make the adjustment.

(2) The adjustment would reduce the actuarial value of the income interest in a
trust to which a person transfers property with the intent to qualify for a Federal gift tax
exclusion.

(3) The adjustment would change the amount payable to a beneficiary as a fixed
annuity or a fixed fraction of the value of the trust assets.

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

(5) If:

   (i) possessing or exercising the power to make an adjustment would cause
       an individual to be treated as the owner of all or part of the trust for Federal income tax purposes;
       and

   (ii) the individual would not be treated as the owner if the trustee did not
       possess the power to make an adjustment.

(6) If:

   (i) possessing or exercising the power to make an adjustment would cause
       all or part of the trust assets to be subject to Federal estate or gift tax with respect to an
       individual; and

   (ii) the assets would not be subject to Federal estate or gift tax with
       respect to the individual if the trustee did not possess the power to make an adjustment.

(7) If the trustee is a beneficiary of the trust.
(8) If the trust has been converted under section 8105 (relating to power to convert to unitrust).

(d) Permissible adjustment when otherwise prohibited.--If subsection (c)(5), (6) or (7) applies to a trustee and there is more than one trustee, a co-trustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is prohibited by the governing instrument.

(e) Release of the power to adjust.--

(1) If paragraph (2) applies, a trustee may release any of the following:

(i) The entire power conferred by subsection (a).

(ii) The power to adjust from income to principal.

(iii) The power to adjust from principal to income.

(2) A release under paragraph (1) is permissible if any of the following apply:

(i) The trustee is uncertain about whether possessing or exercising the power will cause a result described in subsection (c)(1) through (6).

(ii) The trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (c).

(3) The release may be permanent or for a specified period, including a period measured by the life of an individual.

(f) Application.--A governing instrument which limits the power of a trustee to make an adjustment between principal and income does not affect the application of this section unless it is clear from the governing instrument that it is intended to deny the trustee the power of adjustment conferred by subsection (a).

[Uniform Act Comments Not Included-may be found at http://www.law.upenn.edu/bll/ulc/ulc_frame.htm]

Pennsylvania Comment: Section 8104. Paragraphing has been changed for clarity.

Section 8104(a) deletes the requirement in the Uniform Act that in order to adjust, the trustee must follow the prudent investor rule. Such a requirement runs the risk of inadvertently negating the power to adjust.

Section 8104(b) follows to the extent possible the version and the ordering of this list in Pennsylvania’s Prudent Investor Act.
The prohibition under section 8104(c)(1) does not extend to a trust which the fiduciary could but does not qualify as a QTIP, because in that situation no marital deduction would be allowed.

Regarding section 8104(c)(6), the language of the Uniform Act has been expanded to allow for additional situations in which an estate tax problem might arise.

Regarding section 8104(c)(8), the language in the Uniform Act prohibiting adjustments if the trustee is not a beneficiary but would be directly or indirectly benefited by the adjustment has been deleted, because it might prohibit a corporate trustee from, say, making an adjustment from income to principal and thereby increasing its future fees. Section 8104(c)(7) seems like sufficient protection from conflicts of interest.

§ 8105. Power to convert to unitrust

(a) Conversion. -- Unless expressly prohibited by the governing instrument, a trustee may release the power under section 8104 (relating to trustee's power to adjust) and convert a trust into a unitrust as described in this section if all of the following apply:

(1) The trustee determines that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust.

(2) The trustee gives written notice of the trustee's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including what initial decisions the trustee will make under this section, to all the sui juris beneficiaries who:

(i) are currently eligible to receive income from the trust; and

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

(3) There is at least one sui juris beneficiary under paragraph (2)(i) and at least one sui juris beneficiary under paragraph (2)(ii).

(4) No sui juris beneficiary objects to the conversion to a unitrust in a writing delivered to the trustee within 60 days of the mailing of the notice under paragraph (2).

(b) Judicially approved conversion. --

(1) The trustee may petition the court to approve the conversion to a unitrust if any of the following apply:
(i) A beneficiary timely objects to the conversion to a unitrust.

(ii) There are no sui juris beneficiaries under subsection (a)(2)(i).

(iii) There are no sui juris beneficiaries under subsection (a)(2)(ii).

(2) A beneficiary may request a trustee to convert to a unitrust. If the trustee does not convert, the beneficiary may petition the court to order the conversion.

(3) The court shall approve the conversion or direct the requested conversion if the court concludes that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust.

(c) Consideration. -- In deciding whether to exercise the power conferred by subsection (a), a trustee may consider, among other things, all of the following:

(1) The size of the trust.

(2) The nature and estimated duration of the trust.

(3) The liquidity and distribution requirements of the trust.

(4) The needs for regular distributions and preservation and appreciation of capital.

(5) The expected tax consequences of the conversion.

(6) 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; and the extent to which an asset is used by a beneficiary.

(7) To the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument.

(8) Whether and to what extent the governing instrument gives the trustee the power to invade principal or accumulate income or prohibits the trustee from invading principal or accumulating income and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.

(9) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.

(d) Post conversion. -- After a trust is converted to a unitrust, all of the following apply:

(1) The trustee shall follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived:
(i) from appreciation of capital;

(ii) from earnings and distributions from capital; or

(iii) from both.

(2) The trustee shall make regular distributions in accordance with the governing instrument construed in accordance with the provisions of this section.

(3) The term "income" in the governing instrument shall mean an annual distribution (the unitrust distribution) equal to 4% (the payout percentage) of the net fair market value of the trust's assets, whether such assets would be considered income or principal under the provisions of this chapter, averaged over the lesser of:

(i) the three preceding years; or

(ii) the period during which the trust has been in existence.

(e) Discretion of trustee. -- The trustee may in the trustee's discretion from time to time determine all of the following:

(1) The effective date of a conversion to a unitrust.

(2) The provisions for prorating a unitrust distribution for a short year in which a beneficiary's right to payments commences or ceases.

(3) The frequency of unitrust distributions during the year.

(4) The effect of other payments from or contributions to the trust on the trust's valuation.

(5) Whether to value the trust's assets annually or more frequently

(6) What valuation dates to use

(7) How frequently to value non-liquid assets and whether to estimate their value.

(8) Whether to omit from the calculations trust property occupied or possessed by a beneficiary.

(9) Any other matters necessary for the proper functioning of the unitrust.

(f) Allocation. --
(1) Expenses which would be deducted from income if the trust were not a unitrust may not be deducted from the unitrust distribution.

(2) Unless otherwise provided by the governing instrument, the unitrust distribution shall be paid from net income, as such term would be determined if the trust were not a unitrust. To the extent net income is insufficient, the unitrust distribution shall be paid from net realized short-term capital gains. To the extent income and net realized short-term capital gains are insufficient, the unitrust distribution shall be paid from net realized long-term capital gains. To the extent income and net realized short-term and long-term capital gains are insufficient, the unitrust distribution shall be paid from the principal of the trust.

(g) Court orders. -- The trustee or, if the trustee declines to do so, a beneficiary may petition the court to:

(1) Select a payout percentage different than 4%.

(2) Provide for a distribution of net income, as would be determined if the trust were not a unitrust, in excess of the unitrust distribution if such distribution is necessary to preserve a tax benefit.

(3) Average the valuation of the trust's net assets over a period other than three years.

(4) Reconvert from a unitrust. Upon a re-conversion, the power to adjust under section 8104 shall be revived.

(h) Application. -- A conversion to a unitrust does not affect a provision in the governing instrument directing or authorizing the trustee to distribute principal or authorizing a beneficiary to withdraw a portion or all of the principal.

(i) Prohibited conversions. -- A trustee may not convert a trust into a unitrust in any of the following circumstances:

(1) If payment of the unitrust distribution would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.

(2) If the unitrust distribution would be made from any amount which is permanently set aside for charitable purposes under the governing instrument and of which a Federal estate or gift tax deduction has been taken, unless both income and principal are so set aside.

(3) If:

   (i) possessing or exercising the power to convert would cause an individual to be treated as the owner of all or part of the trust for Federal income tax purposes; and

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(ii) the individual would not be treated as the owner if the trustee did not possess the power to convert.

(4) If:

(i) possessing or exercising the power to convert would cause all or part of the trust assets to be subject to Federal estate or gift tax with respect to an individual; and

(ii) the assets would not be subject to Federal estate or gift tax with respect to the individual if the trustee did not possess the power to convert.

(5) If the conversion would result in the disallowance of a Federal estate tax or gift tax marital deduction which would be allowed if the trustee did not have the power to convert.

(6) If the trustee is a beneficiary of the trust.

(j) Permissible conversion when otherwise prohibited. --

(1) If subsection (i)(3), (4) or (6) applies to a trustee and there is more than one trustee, a co-trustee to whom the provision does not apply may convert the trust, unless the exercise of the power by the remaining trustee or trustees is prohibited by the governing instrument.

(2) If subsection (i)(3), (4) or (6) applies to all the trustees, the trustees may petition the court to direct a conversion.

(k) Release of the power to convert. --

(1) A trustee may release the power conferred by subsection (a) to convert to a unitrust if any of the following apply:

(i) The trustee is uncertain about whether possessing or exercising the power will cause a result described in subsection (i)(3), (4) or (5).

(ii) The trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (i).

(2) The release may be permanent or for a specified period, including a period measured by the life of an individual.
**Pennsylvania Comment:** Section 8105. This section allows conversion to a unitrust, in which case the question of how to allocate receipts and disbursements between income and principal becomes irrelevant. The 4% unitrust is an alternative to using the power to adjust under section 8104 to determine the appropriate distribution to the current beneficiary. Caveat: The federal income tax treatment of unitrusts is uncertain and converting a trust exempt from generation-skipping tax into a unitrust may result in a loss of the exemption. Subsection (g) is designed in part to allow the trustee by petition to the court to preserve this tax benefit.

Under section 8105(a)(2), since the unitrust may not be familiar to most beneficiaries, the trustee is required to notify them, and cannot convert to a unitrust in the face of an objection from a beneficiary without a court order.

Under section 8105(c), the list of factors to consider is parallel to the list in the prudent investor act in 20 Pa.C.S. § 7203(c).

Giving the trustee discretion under section 8105(e) seems preferable to creating a statutory straightjacket.

Section 8105(i), (j) and (k) parallel similar provisions in section 8104 regarding the power to adjust.

§ 8106. Judicial control of discretionary powers.

(a) Standard of review.--A court shall not change a fiduciary’s decision to exercise or not to exercise a discretionary power conferred by this chapter unless it determines that the decision was an abuse of the fiduciary’s discretion.

(b) Remedies.--If a court determines that a fiduciary has abused its discretion regarding a discretionary power conferred by this chapter, the remedy is to restore the income and remainder beneficiaries to the positions they would have occupied if the fiduciary had not abused its discretion, according to the following rules:

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

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

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(3) If the abuse of discretion concerns the power to convert a trust into a unitrust, the court shall require the trustee either to convert into a unitrust or to reconvert from a unitrust.

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

[Uniform Act Provision and Comments can be found at the following URL Site--http://www.law.upenn.edu/bll/ulc/ulc_frame.htm

Pennsylvania Comment: Section 8106(a). The Uniform Act provision that a court should not determine that a trustee abused its discretion merely because the court would have exercised the discretion differently is omitted as unnecessary.

Section (b) of the Uniform Act lists the determinations to which subsection (a) applies. This has been omitted as unnecessary.

Subsection (d) of the Uniform Act allows the trustee to obtain an advisory opinion. It is omitted because it is inconsistent with Pennsylvania law, which does not permit the courts to give advisory opinions.

APPENDIX 9

QUESTIONS AND ANSWERS CONCERNING THE UNITRUST CONVERSION STATUTE

1. Why choose a 4% payout rate?

   A. As a default rate, 4% provides a generous current return while also providing good prospects for the preservation of real value of the trust over long periods assuming a conservative investment mix of approximately two-thirds equities and one-third bonds.

   B. Through the period 1960 through 2003, such a unitrust would keep the distribution going throughout this long period, producing very close to the highest rate of distribution at the end of all possible rates (depending a bit on investment mix). Higher rates over long periods depress growth.

   C. Such a rate would provide considerable relief. In today's markets, a 4% distribution from an income rule trust would require as much as 90% of the trust to be invested in fixed income. That would be impossible as a prudent investor.

2. Why not give the trustee full discretion to select the percentage?

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A. Trustees today have little or no experience in selecting such rates, so for most of them such a choice would be burdensome rather than attractive.

B. The proposed statute allows a different rate to be selected, but requires court approval since changing rates, particularly at the extremes, affects tremendously the economics of the trust and the apportionment of benefits between current and remainder beneficiaries.

C. Since one can make a statistical case that a trust invested for total return with a reasonable asset allocation can preserve the real value of the trust with a 4% distribution, one can argue that such preservation is consistent with the original meaning of the word "income", and consistent with the true intent of the settlor.

D. The change from an income rule trust to, for example, a 2% trust or a 7% trust by a non-independent trustee, might be considered to be a taxable transfer for gift tax purposes, because of the substantial shift in economic benefits.

3. Why not allow the trustee to select the distribution rate annually?

A. An annual requirement to select a distribution rate would be unattractive to trustees who must then make a fundamental decision about the trust at least once a year.

B. The temptation would be to pay out a higher rate when interest rates are high and a lower rate when they are low. This is exactly contrary to good financial practice. High interest rates imply high inflationary expectations and typically are a companion of very low total returns, hence reflecting the very reverse of what should occur in distribution practice.

C. The 1970's are an ideal example of this in which the periods of high interest rates would have been the very worst and most expensive time to increase distributions. Consider the interest rates in 1981 and the implications of increasing distribution (decreasing investment) just before the start of the bull market in 1982.

D. A consistent unitrust distribution requires distribution of higher amounts during high markets (selling high) and distribution of lower amounts in low markets (buying low).

4. Why adopt a default rule using calendar years and a three year smoothing rule?

A. Three years was developed as the smallest number of years needed to significantly reduce the number and magnitude of declines in annual distributions during long periods of time. While longer periods will produce somewhat smoother distributions, the trade-off generally may not be worth it at the cost of unlinking the fortunes of present and future beneficiaries.
B. The longer the smoothing rule, the smaller the dollar averaging benefit.

