THE TRU DEBATE: IF TOTAL RETURN UNITRUSTS ARE SO GOOD, THEN WHY ARE THEY NOT ALREADY MORE WIDELY ACCEPTED BY PRACTITIONERS?

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INTRODUCTION

Traditionally, trusts were drafted with the distinction between income and principal guiding the trustee's every action. In these "income rule" trusts, the trustee held the principal and distributed the income. This strict distinction between principal and income led to conflict between the income beneficiary, who wanted the trust assets invested to produce the highest possible income, and the remainder beneficiaries who sought the trust assets to be invested for growth. Trustees were handcuffed in their investment decisions because their investment duties were defined by the Prudent Person Rule,[1] which stated the trustee had a duty "to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived."[2] Furthermore, because the trustee was driven by the duty of impartiality as to the trusts beneficiaries, the more often than not result was that everyone was unhappy under this traditional regime.

However, recent and ongoing changes to trust investment law[3] have facilitated a trustee's ability to invest trust assets for total return in accordance with the modern portfolio theory.[4] Furthermore, with the advent of the changes in the Uniform Principal and Income Act (UPIA),[5] coupled with state law changes allowing for equitable adjustments or the use of non-charitable

[1] Restatement of Trusts section 227 (1935).
[2] Restatement (Second) of Trusts sec. 227 (1959).
[3] Restatement (Third) of Trusts sec. 227 (1992). Under the current Prudent Investor Rule, the trustee is charged with investing assets "as a prudent investor would do given the purpose, terms, distribution requirements and other circumstances of the trust."
[4] See Jonathan R. Macy, An Introduction To Modern Financial Theory (2d ed. 1998).
[5] As of this writing, 30 states plus the District of Columbia have adopted the UPIA and another 5 states have legislation pending.

unitrusts[6] and the proposed regulations dealing with the taxation of trust income,[7] the landscape of trust administration in the United States has been changed forever.

Possibly the most important of these changes in trust administration are those reflecting the movement to facilitate the ability of trustees to invest for total return in keeping with the notion of modern portfolio theory. It is argued that such investing would ultimately result in more income being distributed to income beneficiaries and more principal remaining for remainder beneficiaries by virtue of a higher total return on the trust assets than was available under "income rule" trusts.

The purpose of this paper is to take an objective look at the changing dynamics of trust administration brought about by the onslaught of recent changes under both state and federal trust law. Accordingly, this paper is divided into six sections. The first section takes a look at the traditional methods of drafting trusts and accounting for distributions and the problems that have arisen in recent years. The second section explains the changing landscape of investment considerations available to a trustee under current law and how this can have a positive effect upon all the trust parties. Section three examines the recent state action in the area of unitrust legislation and briefly compares and contrasts the major points of several state statutes. Section four examines the proposed federal regulations dealing with the changing nature of the definition of income and what effect this could have upon the taxation of both the trust and its beneficiaries. The fifth section discusses the present state of Total Return Unitrusts (TRUs) under current law and debates some of the corresponding advantages, disadvantages and economic considerations therein. Finally, section six analyzes the possible reasons why Total

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[6] As of this writing, 12 states (Delaware, Florida, Illinois, Iowa, Maine, Maryland, Missouri, New Hampshire, New York, Pennsylvania, South Dakota, and Washington) have adopted laws allowing for total return unitrusts (TRUs), plus New Jersey and Louisiana have unitrust Safe Harbors. Also, Wisconsin and Alaska have legislative proposals in various stages from legislative committee drafts to bill form regarding TRUs.

[7] Proposed regulation 1.643

Return Unitrusts have not been more widely accepted by practitioners and discusses the possibility that failure to seriously consider TRUs, where they can be advantageous to trust beneficiaries, could lead to lawsuits in the future from unhappy income beneficiaries and remaindermen.

Section One: The "Old Guard" – traditional methods of drafting trusts and accounting for distributions

A. Historical Origins of Today's Trusts

Centuries ago, in medieval England, land and wealth were viewed synonymously. Nobleman controlled the land, and used it as a method of buying or rewarding lesser nobles who had supported them in some way. When these lesser nobles died the land would revert to the original owner. In order to avoid problems inherent in the feudal system and also to avoid the loss of land upon death, noblemen developed the idea of transferring land to one or more persons "for use of another."[8] Because the many holders of the "use" never entirely died out, there was never a reversion. Furthermore, the land "user" owed no feudal duties, as they did not actually own the land.