C. A calendar year valuation was adopted because this allows the trustee and beneficiary to know the distributions for the entire next year at the beginning of the year. This optimizes the beneficiary's ability to budget--an ability often missing from trust income. It also allows the trustee to know how much liquidity it will need throughout the course of the year.

D. The recent extraordinary bull market from 1995-1999 (greatest 5 year advance ever) and then bear market from 2000-2002 (worst bear market since 1973-1974) really pushes the three year smoothing rule to its limits. If this extraordinary year to year volatility were likely to be typical in the future, a longer smoothing rule, such as 4 or 5 years, might be preferable, despite the disadvantages noted above.

5. Why do we think the research data from the past will reflect the future?

A. We have studied the results of different distribution methods and asset allocations through three extended periods of time:

1960 through 2003 - A long period containing all types of markets--with a bull market, several bear markets and some in-between. It contains a period of high inflation and very low inflation.

1973 through 2003 - A worst-case scenario from the point of view of equity investing because of the 1973/1974 period (worst two year period since the 1930's) and the rest of the bear market of the 70's.

1926 through 2003 - We have examined the effect during the entire Ibbotson period for which truly accurate and standardized data has been provided.

B. We have studied all of the rolling twenty-year periods since 1926. A 4% unitrust payout with an 80/20 equity mix would have preserved the real value of the trust in 59% of the periods, and beats a 50/50 income rule trust in ending market value in 53 out of 54 rolling twenty-five year periods.

C. Professor Jeremy Siegal has tracked these returns normalized for inflation back to the year 1801. His conclusion on the trend line of total return from equities is that they produce after inflation (real) returns of 6.8%. Once trustee's fees and expenses and taxes are taken into account, this two century thesis is extremely consistent with our computer modeling findings.

D. Unitrust theory depends on mathematics - not prognostication.
6. What if the trustee converts to a Total Return Trust and the trustee and the beneficiaries are dissatisfied with the Total Return Trust?

   B. The trustee can reconvert by obtaining court approval.
   C. The mathematics of unitrust theory and historical study suggests that periods in which the current beneficiary may be dissatisfied with the payout is precisely when the trustee should "stay the course" for the long term economic health of the trust and its beneficiaries.

APPENDIX 10

§ 3527. Total return unitrusts.

(a) In this section:

   (1) "Disinterested person" means a person who is not a "related or subordinate party" (as defined in § 672(c) of the Internal Revenue Code [26 U.S.C. §1, et seq.] or any successor provision thereof (hereinafter referred to in this section as the "I.R.C.") with respect to the person then acting as trustee of the trust and excludes the trustor of the trust and any interested trustee.

   (2) "Income trust" means a trust, created by either an inter vivos or a testamentary instrument, which directs or permits the trustee to distribute the net income of the trust to 1 or more persons, either in fixed proportions or in amounts or proportions determined by the trustee. Notwithstanding the foregoing, no trust that otherwise is an "income trust" shall qualify hereunder if it may be subject to taxation under I.R.C. § 2001 or §2501 [26 U.S.C. § 2001 or § 2501] until the expiration of the period for filing the return therefor (including extensions).

   (3) "Interested distributee" means a person to whom distributions of income or principal can currently be made who has the power to remove the existing trustee and designate as successor a person who may be a "related or subordinate party" (as defined in I.R.C. § 672(c) [26 U.S.C. § 672(c)]) with respect to such distributee.

   (4) "Interested trustee" means:

      a. An individual trustee to whom the net income or principal of the trust can currently be distributed or would be distributed if the trust were then to terminate and be distributed,

      b. Any trustee who may be removed and replaced by an interested distributee and/or

      c. An individual trustee whose legal obligation to support a beneficiary may be satisfied by distributions of income and principal of the trust.
(5) 'Total return unitrust' means an income trust which has been converted under and meets the provisions of this section.

(6) "Trustee" means all persons acting as trustee of the trust (except where expressly noted otherwise), whether acting in their discretion or on the direction of 1 or more persons acting in a fiduciary capacity.

(7) "Trustor" means an individual who created an inter vivos or a testamentary trust.

(8) "Unitrust amount" means an amount computed as a percentage of the fair market value of the trust.

(b) A trustee, other than an interested trustee, or where 2 or more persons are acting as trustee, a majority of the trustees who are not an interested trustee (in either case hereafter "trustee"), may, in its sole discretion and without the approval of the Court of Chancery:

(1) Convert an income trust to a total return unitrust;

(2) Reconvert a total return unitrust to an income trust; or

(3) Change the percentage used to calculate the unitrust amount and/or the method used to determine the fair market value of the trust if:

   a. The trustee adopts a written policy for the trust providing:

      1. In the case of a trust being administered as an income trust, that future distributions from the trust will be unitrust amounts rather than net income;

      2. In the case of a trust being administered as a total return unitrust, that future distributions from the trust will be net income rather than unitrust amounts; or

      3. That the percentage used to calculate the unitrust amount and/or the method used to determine the fair market value of the trust will be changed as stated in the policy;

   b. The trustee sends written notice of its intention to take such action, along with copies of such written policy and this section, to:

      1. The trustor of the trust, if living;

      2. All living persons who are currently receiving or eligible to receive distributions of income of the trust;
3. All living persons who would receive principal of the trust if the trust were to terminate at the time of the giving of such notice (without regard to the exercise of any power of appointment) or, if the trust does not provide for its termination, all living persons who would receive or be eligible to receive distributions of income or principal of the trust if the persons identified in subsubparagraph 2. of this subparagraph b. were deceased; and

4. All persons acting as adviser or protector of the trust;

   c. At least one person receiving notice under each of subsubparagraphs 2. and 3. of subparagraph b. above is legally competent; and

   d. No person receiving such notice objects, by written instrument delivered to the trustee, to the proposed action of the trustee within sixty (60) days of receipt of such notice.

(c) If there is no trustee of the trust other than an interested trustee, the interested trustee or, where two or more persons are acting as trustee and are interested trustees, a majority of such interested trustees may, in its sole discretion and without the approval of the Court of Chancery:

   (1) Convert an income trust to a total return unitrust;

   (2) Reconvert a total return unitrust to an income trust; or

   (3) Change the percentage used to calculate the unitrust amount and/or the method used to determine the fair market value of the trust if:

       a. the trustee adopts a written policy for the trust providing:

           1. In the case of a trust being administered as an income trust, that future distributions from the trust will be unitrust amounts rather than net income;

           2. In the case of a trust being administered as a total return unitrust, that future distributions from the trust will be net income rather than unitrust amounts; or

           3. That the percentage used to calculate the unitrust amount and/or the method used to determine the fair market value of the trust will be changed as stated in the policy;

       b. the trustee appoints a disinterested person who, in its sole discretion but acting in a fiduciary capacity, determines for the trustee:

           1. the percentage to be used to calculate the unitrust amount;
2. the method to be used in determining the fair market value of the trust; and

3. which assets, if any, are to be excluded in determining the unitrust amount;

c. the trustee sends written notice of its intention to take such action, along with copies of such written policy and this section, and the determinations of the disinterested person to:

1. the trustor of the trust, if living;

2. all living persons who are currently receiving or eligible to receive distributions of income of the trust;

3. all living persons who would receive principal of the trust if the trust were to terminate at the time of the giving of such notice (without regard to the exercise of any power of appointment) or, if the trust does not provide for its termination, all living persons who would receive or be eligible to receive distributions of income or principal of the trust if the persons identified in subsubparagraph 2. of subparagraph c. were deceased; and

4. all persons acting as adviser or protector of the trust;

d. at least one person receiving notice under each of subsubparagraphs 2. and 3. of subparagraph c. of this subdivision is legally competent; and

e. no person receiving such notice objects, by written instrument delivered to the trustee, to the proposed action of the trustee or the determinations of the disinterested person within sixty (60) days of receipt of such notice.

(d) If any trustee desires to (i) convert an income trust to a total return unitrust, (ii) reconvert a total return unitrust to an income trust, or (iii) change the percentage used to calculate the unitrust amount and/or the method used to determine the fair market value of the trust but does not have the ability to or elects not to do it under the provisions of subsection (b) or (c) above, the trustee may petition the Court of Chancery for such order as the trustee deems appropriate. In the event, however, there is only one trustee of such trust and such trustee is an interested trustee or in the event there are two or more trustees of such trust and a majority of them are interested trustees, the Court, in its own discretion or on the petition of such trustee or trustees or any person interested in the trust, may appoint a disinterested person who, acting in a fiduciary capacity, shall present such information to the Court as shall be necessary to enable the Court to make its determinations hereunder.

(e) The fair market value of the trust shall be determined at least annually, using such valuation date or dates or averages of valuation dates as are deemed appropriate. Assets for which a fair market value cannot be readily ascertained shall be valued using such valuation methods as are deemed reasonable and appropriate. Such assets may be excluded from valuation,
provided all income received with respect to such assets is distributed to the extent distributable in accordance with the terms of the governing instrument.

(f) The percentage to be used in determining the unitrust amount shall be a reasonable current return from the trust, in any event not less than three (3) percent nor more than five (5) percent, taking into account the intentions of the trustor of the trust as expressed in the governing instrument, the needs of the beneficiaries, general economic conditions, projected current earnings and appreciation for the trust, and projected inflation and its impact on the trust.

(g) The unitrust amount shall not be less than the net income of the trust, determined without regard to the provisions of subsection (h), for (i) a trust for which a marital deduction has been taken for federal tax purposes under I.R.C. § 2056 or § 2523 [26 U.S.C. § 2056 or § 2523] (during the lifetime of the spouse for whom the trust was created), or (ii) a trust to which the generation-skipping transfer tax due under I.R.C. § 2601 [26 U.S.C. § 2601] does not apply by reason of any effective date or transition rule.

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

(1) shall treat the unitrust amount as if it were net income of the trust for purposes of determining the amount available, from time to time, for distribution from the trust; and

(2) may allocate to trust income for each taxable year of the trust (or portion thereof):

   a. net short-term capital gain described in I.R.C. § 1222(5) [26 U.S.C. § 1222(5)] for such year (or portion thereof) but only to the extent that the amount so allocated together with all other amounts allocated to trust income for such year (or portion thereof) does not exceed the unitrust amount for such year (or portion thereof); and

   b. net long-term capital gain described in I.R.C. § 1222(7) [26 U.S.C. § 1222(7)] for such year (or portion thereof) but only to the extent that the amount so allocated together with all other amounts, including amounts described in paragraph a. of this subdivision, allocated to trust income for such year (or portion thereof) does not exceed the unitrust amount for such year (or portion thereof).

(i) In administering a total return unitrust, the trustee may, in its sole discretion but subject to the provisions of the governing instrument, determine:

(1) the effective date of the conversion;

(2) the timing of distributions (including provisions for prorating a distribution for a short year in which a beneficiary's right to payments commences or ceases);

(3) whether distributions are to be made in cash or in kind or partly in cash and partly in kind;

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(4) if the trust is reconverted to an income trust, the effective date of such reconversion; and

(5) such other administrative issues as may be necessary or appropriate to carry out the purposes of this section.

(j) Conversion to a total return unitrust under the provisions of this section shall not affect any other provision of the governing instrument, if any, regarding distributions of principal.

(k) In the case of a trust for which a marital deduction has been taken for federal tax purposes under I.R.C. § 2056 or § 2523 [26 U.S.C. § 2056 or § 2523], the spouse otherwise entitled to receive the net income of the trust shall have the right, by written instrument delivered to the trustee, to compel the reconversion during his or her lifetime of the trust from a total return unitrust to an income trust, notwithstanding anything in this section to the contrary.

(l) This section shall be construed as pertaining to the administration of a trust and shall be available to any trust that is administered in Delaware under Delaware law unless:

(1) the governing instrument reflects an intention that the current beneficiary or beneficiaries are to receive an amount other than a reasonable current return from the trust;

(2) the trust is a trust described in I.R.C. § 170(f)(2)(B), § 664(d), § 1361(d), § 2702(a)(3) or § 2702(b) [26 U.S.C. § 170(f)(2)(B), § 664(d), § 1361(d), § 2702(a)(3) or § 2702(b)];

(3) one or more persons to whom the trustee could distribute income have a power of withdrawal over the trust that is not subject to an ascertainable standard under I.R.C. § 2041 or § 2514 [26 U.S.C. § 2041 or § 2514] or that can be exercised to discharge a duty of support he or she possesses; or

(4) the governing instrument expressly prohibits use of this section by specific reference to the section.

A provision in the governing instrument that "The provisions of 12 Delaware Code, Section 3527, as amended, or any corresponding provision of future law, shall not be used in the administration of this trust." or similar words reflecting such intent shall be sufficient to preclude the use of this section.

(m) Any trustee or disinterested person who in good faith takes or fails to take any action under this section shall not be liable to any person affected by such action or inaction, regardless of whether such person received written notice as provided in this section and regardless of whether such person was under a legal disability at the time of the delivery of such notice. Such person's exclusive remedy shall be to obtain an order of the Court directing the
trustee to convert an income trust to a total return unitrust, to reconvert from a total return unitrust to an income trust or to change the percentage used to calculate the unitrust amount.

(n) This section shall be effective upon enactment and shall be available to trusts in existence at the date of enactment or created thereafter.

(73 Del. Laws, c. 48, § 1.)

§ 3527A. Express total return unitrusts.

(a) The following provisions shall apply to a trust that, by its governing instrument, requires or permits the distribution, at least annually, of a unitrust amount equal to a fixed percentage of not less than 3 nor more than 5 percent per year of the fair market value of the trust's assets, valued at least annually, such trust to be referred to in this section as an 'express total return unitrust.'

(b) The unitrust amount for an express total return unitrust may be determined by reference to the fair market value of the trust's assets in 1 year or more than 1 year.

(c) Distribution of such a fixed percentage unitrust amount is considered a distribution of all of the income of the express total return unitrust.

(d) An express total return unitrust may or may not provide a mechanism for changing the unitrust percentage similar to the mechanism provided under § 3527 of this title, based upon the factors noted therein, and may or may not provide for a conversion from a unitrust to an income trust and/or a reconversion of an income trust to a unitrust similar to the mechanism under § 3527 of this title.

(e) If an express total return unitrust does not specifically or by reference to § 3527 of this title deny a power to change the unitrust percentage or to convert to an income trust, then the trustee shall have such power.

(f) The distribution of a fixed percentage of not less than 3 percent nor more than 5 percent reasonably apportions the total return of an express total return unitrust.

(g) The trust instrument may grant discretion to the trustee to adopt a consistent practice of treating capital gains as part of the unitrust distribution, to the extent that the unitrust distribution exceeds the net accounting income, or it may specify the ordering of such classes of income.

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

(1) From net accounting income determined as if the trust were not a unitrust;
(2) From ordinary income not allocable to net accounting income;

(3) After calculating the trust's capital gain net income as described in Internal Revenue Code ("I.R.C.") [26 U.S.C. § 1, et seq.] § 1222(9) [26 U.S.C. § 1222(9)], from net realized short-term capital gain as described in I.R.C. § 1222(5) [26 U.S.C. § 1222(5)] and then from net realized long-term capital gain described in I.R.C. § 1222(7) [26 U.S.C. § 1222(7)]; and

(4) From the principal of the trust.

(i) The trust instrument may provide that:

(1) Assets for which a fair market value cannot be readily ascertained shall be valued using such valuation methods as are deemed reasonable and appropriate; and

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

(74 Del. Laws, c. 270, § 13.)

APPENDIX 11

SUPPLEMENTAL FORMS

INTRODUCTION

In addition to the Total Return Unitrust form in the body of the materials, the following are excerpts from additional forms that may be of use to the drafter. In the interests of space conservation, only the portions of the trust provisions that are unique as opposed to the detailed Basic Form in the materials are set forth hereinafter. The balance of the form language can be obtained from the more complete form in the materials and from other forms used by the drafter in his or her discretion.

Form 2 – Marital and Credit Shelter Trusts/Pecuniary Bequest Formula/Separate Total Return Unitrusts/Payout for Spouse

Drafting Note: Pecuniary Marital Bequest: A pecuniary marital bequest will shift the appreciation and depreciation of the estate assets after the Testator’s/Grantor’s death but prior to separate funding of the Marital TRU to the Shelter TRU. This is beneficial in a rising market since it will increase the size of the Shelter TRU, and unhelpful in a declining market, which will make the Shelter TRU smaller. To avoid significant market risk, partial funding can be made as promptly as practicable after Testator’s/Grantor’s death to the extent that sufficient information is known about the taxable estate. Attorney may wish to avoid using a pecuniary formula trust division if a major portion of the assets passing to the trustees are income in respect under Section 691 of the Code, since there is risk of a realization of the IRD as a result of the pecuniary formula.
3. Division of Residuary Estate if my Spouse Survives.
   A. Marital Formula Bequest. If my ____________, ______________, survives me, I give to my trustees, appointed hereinafter, to hold in trust as the Marital Total Return Unitrust ("Marital TRU"), the minimum amount necessary, if any, to reduce my United States Estate Tax ("Estate Tax") under the Internal Revenue Code of 1986, as amended ("Code") to zero or the smallest possible amount after the use of the applicable credit amount and any other credits available to my estate (exclusive of any credits the use of which would increase my total death taxes). The foregoing amount ("Marital Bequest") shall be determined after taking into account any other assets passing to my ____________ and qualifying for the marital deduction, whether such other assets pass under this will or otherwise, as well as any other deductions taken and allowed on my Estate Tax Return. This amount shall be computed as if all qualified terminable interests were elected as part of the marital deduction on my Estate Tax Return, regardless of the election actually filed. This bequest may be satisfied with proceeds of life insurance or other assets paid directly to my trustees.

   1. Funding Terms. To the extent that the amount to be held as the Marital TRU is satisfied with property in kind, such property shall be distributed at its market value as of the date or dates of distribution. There shall be excluded from the Marital TRU, any property (or the proceeds of any property) which does not qualify for the marital deduction or which is not subject to federal estate tax by reason of my death.

   2. Income or Interest Prior to Funding. In lieu of any statutory interest required to be paid on a pecuniary bequest in trust, my Marital TRU shall be entitled to a pro rata share of the income from the assets held in my estate or from other assets payable to the trustees but prior to the complete funding of my Marital TRU. [Drafting Note: This provision eliminates any statutory interest requirement for a pecuniary bequest which is problematic because the interest is not deductible to the trust, but is fully taxable to the beneficiary. This results in an unfortunate double taxation, or the potential conversion of tax free income into taxable income if municipal bonds are held in the estate.]

   B. Bequest and Funding of Credit Shelter TRU. I give the residue of my estate after the satisfaction of the Marital Bequest (or all thereof, if there is no Marital Bequest) to my trustees as the Credit Shelter Total Return Unitrust as set forth below ("Shelter TRU").

   C. Estate Tax Repeal. If at the time of my death there is no Estate Tax by virtue of repeal, it is intent that my entire residuary estate shall be held as the Shelter TRU as set forth below. [Drafting Note: This last language is added to guard against ambiguity if at the time of death the Estate Tax has been eliminated. The theory behind this choice is that you might want all of the estate protected against further taxation or other risks in that event. This should be discussed with each client separately to choose between a trust or outright bequest depending upon the client’s intent and the attorney’s judgment.]

   D. Survivorship Presumption. If my ________ and I die under circumstances in which there is insufficient evidence of who was the survivor, it shall be conclusively presumed that ___________________. [Typically it is best to presume that the spouse with the largest estate has predeceased, to give the greatest flexibility for disclaimer planning.]

   E. Right to Disclaim. If my ______________ disclaims _____ interest in any portion of the Marital TRU, [Option 1 - disclaimed portion added to Shelter TRU: such portion shall be added to the Shelter TRU, and my ________ shall have all the rights therein hereinafter set forth with the exception of any power of appointment. If my
dies before accepting any benefits, _______ personal representative shall have the right to disclaim _______ interest in all or a portion of Marital TRU.] [Note that such a disclaimer will presumably produce Federal Estate Tax in the decedent's estate. This may reduce the aggregate tax in both estates if it serves to equalize the tax brackets in both estates. This Separate Payout Marital and Shelter TRU Form retains the potential benefit of the credit for previously taxed property, since the value of the life interest in the Shelter TRU can be determined actuarially as opposed to the Ordered Payout format where the Combined Unitrust Amount is entirely paid from The Marital TRU as long as possible. The manner of valuation for a unitrust should be as a unitrust, but there is a question as to whether it may be valued as an “income” interest, in a unitrust state. That will be beneficial whenever the 7520 rate is greater than the unitrust rate.]

[Option 2 - disclaimed portion paid out to children and issue: such portion shall be distributed to my living issue, per stirpes.] [Note that this is chosen if the client's desire is for the disclaimed amount to pass free of trust to children, subject to the Trust Continuation Provisions.]  

4. Marital and Shelter TRU Provisions. If my _____________, _______________, survives me, it is my intent to create two Total Return Unitrusts, the Marital TRU and the Shelter TRU. Except as indicated below, the terms of both trusts shall be the same:  

A. During __________’s Life. In each trust calendar year or such portion thereof in the first or final year of each trust ("Trust Year"), my trustees shall pay to or for the benefit of my _____________, _______________, during his life, in quarter-annual installments, the unitrust amounts set forth below ("Unitrust Amount") for the Marital TRU and for the Shelter TRU.  

B. Unitrust Rate. The unitrust rate for the Marital TRU shall be _______ (____%) percent and the unitrust rate from the Shelter TRU shall be _______ (____%) percent (hereafter, as respects each trust, the "Applicable Unitrust Rate").  

C. Unitrust Amount. The Unitrust Amount for each trust shall be equal to the average of the fair market values ("Average Value") of the assets of the trust as of the close of the first business day of the Trust Year (or the date of first funding for the first Trust Year) and the two previous Trust Years (or such lesser number of Trust Years as are available for the first two Trust Years) multiplied by the Applicable Unitrust Rate for that trust. In the case of a short Trust Year, the Unitrust Amount shall be calculated as set forth in subparagraph D. below. In the case of additions to or distributions from the trusts, the Unitrust Amount shall be determined as set forth in subparagraph E. below. Expenses which would be deducted from income if the trusts were not unitrusts shall not be deducted from the payment of the Unitrust Amount.  

D. Short Year. For a short Trust Year, including the year of initial funding and the year of my ____________’s death, the Unitrust Amount shall be based upon a prorated portion of the Unitrust Amount set forth above, comparing the number of days in the short Trust Year to the number of days in the calendar year of which the short Trust Year is a part.  

E. Adjustments for Additions and Distributions. In a Trust Year in which assets are added to a trust (other than the first funding of the trust) or distributed from a trust (other than the Unitrust Amount), the Unitrust Amount for such year (hereinafter, "Adjustment Year") shall thereafter be increased in the case of an addition, or decreased in the case of a distribution, by an amount computed by first multiplying the fair market value of the assets
added or distributed (as of the date or dates of the addition or distribution), by the Applicable Unitrust Rate for the trust. The result is then multiplied by a fraction, the numerator of which is the number of days from the addition or distribution to the end of the Trust Year and the denominator of which is the days in the calendar year.

Further, the fair market value of the assets of the trust for the Adjustment Year and the Trust Year immediately preceding the Adjustment Year shall be increased or decreased, as the case may be, by the net addition or distribution during the Adjustment Year for purposes of determining the Average Value applicable for the subsequent Trust Years. [See notes to Basic Form for smoothing rule explanation]

F. Valuation. All computations of a trust's fair market value, or the value of any additions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. Liabilities of the trust, other than the Unitrust Amount or ordinary operating expenses, such as trustees' fees, investment advisor fees or fiduciary income taxes, shall be taken into account in determining the fair market value of the assets of each trust. If a trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their discretion under the circumstances. [See notes to Basic form concerning closely held businesses or illiquid assets]

G. Distribute all Income in Marital TRU. If in any Trust Year the net income earned in the Marital TRU exceeds the Unitrust Amount to be paid from the Marital TRU, such excess net income shall be distributed to my said at least annually. If at the time of my death, the distribution of such excess net income is not necessary to qualify for the marital deduction, then such excess net income shall not be distributed. [This subparagraph is necessary in states without a unitrust definition of income statute in order to preserve the marital deduction for the Marital TRU. Note also that the Final Regulations specifically refer to a unitrust interest of 3% to 5% as being a reasonable allocation of annual total return. The use of a rate under 3% for a Marital TRU for which the attorney intends to qualify for the marital deduction without the provision for distribution of excess income is therefore not recommended. Further, if your TRU state law has a specific conversion rate, such as 4%, you may not be safe in adopting a rate lower than the default rate for your state, unless there is a specific provision in your statute that allows a lower rate, such as 3%, to be considered “income”. See detailed analysis of the Final Regulations at Section X. E.]

H. Income Earned in Estate Prior to Trust Funding. In addition to the Unitrust Amount as determined above for the Marital TRU and the Shelter TRU, the income earned from the assets held in my estate or from other assets payable to the trustees, and distributed to my trustees hereunder, prior to the complete funding of each trust, shall be distributed to my said .

I. Ordering Rule. The Unitrust Amount for both the Marital TRU and the Shelter TRU as well as any discretionary distributions shall be considered to have been paid first from net accounting income of the trust, next from ordinary taxable income not allocable to net accounting income, next from net realized short term capital gains, then from net realized long term capital gains, and finally, as necessary, from the principal of the trust. [See notes to Basic Form for discussion of unitrust ordering rule, and consider alternatives discussed in Section X. G. to grant discretion to trustee to include capital gains in income or deem capital gains to be a part of DNI, if after consideration of the Final Regulations and applicable local law, it is thought to be necessary or desirable to do so.]
J. Discretionary Distributions of Additional Amounts. In addition to the Unitrust Amount as set forth above, my trustees shall distribute such additional amounts to my said _______ as the trustees deem advisable for h__ health, education, maintenance, and support in h__ accustomed manner of living, taking into account other assets and income otherwise available to h__; provided, however, that my trustees shall first utilize the trust assets of the Marital TRU prior to distributing any trust assets from the Shelter TRU.

K. Total Return Unitrust Design and Goals of Trusts [Optional. And trustees' power to increase Applicable Unitrust Rate under ascertainable standards.] I have chosen to create Total Return Unitrusts in order to allow the trusts to be invested for total return without the artificial distinction between accounting income and principal appreciation. By doing so, the trusts can be invested without conflict between the interests of the current beneficiary and the remainder beneficiaries. [Select whichever option reflects best the client’s intent:

Option 1: The trustees may wish to take into account that my primary goal is to benefit my ______ during h___ lifetime and that the buildup of funds for the next generation is of secondary importance. OR

Option 2: The trustees may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my ______ and that the buildup of value to be passed forward into the next generation is of considerable importance.

Note also that client’s intent may be different for the different trusts. For example, the Marital TRU may be relatively more focused upon the needs of the surviving spouse while the Credit Shelter TRU may be more focused on growth for the next generation. The foregoing samples are “generic” statements. Something more concrete and individualized may be more desirable where appropriate.]

[Optional. If the trustees become convinced that the unitrust rate established for h___ will not be sufficient to satisfy h__ needs under the ascertainable standards set forth in subparagraph J. above, and would otherwise require a continuing exercise of that discretionary distribution power, then the trustees may increase the unitrust rate to satisfy h__ needs pursuant to those standards for as long as necessary, provided that the unitrust rate shall not be increased to a rate in excess of seven (7%) percent. The trustees shall not be held liable for the good faith exercise or non-exercise of this power. ] [ Drafting Note: Granting this power to the trustees is not intended to water down the requirements of the ascertainable standards of health, education, maintenance and support, but is merely intended to allow a unitrust method for implementing those discretionary powers should this be helpful. It is suggested that the justification for such an exercise of discretion should be reviewed by the trustees at least once a year.]