This system of "uses" became so popular that by the early 1400's, the majority of real estate in England was held "for the use of" someone other than the actual land owner. The Crown of England viewed such widespread removal of land from the feudal system as unacceptable. Accordingly, The Statue of Uses and The Rule Against Perpetuities were developed in order to clamp down upon such "uses."

The equitable concept of the "active trust" arose from this conflict, which was a precursor to the modern trust design used today. These original trusts were designed and developed as a method to allow the use or benefit of real estate by one person in land in which another held

[8] For a further discussion of the origins of today's trust design, See Mark B. Edwards, "Trusts For The New Century: The Third Paradigm," 18 The Will And The Way, No. 1 (November 1998).

title.[9] This early notion of the original trusts later developed into a system where almost any imaginable type of asset was held in trust.

B. Income Rule Trusts

Income rule trusts are the traditional trust model used in the United States. One of the overriding concepts inherent in these trusts is the notion of a bifurcation of the trust's asset value between income and principal. The governing provision behind such trusts was that income would be paid to a current beneficiary for a length of time (term of years, life, etc.) with the underlying principal passing to one or more remainder beneficiaries at the end of the trust term. In its simplest form, such a trust can be described by the "fruit from the tree" dichotomy whereby the income beneficiary would be entitled to the annual harvest of fruit, but upon the trust termination the ownership of the tree along with all future harvests of the fruit would pass to the remainderman. An example of such a trust would provide for "*income to A for life, remainder to B*."[10] Under these traditional trusts, trustees were governed in their actions by a number of controlling principals and were subjected to a number of duties.[11] A trustee has a duty to deal impartially with beneficiaries,[12] make the trust property productive,[13] and pay the net income to the beneficiary.[14]

C. Prudent Man Standard

For well over a hundred years, the "prudent man rule" had guided trust investing. Trustees were instructed under this rule to "observe how men of prudence, discretion, and

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[9] Id.
[10] For a more complete examination of income rule trusts, See David A. Diamond, "Trust Design and Investment Strategy for the Next Millennium: Pulling the Plug on Income Rule Trust."(2000). Available on http://leimberg.com.
[11] See Edward Jay Beckwith, "Distribution Issues For Substantially Appreciated Trusts – Is It Possible To Provide A Fair Return to both Current And Future Beneficiaries?," SF68 ALI-ABA 555 (2001).
[12] Restatement (Third) of Trusts sec. 183 (1990).
[13] Restatement (Third) of Trusts sec. 181 (1990).
[14] Restatement (Second) of Trusts sec. 182 (1957).

intelligence manage their own affairs, not in regards to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."[15]

The prudent man rule was consistent with the notion of the "value theory" of investing whereby it was assumed that a trustee acts in good faith by being careful and cautious in selecting stocks and bonds for investment.[16] In practice, however, the rule boiled down to preservation of capital. Under the "prudent man rule," the trustee was required to view each investment separately rather than the portfolio as a whole. Moreover, the governing rule of the time would hold the trustee liable for losing money on a single investment even though total return on the entire portfolio was better than average. Such a harsh rule led trustees to invest in a conservative manner, which accordingly led to below market returns and less income and principal for the trust beneficiaries.

D. Traditional Methods of Distributing Principal and The Power To Allocate Principal To Income

Under the traditional laws governing trusts, trustees were limited in the power available to them to both (1) distribute principle to beneficiaries, and (2) to allocate principal to income.[17] The most basic method used in distributing principal to an income beneficiary has been through the use of a discretionary power held by the trustee. The broadest power to distribute principal, without regard to any standard, is an absolute power where a trustee can make discretionary principal distributions in order to give additional benefits to the income beneficiary.[18] The more common method is the trustee's limited discretionary power to distribute principal to whom its

[15] Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830), at 461.
[16] David Schaengold, "Decade of Change: Revising Trust Investment Law To Coordinate With Modern Portfolio Theory," 26 TMEGTJ 257, (November, 2001).
[17] For a more complete discussion of these trustee powers see Richard W. Nenno, "Where the Rubber Meets the Road: Implementing Total Return Trust Statutes," 36 U. Miami Inst. On Est. Plan 1400 (2002).
[18] Noteworthy, however, is the fact that even with such an absolute power the trustee is always bound by their fiduciary duty of impartiality.

power is typically limited to categories of need such as beneficiary's health, maintenance, education, and/or support.