L. On Spouse’s Death. Upon the death of my _____, __________________, the trustees shall pay any accrued or undistributed Unitrust Amount attributable to the Marital TRU [Drafting Note: If Paragraph F above is required, add the following: or, if greater, any accrued or undistributed income of the Marital TRU.] to my ___________'s estate. In addition,
the trustees shall pay to the personal representative of my ___________'s estate or directly to the
taxing authority from the Marital TRU, an amount equal to the increase in federal and state death
taxes caused by the inclusion of the assets of the Marital TRU in my ___________'s estate for
such tax purposes. Such amount, if any, shall be paid to the extent possible from the portion of
the Marital TRU that is included in my __________’s gross estate for Estate Tax purposes and as
to which he is the transferor for generation skipping transfer tax purposes. The balance of the
Marital TRU and the Shelter TRU shall be distributed outright to or in further trust for such one
or more of the my issue and spouses of issue, [Optional: or charities], in such proportions and
subject to such trusts and conditions, as my said ______ directs by specific reference to this
power and the separate trust (the Marital TRU and/or the Shelter TRU) to which it applies in
________ Last Will and Testament as admitted to probate. Any unappointed assets shall pass to
my issue who survive me, per stirpes, subject to the Trust Continuation Provisions set forth
hereinafter.

5. Disposition of Residuary Estate if Spouse Fails to Survive. If my ________,
_________________, fails to survive me, my residuary estate shall pass to my issue who survive
me, per stirpes, subject to the Trust Continuation Provisions set forth hereafter.

Form 3 - Marital/Credit Shelter Trusts/Fractional Share Division/Ordered Unitrust
Provisions.

Drafting Note: A fractional share formula will equitably apportion the appreciation and
depreciation of the trust assets after the client’s death but prior to the separate funding of
the Marital TRU and Shelter TRU between the two TRUs. The Marital and Credit Shelter
trusts will therefore share the risk of a rising or falling market. This may be particularly
important if the likely size of the Marital Share is very large compared to the Credit
Shelter share. In a severe market downturn, the Credit Shelter share could be eliminated
with a pecuniary marital, and tax paid out of the Marital Share; an unfortunate result. In
a rising market, a pecuniary credit shelter trust will exclude the appreciation from the
credit shelter trust, so that the marital trust to be taxed later will be increased in size. In a
rising market, the pecuniary marital is best, while in a falling market, the pecuniary credit
shelter is best. No one form is ideal for all circumstances, or all estate plans. The funding of
the fractional shares is more challenging, particularly if the funding cannot be
accomplished on a strictly pro rata basis, since the assets used to fund the shares should be
fairly representative of the appreciation and depreciation of the assets available for
funding. For a variety of reasons, however, the fractional formula may be safer and thus is
likely to be chosen more frequently in the future than it has been in the past.

3. Division of Residuary Estate.
   A. Division If Spouse Survives. If my ________,
_________________, survives me, my residuary estate shall be divided into two separate shares, designated the Marital
Share and the Credit Shelter Share to be held in trust by my trustees, hereinafter appointed. The
division into the Marital Share and the Credit Shelter Share shall be made as follows:
   (1) Fractional Share Formula. The Credit Shelter Share shall consist
of a fractional share of my residuary estate, subject to subparagraph (a) below. The numerator of
such fraction shall be the maximum amount which can pass free of United States Estate Tax
("Estate Tax") under the Internal Revenue Code of 1986 as amended ("Code") at my death by
reason of the applicable credit amount and any other credits available to my estate (exclusive of

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any credits the use of which would increase the total death taxes in my estate), when considered with any assets in my taxable estate not forming part of my residuary estate and not deductible in my estate. The denominator of such fraction shall be the value of the residuary estate as finally determined for Estate Tax purposes prior to the payment of death taxes therefrom. Any death taxes or administration expenses payable from my residuary estate that are not taken and allowed as estate tax deductions shall be charged against the Credit Shelter Share. The Marital Share shall consist of the other fractional share.

(a) Definition of Residuary Estate. For purposes of the calculation of the fractional shares, my residuary estate shall include any assets payable directly to the trustees and includible in my estate for Estate Tax purposes, but shall not include any items paid directly to the trustees and not forming part of my said taxable estate, which nontaxable items shall be added to the Credit Shelter Share, in addition to the fractional share hereinabove specified, and shall not be used for the payment of death taxes, debts or administration expenses.

(b) Satisfaction of Shares. The trustees need not make a pro rata division of each asset, but may allocate different kinds of or interests in property to each share, so long as the total fair market value of assets being allocated to each share is not affected by any such non-pro rata distribution as of the time or times of distribution. My intent hereby is to provide that property distributed in satisfaction of the shares defined above shall be fairly representative of the appreciation or depreciation in the value of all property available for distribution. No property, nor the proceeds of any property which does not qualify for the marital deduction shall be allocated to the Marital Share.

(2) Marital TRU and Shelter TRU. The Marital Share and the Credit Shelter Share shall be held by the trustees in separate Total Return Unitrusts and referred to as the "Marital TRU" and the "Shelter TRU" as set forth in Paragraph 4 below.

(3) Estate Tax Repeal. If at the time of my death there is no Estate Tax by virtue of repeal, it is intent that my entire residuary estate shall be held as the Shelter TRU as set forth below. [Drafting Note: See Note to Form 1 for discussion.]

(4) Survivorship Presumption. If my _________ and I die under circumstances in which there is insufficient evidence of who was the survivor, it shall be conclusively presumed that___________________.

(5) Right to Disclaim. If my _____________ disclaims ________ interest in any portion of the Marital TRU, [Option 1 - disclaimed portion added to Shelter TRU: such portion shall be added to the Shelter TRU, and my ____________ shall have all the rights therein hereinafter set forth with the exception of any power of appointment. If my ____________ dies before accepting any benefits, ____________'s personal representative shall have the right to disclaim ____________'s interest in all or a portion of Marital TRU.] [Note that such a disclaimer will presumably produce Federal Estate Tax in the decedent's estate. This may reduce the aggregate tax in both estates if it serves to equalize the tax brackets in both estates. If attorney wishes to retain the potential benefit of the credit for previously taxed property, Form 2 with a Separate Payout Marital and Shelter TRU Form should be used, since the value of the life interest in the Shelter TRU cannot be determined actuarially where the Combined Amount is entirely paid from The Marital TRU as long as possible.] [Option 2 - disclaimed portion paid out to children and issue: such portion shall be distributed to my living issue, per stirpes.] [Note that this is chosen if the client's desire is for

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the disclaimed amount to pass free of trust to children, subject to the Trust Continuation Provisions.]

B. If Spouse Fails to Survive. If my ________________, ________________, fails to survive me, my residuary estate shall pass to my issue who survive me, per stirpes, subject to the Trust Continuation Provisions set forth hereinafter.

4. Marital and Shelter TRU Provisions. If my ________________, ________________, survives me, it is my intent to create two Total Return Unitrusts, the Marital TRU and the Shelter TRU. Except as indicated below, the terms of both trusts shall be the same:

A. During ________’s Life. In each trust calendar year or such portion thereof in the first or final year of each trust ("Trust Year"), my trustees shall pay to or for the benefit of my ________________, ________________, during h__ life, in quarter-annual installments, an amount equal to the unitrust amount set forth below ("Unitrust Amount") for the Marital TRU and the Shelter TRU, (the sum shall be referred to as the "Combined Amount").

B. Unitrust Amount. The Unitrust Amount for each trust shall be equal to the average of the fair market values ("Average Value") of the assets of the trust as of the close of the first business day of the Trust Year (or the date of first funding for the first Trust Year) and the two previous Trust Years (or such lesser number of Trust Years as are available for the first two Trust Years) multiplied by ______ (____%) percent ("Applicable Unitrust Rate"). In the case of a short Trust Year, the Unitrust Amount shall be calculated as set forth in subparagraph C. below. In the case of additions to or distributions from the trusts, the Unitrust Amount shall be determined as set forth in subparagraph D. below; provided, however, that the Combined Amount shall be paid from the Marital TRU and nothing shall be paid from the Credit Shelter TRU unless or until the Marital TRU is exhausted. After the Marital TRU is exhausted, the entire or remaining Combined Amount shall be paid from the Shelter TRU. If there is no Marital TRU, the Unitrust Amount shall be paid from the Shelter TRU. Expenses which would be deducted from income if the trusts were not unitrusts shall not be deducted from the payment of the Unitrust Amount.

C. Short Year. For a short Trust Year, including the year of initial funding and the year of my ________________’s death, the Unitrust Amount shall be based upon a prorated portion of the Unitrust Amount set forth above, comparing the number of days in the short Trust Year to the number of days in the calendar year of which the short Trust Year is a part.

D. Adjustments for Additions and Distributions. In a Trust Year in which assets are added to a trust (other than the first funding of the trust) or distributed from a trust (other than the Unitrust Amount), the Unitrust Amount for such year (hereinafter, "Adjustment Year") shall thereafter be increased in the case of an addition, or decreased in the case of a distribution, by an amount computed by first multiplying the fair market value of the assets added or distributed (as of the date or dates of the addition or distribution), by the Applicable Unitrust Rate for the trust. The result is then multiplied by a fraction, the numerator of which is the number of days from the addition or distribution to the end of the Trust Year and the denominator of which is the days in the calendar year.

Further, the fair market value of the assets of the trust for the Adjustment Year and the Trust Year immediately preceding the Adjustment Year shall be increased or decreased, as the case may be, by the net addition or distribution during the Adjustment Year for
purposes of determining the Average Value applicable for the subsequent Trust Years. [See notes to Basic Form for smoothing rule explanation]

E. Valuation. All computations of a trust's fair market value, or the value of any additions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. Liabilities of the trust, other than the Unitrust Amount or ordinary operating expenses such as trustees' fees, investment advisor fees or fiduciary income taxes, shall be taken into account in determining the fair market value of the assets of each trust. If a trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their discretion under the circumstances. [See notes to Basic form concerning closely held businesses or illiquid assets]

F. Distribute all Income in Marital TRU. If in any Trust Year the net income earned in the Marital TRU exceeds the Combined Amount to be paid from the Marital TRU, such excess net income shall be distributed to my said _________ at least annually. If at the time of my death, the distribution of such excess net income is not necessary to qualify for the marital deduction, then such excess net income shall not be distributed. [This subparagraph is necessary in states without a unitrust definition of income statute in order to preserve the marital deduction for the Marital TRU. Note also that the Final Regulations specifically refer to a unitrust interest of 3% to 5% as being a reasonable allocation of annual total return. The use of a rate under 3% for a Marital TRU for which the attorney intends to qualify for the marital deduction without the provision for distribution of excess income is therefore not recommended. Further, if your TRU state law has a specific conversion rate, such as 4%, you may not be safe in adopting a rate lower than the default rate for your state, unless there is a specific provision in your statute that allows a lower rate, such as 3%, to be considered “income”. See detailed analysis of the Final Regulations at Section X. E.]

G. Income Earned in Estate Prior to Trust Funding. In addition to the Unitrust Amount as determined above for the Marital TRU and the Shelter TRU, the income earned from the assets held in my estate or from other assets payable to my trustees hereunder, prior to the complete funding of each trust, shall be distributed to my said__________.

H. Ordering Rule. The Combined Amount (or, if applicable, the Unitrust Amount) for a trust as well as any discretionary distributions from a trust shall be considered to have been paid first from net accounting income of the trust, next from ordinary taxable income not allocable to net accounting income, next from net realized short term capital gains, then from net realized long term capital gains, and finally, as necessary, from the principal of the trust. [See notes to Basic Form for statutory unitrust ordering rule. and consider alternatives discussed in Section X. G., infra, to grant discretion to trustee to include capital gains in income or deem capital gains to be a part of DNI, if after consideration of the Final Regulations and applicable local law, it is thought to be necessary or desirable to do so.]

I. Discretionary Distributions of Additional Amounts. In addition to the Unitrust Amounts as set forth above, my trustees shall distribute such additional amounts to my said ______ as the trustees deem advisable for h__ health, education, maintenance, and support in h__ accustomed manner of living, taking into account other assets and income otherwise available to h__; provided, however, that my trustees shall first utilize the trust assets of the Marital TRU prior to distributing any trust assets from the Shelter TRU.

J. Total Return Unitrust Design and Goals of Trusts. I have chosen to create Total Return Unitruts in order to allow the trusts to be invested for total return without the artificial distinction between accounting income and principal appreciation. By doing so, the
trusts can be invested without conflict between the interests of the current beneficiary and the remainder beneficiaries.

[Select whichever option reflects best the settlor's intent:

Option 1: The trustees may wish to take into account that my primary goal is to benefit my __________ during h___ lifetime and that the buildup of funds for the next generation is of secondary importance. OR

Option 2: The trustees may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my _________ and that the buildup of value to be passed forward into the next generation is of considerable importance.

Other Options: If a Force Majeure ability of an independent trustee to change the Applicable Unitrust Rate is desired, see the basic form in the materials. If an ability of the trustees to increase the Applicable Unitrust Rate under ascertainable standards is desired, see Form 2.

Note also that client’s intent may be different for the different trusts. For example, the Marital TRU may be relatively more focused upon the needs of the surviving spouse while the Credit Shelter TRU may be more focused on growth for the next generation. The foregoing samples are “generic” statements. Something more concrete and individualized may be more desirable where appropriate.]

K. On Spouse’s Death. Upon the death of my _____, ________________, the trustees shall pay any accrued or undistributed Unitrust Amount attributable to the Marital TRU [Drafting Note: If Paragraph F above is required, add the following: or, if greater, any accrued or undistributed income of the Marital TRU,] to my ___________'s estate. In addition, the trustees shall pay to the personal representative of my ___________’s estate or directly to the taxing authority from the Marital TRU, an amount equal to the increase in federal and state death taxes caused by the inclusion of the assets of the Marital TRU in my __________’s estate for such tax purposes. Such amount, if any, shall be paid to the extent possible from the portion of the Marital TRU that is included in my ___________’s gross estate for Estate Tax purposes and as to which he is the transferor for generation skipping transfer tax purposes. The balance of the Marital TRU and the Shelter TRU shall be distributed outright to or in further trust for such one or more of the my issue and spouses of issue, [Optional: or charities], in such proportions and subject to such trusts and conditions, as my said _____ directs by specific reference to this power and the separate trust (the Marital TRU and/or the Shelter TRU) to which it applies in _________ Last Will and Testament as admitted to probate. Any unappointed assets shall pass to my issue who survive me, per stirpes, subject to the Trust Continuation Provisions set forth hereinafter.
Form 4 - Three TRU GST Plan—Exempt and Non-exempt Marital TRU and Credit Shelter TRU—Ordered Unitrust Plan.

(3) Exempt Marital, Non-exempt Marital and Credit Shelter TRU’s. During the lifetime of my _______, _________, my trustees shall administer the Exempt Marital Share, the Non-exempt Marital Share and the Credit Shelter Share as Total Return Unitrusts and shall be referred to hereinafter as the Exempt Marital TRU, Non-exempt TRU and the Shelter TRU (collectively, the "TRUs"). Except as indicated below, the terms of all three trusts shall be the same.

(a) During _________’s Life. In each trust calendar year or such portion thereof in the first or final year of each trust ("Trust Year"), my trustees shall pay to or for the benefit of my _____________ during h____ life, in quarter-annual installments, an amount equal to the unitrust amount set forth below ("Unitrust Amount") for the Non-exempt Marital TRU, the Marital TRU and the Shelter TRU (the sum shall be referred to as the "Combined Amount").

(b) Unitrust Amount. The Unitrust Amount for each trust shall be equal to the average of the fair market values ("Average Value") of the assets of the trust as of the close of the first business day of the Trust Year (or the date of first funding for the first Trust Year) and the two previous Trust Years (or such lesser number of Trust Years as are available for the first two years of the trusts) multiplied by ________ (____%) percent ("Applicable Unitrust Rate"). In the case of a short Trust Year, the distribution shall be calculated as set forth in subparagraph (c) below. In the case of additions to or distributions from a trust, the Unitrust Amount shall be determined as set forth in subparagraph (d) below; provided, however, that the Combined Amount shall be paid to the extent possible entirely from the Non-exempt Marital TRU and none of the Combined Amount shall be paid from the Exempt Marital TRU or Shelter TRU unless or until the Non-exempt Marital TRU is exhausted. If there is no Non-exempt Marital TRU or the Non-exempt Marital TRU is exhausted, the entire or remaining Combined Amount shall be paid from the Exempt Marital TRU or Shelter TRU unless or until the Exempt Marital TRU is exhausted. If the Exempt Marital TRU is exhausted, the remaining Combined Amount shall be paid from the Shelter TRU. If there is no Non-exempt Marital TRU nor an Exempt Marital TRU, then the Unitrust Amount shall be paid from the Shelter TRU. If in any Trust Year, the net income earned in the Non-exempt Marital TRU or the Exempt Marital TRU exceeds the Combined Amount payable from each such trust, such excess net income shall be distributed to my __________ at least annually. [Last sentence required for non-unitrust states and may be preferable in three trust plan even in unitrust states, because the Exempt Marital TRU must separately qualify for the marital deduction, and the Final Regulations indicate only that a 3-5% range is acceptable. As a result, to be sure of qualifying for the Marital Deduction, the Exempt Marital TRU may separately require a payout of either the "income" or a 3% TRU distribution. Since 3% is likely to be more than the accounting income, paying out the "income" from the Exempt Marital Trust as a "bonus" may be the least complicated drafting alternative. Subtracting the "income" paid from the Exempt Marital TRU from the unitrust amount to be paid from the Non-exempt Marital TRU would also qualify but is confusing, especially since this would mean that at the beginning of the trust year you couldn’t say how much the unitrust amount would be (since you don’t know in advance what the "income" from the Exempt Marital Trust will be!). While the GST Exemption and the Applicable Credit Amount are...]

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merged for 2004 years and later, there will be instances where the client has used part or all of her applicable credit amount to make gifts to children, leaving more GST Exemption than Applicable Credit Amount available. Hence drafting attention must still be given to the qualification of the "exempt" marital for the marital deduction. Because of the potentially huge change in the size of the Credit Shelter TRU under EGTRRA, this approach will give greater certainty to the distributions for the surviving spouse than drafting for example a 5% Non-exempt Marital TRU, a 3% Exempt Marital TRU and a Fully Discretionary Credit Shelter Trust. It will also likely give you better leverage of the GST exemption.]

(c) Short year. For a short Tax Year, including the year of initial funding and the year of my ________’s death, the Unitrust Amount for each trust shall be based upon a prorated portion of the Unitrust Amount set forth above, comparing the number of days in the short Tax Year to the number of days in the calendar year of which the short Tax Year is a part.

(d) Additions and Distributions. In a Trust Year in which assets are added to the trusts (other than the first funding of the trusts) or distributed from the trusts (other than the Unitrust Amount), the Unitrust Amount for such year (hereinafter "Adjustment Year") shall thereafter be increased, in the case of an addition, or decreased in the case of a distribution, by an amount computed by first multiplying the fair market value of the assets added or distributed (as of the date or dates of addition or distribution) by the Applicable Unitrust Rate. The result is then multiplied by a fraction, the numerator of which is the number of days from the addition or distribution to the end of the Trust Year and the denominator of which is the days in the calendar year.

Further, the fair market values of the assets of a trust for the Adjustment Year and the Trust Year immediately preceding the Adjustment Year shall be increased or decreased, as the case may be, by the net addition or distribution during the Adjustment Year, for purposes of determining the Average Value applicable for subsequent Trust Years. [This complicated language is needed to accommodate multi-year funding of the trust from estates or other sources, and discretionary distributions, in light of the three-year smoothing rule.]

(e) Valuation. In determining the Unitrust Amount for any Trust Year, principal and accumulated income shall be included in determining the fair market value of each trust, but no accruals shall be required. Liabilities of a trust other than the Unitrust Amount or ordinary operating expenses such as trustees' fees, investment advisory fees, or fiduciary income taxes, shall be taken into account in determining the fair market value of the trust. If a trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their sole discretion under the circumstances. [See notes to Basic form concerning closely held or illiquid assets]

(f) Income earned in estate prior to trust funding. In addition to the Unitrust Amount as determined above, the net accounting income earned in my estate and allocable to the Marital Exempt TRU and the Marital Non-Exempt TRU shall be paid to the respective trusts, and distributed to my _____ in addition to the Unitrust Amount set forth above.

(g) Ordering Rule. The Combined Amount (or, if applicable, the Unitrust Amount) for a trust and any discretionary distributions from a trust shall be considered to have been paid first from net accounting income, next from ordinary taxable income in the trust not allocable to net accounting income, next from net realized short term capital gains, next
from net realized long term capital gains and finally, from the principal of the trust. This ordering rule is intended to be applied to the trust from which the Combined Amount (or, if applicable, Unitrust Amount) is paid, provided that, to the extent that discretionary distributions are made from any trust hereunder, this same ordering rule shall apply with reference to such discretionary distributions. [See notes to Basic Form for discussion of unitrust ordering rule, and consider alternatives discussed in Section X. G. to grant discretion to trustee to include capital gains in income or deem capital gains to be a part of DNI, if after consideration of the Final Regulations and applicable local law, it is thought to be necessary or desirable to do so.]

(h) Discretionary distributions of additional amounts. In addition to the Unitrust Amount as set forth above, my trustees shall distribute such additional amounts from the trusts to my said __________ as the corporate trustee, acting alone, deems advisable for h___ health, maintenance, and support in h___ accustomed manner of living, and specifically including educational expenses ____ may incur either for h___self or our issue, and taking into account other assets and income otherwise available to h___ and such issue; provided, however, it is my direction that such discretionary distributions be made entirely from my Non-Exempt Marital TRU to the extent possible until exhaustion thereof, prior to the distributions of such additional discretionary distributions from the Exempt Marital TRU, and thereafter that such additional discretionary distributions be made entirely from my Exempt Marital TRU to the extent possible until exhaustion thereof, prior to any such distributions from the Shelter TRU.

(i) Total Return Unitrust Design and Goals of trusts. I have chosen to create Total Return Unitrusts in order to allow the trusts to be invested for total return without the artificial distinction between accounting income and principal appreciation. By doing so, the trusts can be invested without conflict between the interests of the current beneficiary and the remainder beneficiaries.

[Select whichever option reflects best the client’s intent:

Option 1: The trustees may wish to take into account that my primary goal is to benefit my ______ during h___ lifetime and that the buildup of funds for the next generation is of secondary importance. OR

Option 2: The trustees may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my ______ and that the buildup of value to be passed forward into the next generation is of considerable importance.

Other Options: If a Force Majeure ability of an independent trustee to change the Applicable Unitrust Rate is desired, see the basic form in the materials. If an ability of the trustees to increase the Applicable Unitrust Rate under ascertainable standards is desired, see Form 2.

Note also that client’s intent may be different for the different trusts. For example, the Non-exempt marital TRU may be relatively more focused upon the needs of the surviving spouse while the Credit Shelter TRU may be more focused on growth for the next

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generation. The foregoing samples are “generic” statements. Something more concrete and individualized may be more desirable where appropriate.]

(4) Payments on __________’s Death. On the death of my __________, the trustees shall pay any accrued or undistributed Unitrust Amount and, if applicable, excess net income from the Exempt Marital TRU and the Non-exempt Marital TRU to my said __________’s estate. The trustees shall pay to my __________’s executor or directly to the taxing authority from the Non-exempt Marital TRU such amount, if any, as my __________’s executor certifies to be the additional death taxes resulting from the inclusion of the Exempt Marital TRU and the Non-exempt Marital TRU in my __________’s estate for death tax purposes. If there is no Non-exempt Marital TRU, such taxes shall be paid from the Exempt Marital TRU.

(5) Distribution of Exempt and Non-exempt Marital TRU’s After __________’s Death. After the payments described in (4) above are made subsequent to my __________’s death, the remaining Exempt and Non-exempt Marital TRU and the Shelter TRU shall be distributed to such of the members of the class consisting of my issue, in such shares and subject to such trusts and conditions as my __________ shall appoint and direct in his will by specific reference hereto and specific reference to the Exempt Marital TRU, the Non-exempt Marital TRU, the Shelter TRU or all of the TRU's in __________ Last Will and Testament as admitted to probate. Any unappointed amount shall be held, administered and distributed as set forth in paragraph __. below, for provisions following __________’s death or if __________ predeceases.

Form 5 - Marital QTIP Total Return Unitrust With Sprinkle Credit Shelter Trust.

[Drafting Note: This form might be used where the surviving spouse is unlikely to need the return from both the marital and the credit shelter trusts. Because of the substantial changes in the relative size of those trusts under EGTRRA, the most useful form will be a Marital TRU and a Credit Shelter with sprinkling discretion among the spouse and issue. If spouse is likely to need distributions from the Credit Shelter, the Ordered TRU is likely superior.]

2. Marital Total Return Unitrust.

A. Marital Formula Bequest. If my __________, __________, survives me, I give to my trustees, appointed hereinafter, to hold in trust as the Marital Total Return Unitrust ("Marital TRU"), the minimum amount necessary, if any, to reduce my United States Estate Tax ("Estate Tax") under the Internal Revenue Code of 1986, as amended ("Code") to zero or the smallest possible amount after the use of the applicable credit amount and any other credits available to my estate (exclusive of any credits the use of which would increase my total death taxes). The foregoing amount ("Marital Bequest") shall be determined after taking into account any other assets passing to my __________ and qualifying for the marital deduction, whether such other assets pass under this will or otherwise, as well as any other deductions taken and allowed on my Estate Tax Return. This amount shall be computed as if all qualified terminable interests were elected as part of the marital deduction on my Estate Tax Return, regardless of the election actually filed. This bequest may be satisfied with proceeds of life insurance or other assets paid directly to my trustees.

1. Funding Terms. To the extent that the amount to be held as the Marital TRU is satisfied with property in kind, such property shall be distributed at its market value.
value as of the date or dates of distribution. There shall be excluded from the Marital TRU, any property (or the proceeds of any property) which does not qualify for the marital deduction or which is not subject to federal estate tax by reason of my death.

2. **Income or Interest Prior to Funding.** In lieu of any statutory interest required to be paid on a pecuniary bequest in trust, my Marital TRU shall be entitled to a pro rata share of the income from the assets held in my estate prior to the complete funding of my Marital TRU.[Drafting Note: This provision eliminates any statutory interest requirement for a pecuniary bequest which is problematic because the interest is not deductible to the estate or trust and is taxable to the beneficiary, so as to produce double taxation of income or taxation of interest even where municipal bonds are held in the estate.]

B. **Estate Tax Repeal.** If at the time of my death there is no Estate Tax by virtue of repeal, it is intent that my entire residuary estate shall be held as the Shelter Trust as set forth below. [Drafting Note: This last language is added to guard against ambiguity if at the time of the my death the Estate Tax has been eliminated. The theory behind this choice is that you might want all of the estate protected against further taxation or other risks in that event. This should be discussed with each client separately to choose between a trust or outright bequest depending upon the client’s intent and the attorney’s judgment, particularly with this form, where the entire estate would pass into a fully discretionary trust for spouse and issue.]

C. **Survivorship Presumption.** If my _________ and I die under circumstances in which there is insufficient evidence of who was the survivor, it shall be conclusively presumed that ________.

D. **Marital TRU Provision.** In each trust calendar year or such portion thereof in the first or final year of each trust ("Trust Year"), my trustees shall pay to or for the benefit of my _________, ______________________, during h__ life, in quarter-annual installments, the unitrust amount set forth below ("Unitrust Amount") for the Marital TRU.

E. **Unitrust Amount.** The Unitrust Amount for the Marital TRU shall be equal to the average of the fair market values ("Average Value") of the assets of the trust as of the close of the first business day of the Trust Year (or the date of first funding for the first Trust Year) and the two previous Trust Years (or such lesser number of Trust Years as are available for the first two Trust Years) multiplied by __________ (____%) percent ("Applicable Unitrust Rate"). In the case of a short Trust Year, the Unitrust Amount shall be calculated as set forth in subparagraph F. below. In the case of additions to or distributions from the Marital TRU, the Unitrust Amount shall be determined as set forth in subparagraph G. below. Expenses which would be deducted from income if the trust was not unitrust shall not be deducted from the payment of the Unitrust Amount.

F. **Short Year.** For a short Trust Year, including the year of initial funding and the year of my ______________'s death, the Unitrust Amount shall be based upon a prorated portion of the Unitrust Amount set forth above, comparing the number of days in the short Trust Year to the number of days in the calendar year of which the short Trust Year is a part.

G. **Adjustments for Additions and Distributions.** In a Trust Year in which assets are added to the trust (other than the first funding of the trust) or distributed from the trust (other than the Unitrust Amount), the Unitrust Amount for such year (hereinafter, "Adjustment Year") shall thereafter be increased in the case of an addition, or decreased in the case of a distribution, by an amount computed by first multiplying the fair market value of the assets added or
distributed (as of the date or dates of the addition or distribution), by the Applicable Unitrust Rate for the trust. The result is then multiplied by a fraction, the numerator of which is the number of days from the addition or distribution to the end of the Trust Year and the denominator of which is the days in the calendar year.

Further, the fair market value of the assets of the trust for the Adjustment Year and the Trust Year immediately preceding the Adjustment Year shall be increased or decreased, as the case may be, by the net addition or distribution during the Adjustment Year for purposes of determining the Average Value applicable for the subsequent Trust Years. [See notes to Basic Form for smoothing rule explanation]

H. Valuation. All computations of the trust's fair market value, or the value of any additions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. Liabilities of the trust, other than the Unitrust Amount or ordinary operating expenses, such as trustees' fees, investment advisor fees or fiduciary income taxes, shall be taken into account in determining the fair market value of the assets of the trust. If the trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their discretion under the circumstances. [See notes to Basic form concerning closely held businesses or illiquid assets]

I. Distribute all Income in Marital TRU. If, in any Trust Year, the net income earned in the Marital TRU exceeds the Unitrust Amount to be paid from the Marital TRU, such excess net income shall be distributed to my said __________ at least annually. If at the time of my death, the distribution of such excess net income is not necessary to qualify for the marital deduction, then such excess net income shall not be distributed. [This subparagraph is necessary in states without a unitrust definition of income statute in order to preserve the marital deduction for the Marital TRU. Note also that the Final Regulations specifically refer to a unitrust interest of 3% to 5% as being a reasonable allocation of annual total return. The use of a rate under 3% for a Marital TRU for which the attorney intends to qualify for the marital deduction without the provision for distribution of excess income is therefore not recommended. Further, if your TRU state law has a specific conversion rate, such as 4%, you may not be safe in adopting a rate lower than the default rate for your state, unless there is a specific provision in your statute that allows a lower rate, such as 3%, to be considered “income”. See detailed analysis of the Final Regulations at Section X. E.]

J. Income Earned in Estate Prior to Trust Funding. In addition to the Unitrust Amount as determined above for the Marital TRU, the income earned from the assets held in my estate or from other assets payable to the trustees, and distributed to my trustees hereunder, prior to the complete funding of the Marital TRU, shall be distributed to my said __________. [See notes to Basic Form concerning income pending full funding]

K. Ordering Rule. The Unitrust Amount for the Marital TRU as well as any discretionary distributions shall be considered to have been paid first from net accounting income of the trust, next from ordinary taxable income not allocable to net accounting income, next from net realized short term capital gains, then from net realized long term capital gains, and finally, as necessary, from the principal of the trust. [See notes to Basic Form for discussion of unitrust ordering rule, and consider alternatives discussed in Section X. G. to grant discretion to trustee to include capital gains in income or deem capital gains to be a part of DNI, if after consideration of the Final Regulations and applicable local law, it is thought to be necessary or desirable to do so.]
L. **Discretionary Distributions of Additional Amounts.** In addition to the Unitrust Amount as set forth above, my trustees shall distribute such additional amounts to my said _______ as the trustees deem advisable for h__ health, education, maintenance, and support in h__ accustomed manner of living, taking into account other assets and income otherwise available to h__.

M. **Total Return Unitrust Design and Goals of Trusts** [Optional, and trustees' power to increase distribution rate for health, maintenance and support.] I have chosen to create a Marital Total Return Unitrust and a Discretionary Shelter Trust in order to allow the trusts to be invested for total return without the artificial distinction between accounting income and principal appreciation. By doing so, the trusts can be invested without conflict between the interests of the current beneficiary and the remainder beneficiaries.

[Select whichever option reflects best the settlor’s intent:

Option 1: The trustees may wish to take into account that my primary goal is to benefit my ______ during h___ lifetime and that the buildup of funds for the next generation is of secondary importance. OR

Option 2: The trustees may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my ______ and that the buildup of value to be passed forward into the next generation is of considerable importance.

The foregoing samples are “generic” statements. Something more concrete and individualized may be more desirable where appropriate.]

[Optional. If the trustees become convinced that the unitrust rate established for h__ will not be sufficient to satisfy h__ needs under the ascertainable standards set forth in subparagraph J. above, and would otherwise require a continuing exercise of that discretionary distribution power, then the trustees may increase the unitrust rate to satisfy h__ needs pursuant to those standards for as long as necessary, provided that the unitrust rate shall not be increased to a rate in excess of seven (7%) percent. The trustees shall not be held liable for the good faith exercise or non-exercise of this power. ] [ Drafting Note: Granting this power to the trustees is not intended to water down the requirements of the ascertainable standards of health, education, maintenance and support, but is merely intended to allow a unitrust method for implementing those discretionary powers should this be helpful. It is suggested that the justification for such an exercise of discretion should be reviewed by the trustees at least once a year.]

N. **Death of __________.** On the death of my __________, the trustee shall pay any accrued or undistributed unitrust amount and, if applicable, excess net income from the Marital TRU to my said __________’s estate, and the remaining trust shall pass pursuant to the provisions set forth in my Shelter Trust at Paragraph 3.C. hereinafter.

3. **Shelter Trust** I give the residue of my estate to my trustees to hold as the Shelter Trust under the provisions set forth below.
A. **During __________'s Life.** During the life of my __________, ________________, my trustees shall pay so much of the income or principal of the trust to or for the benefit of any one or more of my __________, as well as my children [Optional: children's spouses] and grandchildren [Optional: and grandchildren's spouses] as my trustees shall deem advisable for their health, maintenance and support in their accustomed manner of living, [Optional if independent trustee: any purpose whatsoever] taking into account other sources of income or assets which might be available to each of them, with no duty of equalization. Any undistributed income shall be added to principal and invested as such.

B. **Goal of Trust.** The primary goal of this trust is to preserve and build up value for the benefit of my children and grandchildren [Optional: and their spouses], but be available for my __________, as well as my children and grandchildren, during h__ lifetime to the extent needed. It is my desire that my __________'s own funds and then the Marital TRU be utilized first for my __________'s benefit prior to the use of the income and principal of this Shelter Trust for my __________.

**Form 6 - TRU CAP Index Trust.**

I give the residue of my estate to my trustees to hold as the TRU CAP index trust under the following provisions:

A. **During _______'s life.** In each trust calendar year or portion thereof in the first or final year of the trust ("Trust Year"), my trustees shall pay the unitrust amount set forth below ("Unitrust Amount") to or for the benefit of my ________, during h__ life, in quarter-annual installments.

B. **Unitrust Amount.** The Unitrust Amount shall be equal to the lesser of the Indexed Annuity and the TRU CAP amount as set forth below: [Note that the TRU CAP will not qualify for the marital deduction, unless an “income if greater” requirement is inserted, since the indexed annuity is not an accepted definition of “income” under the Final Regulations or under any state law at the present time.]

1. **Indexed Annuity.** An amount equal to __________ ($_________) per year as adjusted annually to reflect any increase in the consumer price index for all urban consumers from the date of this instrument (__________ as of __________ on the 1967 scale) to the first day of the calendar year in which the annuity is paid. The annuity amount for any short Trust Year including the first year shall be prorated. If the consumer price index is unavailable at any time in the future, my trustees shall select an index for this purpose which most closely follows my intent of preserving the real spending power of the distribution for the beneficiary.

2. **TRU CAP Amount.** A TRU CAP Amount equal to the average of the fair market values ("Average Value") of the trust as of the close of the first business day of the Trust Year (or the date of first funding for the first Trust Year) and the two previous Trust Years (or such lesser number of Trust Years as are available for the first two Trust Years) multiplied by __________ (____%) percent ("TRU CAP Rate"). In the case of a short Trust Year, the TRU CAP Amount shall be calculated as set forth in subparagraph C. below. In the

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502 This particular index may not be the most appropriate for a particular beneficiary, though it will be difficult to predict the best index for a beneficiary in advance, so additional flexibility in selecting an index would be an appropriate option.
case of additions to or distributions from the trust, the TRU CAP Amount shall be determined as set forth in subparagraph D. below.

C. Short year. For a short Trust Year, the Unitrust Amount shall be based upon a prorated portion of the Unitrust Amount set forth above comparing the number of days in the short Trust Year to the number of days in the calendar year of which the short Trust Year is a part.

D. Adjustment for Additions and Distributions. In a Trust Year in which assets are added to a trust other than the first funding of the trust or distributed from the trust (other than the Unitrust Amount) (hereinafter "adjustment year"), the TRU CAP Amount for such year shall be increased in the case of an addition, or decreased in the case of a distribution, by an amount computed by multiplying the fair market value of the assets added or distributed (as of the date or dates of the addition or distribution by the TRU CAP Rate.) The result is then multiplied by a fraction, the numerator of which is the number of days from the addition or distribution to the end of the Trust Year and the denominator of which is the days in the calendar year. Further, the fair market value of the trust for the Adjustment Year and the Trust Year immediately preceding the Adjustment Year shall be increased or decreased, as the case may be, by the net addition, or distribution, during the Adjustment Year for purposes of determining the TRU CAP Amount for subsequent Trust Years. [Note that contributions and distributions are factored into the equation for the TRU CAP amount, but not the Indexed Annuity. An adjustment could be built into the Indexed Annuity as well, but at the cost of even greater complexity.]

E. Valuation. All computations of the trust’s fair market value, or the value of any additions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. Liabilities of the trust, other than the Unitrust Amount or ordinary operating expenses, such as the trustees’ fees, investment advisor fees or fiduciary income taxes, shall be taken into account in determining the fair market value of the assets of the trust. If the trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their sole discretion under the circumstances. [This allows a closely held business interest or real estate to be placed in the trust, but the TRU CAP Index Trust is not designed for this type of asset.]

F. Income earned in estate prior to trust funding. In addition to the Unitrust Amount as determined above, the net accounting income earned in my estate or from some other source and allocable to this trust shall be paid to the trust, and distributed to my _____, unless the Indexed Annuity is the lesser amount, in which case only the Indexed Annuity shall be paid from the date the Indexed Annuity is begun. It is my intent that the Indexed Annuity begin to accrue on the date of my death, and be paid as soon as practicable thereafter.

G. Ordering Rule. The Unitrust Amount for the TRU CAP Index Trust shall be considered to have been paid first from net accounting income of the trust, next from any ordinary income not allocable to net accounting income, next from net realized short term capital gains, then from net realized long term capital gains and finally, as needed, from the principal of the trust. [See notes to Basic Form for discussion of unitrust ordering rule, and consider alternatives discussed in Section X. G. to grant discretion to trustee to include capital gains in income or deem capital gains to be a part of DNI, if after consideration of the Final Regulations and applicable local law, it is thought to be necessary or desirable to do so.]

H. Discretionary distributions of additional amounts. In addition to the Unitrust Amount as set forth above, my trustees shall distribute such additional amounts, if any,
to my said _________ as the corporate trustee, acting alone, deems advisable for h___ health, education, maintenance, and support in h__ accustomed manner of living, and specifically including educational expenses ___ may incur either for h___self or our issue, and taking into account other assets and income otherwise available to h__ and such issue.

I. Goal of trust. The goal of this trust is to provide a very smooth flow of distributions, which will match the initial real spending power after inflation. A second and related goal is to be sure that the trust does not largely or completely deplete itself prior to its termination. This is the reason for the TRU CAP provisions of this trust as set forth above. The TRU CAP unitrust rate has been set at ______________ (_____%) based upon an expectation that one cannot expect to distribute more than this amount for any material period of time and still have the distributions increase sufficiently to offset inflation without complete depletion of the trust [Based upon historical modeling, it is submitted that 10% is a sensible maximum for the "CAP" on the TRU CAP Index Trust. It is even more important that the index payment be set carefully and low enough to give a reasonable prospect that the trust will not be depleted. While the TRU CAP will avoid complete depletion under almost any scenario, it will not avoid a bad result to the remaindermen if the TRU CAP is in effect for a very long period of time, if the TRU CAP payout is too high to allow the value of the trust to preserve itself. It is suggested that the index payment should be set not higher than 3% to 4% of the initial value of the trust if the trust is to last longer than 10 to 15 years (and 4% is getting risky).]

Form 7 - Residuary Total Return Ununitrust With Optional "No-Drop" Language, Fully Discretionary Trust for Children to Age 25 and Indexed Annuity Trust for Children Over Age 25.

Residuary Total Return Unitrust. I give the residue of my estate to my trustees to hold as the Residuary Total Return Unitrust ("Residuary TRU") under the following provisions:

A. During __________'s life. In each trust calendar year or such portion thereof in the first or final year of the trust ("Trust Year"), my trustees shall pay to or for the benefit of my __________, __________, during h___ life, in quarter-annual installments, an amount equal to the unitrust amount set forth below ("Unitrust Amount").

B. Unitrust Amount. The Unitrust Amount for the trust shall be equal to the average of the fair market values ("Average Value") of the assets of the trust as of the close of the first business day of the trust year (or the date of first funding in the first trust year) and the two previous trust years (or such lesser number of trust years as are available for the first two years of the trust) multiplied by __________ (___%) percent ("Applicable Unitrust Rate"). In the case of a short Tax Year, the Unitrust Amount shall be calculated as set forth in subparagraph C below. In the case of additions to or distributions from the trust, the Unitrust Amount shall be determined as set forth in subparagraph D below. Expenses which would be deducted from income as if the trust were not a unitrust shall not be deducted from the payment of the unitrust amount.

[Optional “No Drop” language: The Unitrust Amount shall not be less than the Unitrust Amount in the immediately preceding trust year except in the case of a short year, or in an adjustment year or the year immediately following an adjustment year where the adjustment is caused by an additional distribution from the trust as set forth in paragraph D. below. In such case, the unitrust amount can decrease, but only by an amount equal to the adjustment or in the

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case of the following year by the unitrust rate multiplied by the additional distribution described in paragraph D. below.

C. Short year. For a short Trust Year, including the year of initial funding and the year of a beneficiary's death, the Unitrust Amount shall be based upon a prorated portion of the Unitrust Amount set forth above, comparing the number of days in the short Trust Year to the number of days in the calendar year of which the short Trust Year is a part.

D. Adjustments for Additions and Distributions. In a Trust Year in which assets are added to the trust (other than the first funding of the trust) or distributed from the trust (other than the Unitrust Amount), the Unitrust Amount for such year (hereinafter "Adjustment Year"), shall be increased in the case of an addition, or decreased in the case of a distribution, by an amount computed by first multiplying the fair market value of the assets added or distributed (as of the date or dates of addition or distribution) by the Applicable Unitrust Rate for the trust. The result is then multiplied by a fraction, the numerator of which is the number of days from the addition or distribution to the end of the trust year and the denominator of which is the number of days in the calendar year.

Further, the fair market value of the assets of the trust for the Adjustment Year and the Trust Year immediately preceding the Adjustment Year shall be increased or decreased as the case may be, by the net addition or distribution during the Adjustment Year for purposes of determining the Average Value applicable for subsequent trust years.

E. Valuation. All computations of the trust's fair market value or the value of any additions or distributions as set forth above shall include accounting income and principal, but no accruals shall be required. Liabilities of the trust, other than the Unitrust Amount or ordinary operating expenses such as trustee's fees, investment advisory fees or fiduciary income taxes, shall be taken into account in determining the fair market value of the assets of the trust. If the trust includes assets for which there is no ready market, the trustees shall adopt such method of valuation as they deem reasonable in their discretion. [See Notes to Basic Form concerning closely held business or illiquid assets.]

F. Income earned in Estate prior to Total Return Unitrust funding. In addition to the Unitrust Amount as determined above, the net accounting income earned from assets held in my estate or from other assets payable to the trustees, and distributed to my trustees prior to the complete funding of the Residuary TRU, shall be distributed to my _________. The foregoing income distribution recognizes that until the full funding of the Residuary TRU, assets awaiting distribution to the Residuary TRU will not be taken into account in determining the Unitrust Amount.

G. Discretionary distributions of additional amounts. In addition to the Unitrust Amount as set forth above, my trustees shall distribute such additional amounts of the trust, to my said ____________ as the trustees deem advisable for my ____________'s health, education, maintenance and support in h____ accustomd standard of living, and specifically including educational expenses ________ may incur either for h____self or h____ issue and taking into account such other income or assets which are available to h____ and such issue and are known to the trustees. [Comment: Discretionary distributions may be advisable for the same reasons as they are in any trust. Consider giving an independent trustee broader powers to enable beneficiary "to make estate planning gifts," "for ______ welfare" or "for any purpose in which money is needed."]

H. Ordering Rule. The Unitrust Amount for the trust and any discretionary distributions from the trust shall be considered to have been paid first from net accounting
income of the trust, next from ordinary taxable income not allocable to net accounting income, next from net realized short term capital gains, next from net realized long term capital gains, and finally, from the principal of the trust. [See notes to Basic Form for discussion of unitrust ordering rule, and consider alternatives discussed in Section X. G. to grant discretion to trustee to include capital gains in income or deem capital gains to be a part of DNI, if after consideration of the Final Regulations and applicable local law, it is thought to be necessary or desirable to do so.]

I. Total Return Unitrust Design and Goals of Trust. I have chosen to create a Total Return Unitrust in order to allow the trust to be invested for total return without the artificial distinction between accounting income and principal appreciation. By doing so, the trust can be invested without conflict between the interests of the current beneficiary and the remainder beneficiaries.

[Select whichever option reflects best the settlor’s intent:

Option 1: The Trustees may wish to take into account that my primary goal is to benefit my ______ during h__ lifetime and that the buildup of funds for the next generation is of secondary importance; OR

Option 2: The Trustee may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my ______ and that the buildup of value to be passed forward into the next generation is of considerable importance.

The foregoing samples are “generic” statements. Something more concrete and individualized may be more desirable where appropriate.]

J. Death of ________. On the death of my _____, the trustees shall distribute the remaining trust account to such of the issue of my said _____ and me, in such proportions and subject to such trusts and conditions as my said _____ shall appoint in h__ will by specific reference hereto, or, if such power is not exercised in full, the unappointed amount shall be divided into such number of equal shares as I have children then living, and deceased children with issue then living. The share of each such deceased child shall be distributed to his or her living issue, per stirpes. The share of each living child shall be held in a separate trust as set forth below.

K. Trusts for Children. The trustees shall hold and distribute the trusts for each of our children as follows:

(1) Child Under Twenty-Five (25) Years Old. Until our said child attains the age of Twenty-Five (25) years, my trustees shall pay to or for the benefit of such child such portion of the income and principal thereof in the sole discretion of my trustees as may be advisable for our child's comfort, maintenance, support, health care expenses and complete education, including vocational or post-graduate study. I direct that any payments during such child's minority shall be made without the intervention of a guardian of the estate and the receipt of such person as may be selected by my trustees to disburse the same (including the individual trustee) shall be a sufficient release. I further authorize my trustees, in their discretion, to make payments for my child's benefit to the person having custody of my child to defray any and all costs associated with caring for my said child, including additional housing expenses if such is
incurred. It is my intent hereby to insure that the family caring for my child shall bear no increased financial burden as a result of undertaking that important role. Any excess income shall be accumulated prior to the beneficiary attaining the age of Twenty-Five (25) years and added to principal.

(2) Child Over Twenty-Five (25) Years Old - Indexed Annuity Trust. After a child of ours has reached the age of Twenty-Five (25) years, the trustee shall pay to him or her or for his or her benefit an annuity in quarter-annual installments equal to ___________________ ($____________) dollars per year, as adjusted annually to reflect any increase in the consumer price index for all urban consumers from the date of this instrument (________ as of _________________ on the 1967 scale) to the first day of the calendar year in which the annuity is paid. If the above index is unavailable for any period in which this trust is in operation, the trustee shall select such index of general inflation as may most closely resemble the index referenced above. The annuity amount for any short year of the trust, including the first year, shall be prorated.

(3) Source of Annuity Amounts. The Indexed Annuity and any discretionary distributions from the trust shall be considered to have been paid first from net accounting income of the trust, next from ordinary taxable income not allocable to net accounting income, next from net realized short term capital gains, next from net realized long term capital gains, and finally, from the principal of the trust. See notes to Basic Form for discussion of unitrust ordering rule, and particularly in the case of an annuity trust, consider alternatives discussed in Section X. G. to grant discretion to trustee to include capital gains in income or deem capital gains to be a part of DNI, if after consideration of the Final Regulations and applicable local law, it is thought to be necessary or desirable to do so.

(4) Discretionary distributions of additional amounts. In addition to the annuity amount set forth above, my trustee may distribute such additional amounts, if any, of accounting income, other ordinary taxable income, capital gain or principal to such child as the corporate trustee, acting alone, deems necessary, but only for educational and health care purposes which cannot be met from other sources of income or assets. It is my intent in creating this trust that the annuity provided for above shall be sufficient to augment our child's earnings to a more comfortable level during the early years of his or her career. The corporate trustee should consider the exercise of its discretion in light of my intent to encourage my child's initiative, education, and self-reliance.

(5) Rights of Withdrawal. Upon attaining the age of ___________ (__) years and thereafter, my child may withdraw one-half of the trust corpus, and upon attaining the age of ___________ (__) years, my child may withdraw all of the remaining trust corpus.

(6) Death of Child. In the event of my child's death, before the trust is fully distributed, my trustees shall pay the remaining balance to any one or more of such child's spouse or issue, and subject to such trusts and conditions as such child shall appoint and direct by his or her last will and testament by specific reference hereto, and any portion not so appointed shall be distributed to such child's living issue, per stirpes, subject to the trust continuation provisions set forth hereinafter, and if none, then to my issue then living, per stirpes, provided that the share for any of such issue for whom a trust is held hereunder shall be added to such trust share and administered as though an original part thereof. The annuity amount shall not be increased as a result of any such addition.
Form 8 – Bernstein Collar Unitrust

The following form of Unitrust was suggested in the work of Paul Lee of Bernstein Investment Research & Management and is an interesting variation on the unitrust. What it does is allow the distribution to be a unitrust, but constrains the distribution so that it is never more than 120% of an inflation indexed amount starting with the initial Unitrust Amount, and never less than 70% of that amount. This lowers the potential volatility of the unitrust distribution, and would be very helpful in some markets. There is some increase in risk of depletion, particularly in an inflationary bear market, such as in the 1970s and early 1980s, just as in the TRUCAP Unitrust, but because the collar allows for a 30% loss in real value in the distribution, the risk should be very small as long as the unitrust rate is in the moderate 3-5% range. In a non-inflationary bull market, such as in the 1950s, the distribution would be capped at a very small percentage of current market value. All variations from a straight unitrust will tend to separate the interests of the current beneficiary and the remainder beneficiary. This model could be of interest for the very sophisticated client with definite distribution desires. Perhaps more frequently it might be used as a distribution policy to be employed in a fully discretionary trust or as an implementation of the power to adjust.

I give the residue of my estate to my trustees to hold as a unitrust under the following provisions:

A. During _______'s life. In each trust calendar year or portion thereof in the first or final year of the trust (“Trust Year”), my trustees shall pay the unitrust amount set forth below (“Unitrust Amount”) to or for the benefit of my ________, during h__ life, in quarter-annual installments.

B. Unitrust Amount. The Unitrust Amount shall be equal to the average of the fair market values (“Average Value”) of the trust as of the close of the first business day of the Trust Year (or the date of first funding for the first Trust Year) and the two previous Trust Years (or such lesser number of Trust Years as are available for the first two Trust Years) multiplied by __________ (____%) percent (“Unitrust Rate”). In the case of a short Trust Year, the Unitrust Amount shall be calculated as set forth in subparagraph D. below. In the case of additions to or distributions from the trust, the Unitrust Amount shall be determined as set forth in subparagraph E. below.

C. Unitrust Collar. Beginning in the second Trust Year following the full funding of the trust, the Unitrust Amount as determined above shall be limited so that it shall not be less than seventy (70%) percent, nor shall it be more than one hundred twenty (120%) percent of the Unitrust Amount for the first Trust Year following the full funding of the trust (“Initial Unitrust Amount”), as such Initial Unitrust Amount may be adjusted annually to reflect the increase or decrease in the consumer price index for all urban consumers from the beginning of that first Trust Year after the trust was fully funded to the beginning of the year in which the limitation is to be determined. The limitation amounts for any short Trust Year shall be prorated. If the consumer price index is unavailable at any time in the future, my trustees shall select an index for this purpose which most closely follows my intent of limiting the variation of the Unitrust Amount to an increase of twenty (20%) percent and a decrease of thirty (30%) percent of the real spending power of the Initial Unitrust Amount to be distributed for the beneficiary.

503 This particular index may not be the most appropriate for a particular beneficiary, though it will be difficult to predict the best index for a beneficiary in advance, so additional flexibility in selecting an index would be an appropriate option.
D. **Short year.** For a short Trust Year, the Unitrust Amount shall be based upon a prorated portion of the Unitrust Amount set forth above comparing the number of days in the short Trust Year to the number of days in the calendar year of which the short Trust Year is a part.

E. **Adjustment for Additions and Distributions.** In a Trust Year in which assets are added to a trust other than the first funding of the trust or distributed from the trust (other than the Unitrust Amount) (hereinafter "Adjustment Year"), the Unitrust Amount for such year shall be increased in the case of an addition, or decreased in the case of a distribution, by an amount computed by multiplying the fair market value of the assets added or distributed (as of the date or dates of the addition or distribution by the Unitrust Rate.) The result is then multiplied by a fraction, the numerator of which is the number of days from the addition or distribution to the end of the Trust Year and the denominator of which is the days in the calendar year. Further, the fair market value of the trust for the Adjustment Year and the Trust Year immediately preceding the Adjustment Year shall be increased or decreased, as the case may be, by the net addition, or distribution, during the Adjustment Year for purposes of determining the Unitrust Amount for subsequent Trust Years. The Unitrust Collar shall be changed in an Adjustment Year by an amount equal to seventy (70%) percent of the adjustment to the Unitrust Amount and one hundred twenty (120%) percent of the adjustment to the Unitrust Amount, respectively, computed as set forth above. For years subsequent to the Adjustment Year, the Unitrust Collar shall be proportionately increased or decreased by a percentage equal to the net addition or net distribution divided by the fair market value of the trust on the first day of the Adjustment Year. [The adjustments to both the Unitrust Amount and the Unitrust Collar are intended to be proportionate to the contribution to or distribution from the trust.]

F. **Valuation.** All computations of the trust’s fair market value, or the value of any additions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. Liabilities of the trust, other than the Unitrust Amount or ordinary operating expenses, such as the trustees' fees, investment advisor fees or fiduciary income taxes, shall be taken into account in determining the fair market value of the assets of the trust. If the trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their sole discretion under the circumstances. [This allows a closely held business interest or real estate to be placed in the trust, but this type of trust is not specifically designed for this type of asset.]

G. **Income earned in estate prior to trust funding.** In addition to the Unitrust Amount as determined above, the net accounting income earned in my estate or from some other source and allocable to this trust shall be paid to the trust, and distributed to my _____.

H. **Distribute all Income.** If, in any Trust Year, the net income earned in the trust exceeds the Unitrust Amount to be paid from this trust, such excess net income shall be distributed to my said _______ at least annually. [This subparagraph would be necessary to qualify the trust for the Marital Deduction, since no state statute defines income as a collared unitrust such as the trust illustrated above. It seems quite likely that the power to adjust could be reasonably exercised in this manner, but note that the power to adjust may never be exercised to decrease “income”, so in the marital trust context one must always calculate income to use the power to adjust. The only exception to calculating “income” is in applying a unitrust distribution in a state with a unitrust statute. See detailed analysis of the Final Regulations at Section X. E.]
I. **Ordering Rule.** The Unitrust Amount shall be considered to have been paid first from net accounting income of the trust, next from any ordinary income not allocable to net accounting income, next from net realized short term capital gains, then from net realized long term capital gains and finally, as needed, from the principal of the trust. [See notes to Basic Form for discussion of unitrust ordering rule, and consider alternatives discussed in Section X. G. to grant discretion to trustee to include capital gains in income or deem capital gains to be a part of DNI, if after consideration of the Final Regulations and applicable local law, it is thought to be necessary or desirable to do so.]

J. **Discretionary distributions of additional amounts.** In addition to the Unitrust Amount as set forth above, my trustees shall distribute such additional amounts, if any, to my said __________ as the corporate trustee, acting alone, deems advisable for h__ health, education, maintenance, and support in h__ accustomed manner of living, and specifically including educational expenses ___ may incur either for h__ self or our issue, and taking into account other assets and income otherwise available to h__ and such issue.

K. **Goal of trust.** The goal of this trust is to provide a relatively smooth flow of distributions but not allow the distributions to deviate too far from the real spending power of the initial unitrust distribution. In exercising its discretionary powers to distribute additional amounts,

[Select whichever option reflects best the client’s intent:]

Option 1: the trustees may wish to take into account that my primary goal is to benefit my _____ during h__ lifetime and that the buildup of funds for the next generation is of secondary importance. OR

Option 2: the trustees may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my _____ and that the buildup of value to be passed forward into the next generation is of considerable importance.

Form 9 - Miscellaneous Sample Provisions Related to the Prudent Investor Rule, Uniform Principal and Income Acts and Total Return Trusts.

**Prudent Investor Rule Opt Out.**

The trustees shall not be subject to the provisions of Chapter 72 of the Pennsylvania Probate Estates and Fiduciaries Code otherwise known as the Prudent Investor Act, but shall instead be governed by the investment principles set forth as follows:

[While it seems generally unwise to opt out of the Prudent Investor Rule, if one wishes to do so, the alternative principles should be stated, or else the Opt Out could create a dangerous void. More sensible perhaps would be a partial opt out of specific provisions of the Prudent Investor Rule such as illustrated below]
Sample Partial Prudent Investor Rule Opt Out.

The trustees shall not be subject to certain of the provisions of Chapter 72 of the Pennsylvania Probate Estates and Fiduciaries Code otherwise known as the Prudent Investor Act in the following respects:

i. The trustees shall be under no obligation to diversify investments which are received by them at the inception of the trust from settlor or settlor’s estate. [or] the trustees shall be entitled to retain without diversification investments which are received by them at the inception of the trust from settlor or settlor’s estate, provided that no single stockholding shall exceed 20% of the total market value of the trust.

ii. Notwithstanding the provisions of Section 7209, the trustees shall not be entitled to invest in any mutual fund (other than a temporary cash vehicle or money market fund) for which the trustee acts as investment advisor or custodian and for which the trustee receives compensation in addition to the trustee’s commissions regularly charged for its services.

Power to Adjust Opt Out.

The trustees shall not have the power to adjust between income and principal as provided by Section 8104 of the Pennsylvania Probate Estates and Fiduciaries Code. It is the Settlor’s desire that the trustees invest for income and principal growth as the same have been traditionally defined and the Settlor, after full and complete discussion with counsel desires that the trustees not have the power to adjust. Settlor recognizes that this direction may not allow the trustees to invest for total return. Rather, they must instead consider the interests of income and principal beneficiaries separately, balancing those interests in making their investment decisions.

Power to Convert to a Unitrust Opt Out

The trustees shall not have the power to convert any trust created hereunder to a unitrust as provided by Section 8105 of the Pennsylvania Probate Estates and Fiduciaries Code. It is the Settlor’s desire that the trustees invest for income and principal growth as the same have been traditionally defined and the Settlor, after full and complete discussion with counsel desires that the trustees not have the power to convert to a unitrust. Settlor recognizes that this direction may not allow the trustees to invest for total return. Rather, they must instead consider the interests of income and principal beneficiaries separately, balancing those interests in making their investment decisions.

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Limitation of Liability for Exercising the Power to Adjust or the Power to Convert to a Unitrust

The trustees shall have both the power to adjust between income and principal and the power to convert any trust created hereunder to a unitrust as provided under Sections 8104 and 8105 of the Pennsylvania Probate Estates and Fiduciaries Code. The trustees in exercising their powers under the said statutes shall not be liable to answer in damages to any party for the exercise or non-exercise of the powers granted thereby, even if a court determines that the exercise or non-exercise of those powers were an abuse of discretion, unless it is also determined that the trustees acted in bad faith.

Delaware Directed Trust Provision

Mandatory Direction of Investment Function. The Trustees shall make all “investment decisions” within the meaning of section 3313(d) of Title 12 of the Delaware Code, including, but not limited to, all decisions regarding the exercise of voting rights with respect to securities held as part of the Trust Estate, solely at the direction of ______________ (“Advisor”). It is Settlor’s intent that the protections afforded by 12 Del. C. section 3313 or any successor statute affording comparable protections apply to the trustees. The trustees shall not be liable for any action or inaction pursuant to such direction unless such action or inaction amounts to willful misconduct.

Mandatory Consent of Designated Person Required. The Trustees shall make no “investment decisions” within the meaning of section 3313(d) of Title 12 of the Delaware Code, including, but not limited to, all decisions regarding the exercise of voting rights with respect to securities held as part of the Trust Estate without first obtaining the consent of ____________________. It is Settlor’s intent that the protections afforded by 12 Del. C. section 3313 or any successor statute affording comparable protections apply to the trustees. The trustees shall not be liable for any loss to the trust as a result of __________________________’s failure to consent to any investment decision of the trustees after the trustees have requested such consent unless the trustees are guilty of willful misconduct or gross negligence.

Family Business Interests

The trustees shall have the power to retain any business interest transferred to the trustee in which the Settlor or a member of Settlor’s family was or is a participant. Any such family enterprise shall be deemed to be a suitable investment for the trust, even though such investment may not be marketable, may involve a high degree of investment risk, may not yield a dividend or other income, and may constitute a substantial portion or even all of the trust property. Notwithstanding any rule of law with respect to the suitability of investments purchased or retained by a trustee or diversification requirements for investments, the trustees are expressly authorized to invest the trust estate in any family enterprise and may hold such a family enterprise for any indefinite period and the trustees shall be held harmless and indemnified for any and all actions either taken or not taken in the exercise of its discretion with respect thereto.

[Note that many other detailed provisions concerning special actions, powers, and compensation will be necessary or desirable to take into account the likely investment

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and/or retention of a family enterprise in a trust. This provision just deals with the Prudent Investor piece of the puzzle.]
## APPENDIX 12

### Jurisdictions Having Enacted Uniform Principal and Income Act Section 104 and/or Unitrust Conversion Option

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Sec 104</th>
<th>Unitrust</th>
<th>Notes</th>
<th>UNITRUST CITATION</th>
<th>Unitrust Conversion URL Citation</th>
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<tbody>
<tr>
<td>Alabama</td>
<td>Yes</td>
<td>No</td>
<td>SB 87-Signed July 18, 2003 effective 9/01/03 Structured from PA Statute w/Modifications</td>
<td>Alaska Stat. Section 13.38.200 et seq.</td>
<td><a href="http://www.legis.state.ak.us/basis/get_complete_bill.asp?session=23&amp;bill=SB87">http://www.legis.state.ak.us/basis/get_complete_bill.asp?session=23&amp;bill=SB87</a></td>
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<td>Arizona</td>
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<td>California</td>
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<td>Connecticut</td>
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<tr>
<td>Delaware</td>
<td>No</td>
<td>Yes</td>
<td>Bill Signed -4/16/02 Eff. 1/01/03 --3-5% Rate Option or 1/2 7520 rate b/t 3% &amp; 5%</td>
<td>Section 738.101 et.seq.; Sec. 738.1041</td>
<td><a href="http://election.dos.state.fl.us/laws/02laws/ch_2002-042.pdf">http://election.dos.state.fl.us/laws/02laws/ch_2002-042.pdf</a></td>
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<td>District of Columbia</td>
<td>Yes</td>
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<td>Starting Committee Inquiry on TRU and UPAIA</td>
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<td>Florida</td>
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<td>Hawaii</td>
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<td>Idaho</td>
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<td>Illinois</td>
<td>No</td>
<td>Yes</td>
<td>4% Default, 3-5% w/consent of Trustees. Note Technical Amendments eff. 8/23/04</td>
<td>760 Illinois C.S. 5 et. seq.</td>
<td><a href="http://www.legis.state.il.us/ilcs/ch760/ch760actstoc.htm">http://www.legis.state.il.us/ilcs/ch760/ch760actstoc.htm</a></td>
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<td>Indiana</td>
<td>Yes</td>
<td>Yes</td>
<td>Unitrust Chapter Effective 7/1/03-5%Default 3-5% With Agreement</td>
<td>IC 30-2-14-15</td>
<td><a href="http://www.in.gov/serv/lsa_billinfo?request=getBill&amp;doctype=HB&amp;docno=1115&amp;year=2003&amp;sess=1">http://www.in.gov/serv/lsa_billinfo?request=getBill&amp;doctype=HB&amp;docno=1115&amp;year=2003&amp;sess=1</a></td>
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<td>Iowa</td>
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<td>15 Iowa Code Section 637-101 et seq.</td>
<td><a href="http://www.legis.state.ia.us/cgi-bin/Legislation/Bill.pl">http://www.legis.state.ia.us/cgi-bin/Legislation/Bill.pl</a></td>
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<td>Kansas</td>
<td>Yes</td>
<td>No</td>
<td>Effective 1/1/05. No separate unitrust statute. Unitrust</td>
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<td>Kentucky</td>
<td>Yes</td>
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<tr>
<th>State</th>
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<th>Method of Exercising Power to Adjust</th>
<th>Statute/URL</th>
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<tr>
<td>Louisiana</td>
<td>Yes</td>
<td>No</td>
<td>Just Section 104 - not the rest of UPAIA</td>
<td><a href="http://janus.state.me.us/legis/ros/meconlaw.htm">http://janus.state.me.us/legis/ros/meconlaw.htm</a></td>
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<td>Maine</td>
<td>Yes</td>
<td>Yes</td>
<td>4% Default- PA Model, Bill signed into Law 3/22/02</td>
<td><a href="http://mlis.state.md.us/">http://mlis.state.md.us/</a></td>
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<td>Maryland</td>
<td>Yes</td>
<td>Yes</td>
<td>Signed May 16, 2002-Effective Date 10/1/02</td>
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<td>Michigan</td>
<td>Yes</td>
<td>No</td>
<td>Act No. 159, Public Acts of 2004, eff. 9/1/04</td>
<td><a href="http://www.revisor.leg.state.mn.us/stats/501B/705.html">http://www.revisor.leg.state.mn.us/stats/501B/705.html</a></td>
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<td>Minnesota</td>
<td>Yes</td>
<td>No</td>
<td>Adopted just the power to adjust</td>
<td><a href="http://www.moga.state.mt.us/statutes/chapters/chap469.htm">http://www.moga.state.mt.us/statutes/chapters/chap469.htm</a></td>
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<tr>
<td>Mississippi</td>
<td>No</td>
<td>No</td>
<td>3% Minimum-no maximum-short stat. of limitation</td>
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<td>Missouri</td>
<td>Yes</td>
<td>No</td>
<td>Chapter 469.411 et seq.</td>
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<td>Montana</td>
<td>Yes</td>
<td>No</td>
<td>SB 231-Enacted</td>
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<td>Nebraska</td>
<td>Yes</td>
<td>No</td>
<td><a href="http://www.leg.state.nv.us/72nd/Bills/SB/SB196.html">http://www.leg.state.nv.us/72nd/Bills/SB/SB196.html</a></td>
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<td>Nevada</td>
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<td>New Hampshire</td>
<td>No</td>
<td>Yes</td>
<td>5% Rate-Otherwise Patterned after PA Bill</td>
<td><a href="http://www.moga.state.mt.us/statutes/chapters/chap469.htm">http://www.moga.state.mt.us/statutes/chapters/chap469.htm</a></td>
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<td>New Jersey</td>
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<td>Adjustment up to 4% or down to 6% presumed reasonable</td>
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<td>New Mexico</td>
<td>Yes</td>
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<td><a href="http://www.njleg.state.nj.us/2000/Bills/p101/212.pdf">http://www.njleg.state.nj.us/2000/Bills/p101/212.pdf</a></td>
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<td>New York</td>
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<td>4% Default Rate-Detailed Provisions</td>
<td>Article 11 Section 11-2.1 et seq.</td>
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<td>North Carolina</td>
<td>Yes</td>
<td>Yes</td>
<td>Signed June 19, 2003-Effective 1/1/2004 104 plus Delaware Style Unitrust Statute (3-5%)</td>
<td><a href="http://www.ncga.state.nc.us/html2003/bills/All">http://www.ncga.state.nc.us/html2003/bills/All</a> Versions/Senate/S549vc.html</td>
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<td>North Dakota</td>
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<td>Adopted the Uniform Act without Section 104</td>
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<td>Ohio</td>
<td>Yes</td>
<td>4% Unitrust Safe Harbor</td>
<td>HB 522 Signed Dec. 9, 2002-Adjustment Up to 4% Conclusively Presumed To Be Proper</td>
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<td>Oklahoma</td>
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<td>Oregon</td>
<td>Yes</td>
<td>Yes</td>
<td>H 2063--similar to PA Statute</td>
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<td>State</td>
<td>Unitrust 4% Default</td>
<td>Broad Application of TRU &amp; 104 Signed 5/16/02 Eff. 7/15/02</td>
<td>20 Pa.C.S.A. Section 8101 et seq.</td>
<td>Total In Force w/Section 104</td>
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<td>4% Default Rate-</td>
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<td>Minimum 3% Rate-no maximum-effective July 1, 2002</td>
<td>15 SD Codified Laws Sec. 55-15-1 et seq.</td>
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<td>Texas</td>
<td>Yes</td>
<td>No (but TRU Inc. def.)</td>
<td>SB 573/HB 2241-Contains TRU income definition</td>
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<td>(but TRU Inc. def.)</td>
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