Under such discretionary power, courts have granted trustees broad latitude in exercising their powers. Accordingly, whether or not a trustee determines to use its discretionary power, a court will not disturb a trustee's decision unless the trustee has acted in bad faith or in an arbitrary or unreasonable manner.[19] A trustee may be held to have abused their discretion if it fails to carry out the trustor's intent,[20] as reflected in the trust instrument.[21]

Generally, the applicable jurisdiction's principal and income act govern a trust's classification of receipts and expenses to principal or income. However, a testator or trustor may grant the trustee discretion to deviate from such statutory rules or may direct a different allocation in the trust's governing instrument. Further, courts have at times held that where the trustee is granted discretion to allocate receipts to principal or income the trustee has absolute discretion to allocate without regard to the jurisdiction's principal and income act.[22] Nevertheless, a trustee will be deemed to have abused their discretion if they blindly allocate all gains to income, or conversely simply refuse to allocate gains to income.[23] However, if a trustee is following the applicable principal and income act in exercising its discretion to allocate receipts to income or principal, it may raise a presumption of reasonableness[24] and would be unlikely to constitute an abuse of discretion.

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[19] In re Couch Trust, 723 A.2d 376 (Del. Ch. 1998). Also see III Scott on Trusts 14-27 (Fourth Ed. 1988). Such actions by a trustee would be considered an abuse of their discretion in the trust administration.
[20] Dickinson v. Wilmington Trust Company, 734 A.2d 605 (Del. Ch. 1999), aff'd, Wilmington Trust Company v. Dickinson, 734 A.2d 642 (Del. 1999).
[21] In re Couch Trust, supra note 19 at 382-383.
[22] IIIA Scott on Trusts, 50-58 (Fourth Ed. 1988).
[23] See Nenno, supra note 18.
[24] Markley Estate, 19 Pa. D. &C.2d 143 (O.C. Mont. 1959).

E. Problems Encountered Using These Traditional Notions in Today's Marketplace.

The combination of governing principals and duties placed upon trustees, including the prudent man investing standard, and the limitations towards distributing principal and the power to allocate principal to income have oftentimes "handcuffed " trustees in the changing dynamics of today's marketplace. Because of these duties and limitations placed upon trustees and the changing economic climate of both lower interest rates and dividend yields the result has too often been a system which is "unworkable" in terms of fulfilling the trustor's intent, and expectations, upon the trusts creation. So what has happened to create such chaos in the world of trust administration? Is it the traditional methods, or could it be changing dynamics in the economic marketplace? In this author's opinion, it is a combination of both factors.

Because of the strict guidelines governing income and principal in traditional trusts, the income beneficiary and remainder beneficiary wishes are diametrically opposed. The income beneficiary seeks to maximize income through investment in receipts traditionally allocated to income.[25] Conversely, the remainderman seeks to maximize the principal through investment in growth-oriented companies.[26] Caught in the middle of the disagreement about how to invest the trust assets is the trustee who is governed by a duty of impartiality to all beneficiaries. Often the trustee would invest trust assets with 50% allocated in bonds, and 50% allocated in equities.[27] This, more often than not, would result in both the income beneficiary and remainderman being equally disappointed as under such an asset allocation neither of their expectations would be met.[28] These problems were only further complicated in the current economic marketplace by a significant reduction in interest rates paid by investment grade bonds and the reduction in

[25] Such investments would generally include fixed income securities and dividend paying blue-chip stocks.
[26] The result being capital appreciation that has traditionally be allocated to principal.
[27] See Robert B. Wolf "Defeating the Duty to Disappoint Equally – The Total Return Trust," 32 Real Prop. Prob. & Tr. J. 1 (1997).
[28] Id.

corporate dividends of blue-chip equities. No longer were trustees able to secure 8-10% yields in fixed income investments.[29] Furthermore, trustees were faced with a substantial reduction in blue-chip stock dividends.[30] In fact, in today's marketplace many of the leading corporations have gotten away from the tax inefficient corporate dividend and have opted to reinvest profits in the growth of the company as opposed to distributing dividends which were taxed at both the corporate and shareholder level.[31]

Another vital consideration facing trustees is that of investing in a manner that can keep pace with the economy's underlying inflationary pressures. Although in recent years inflation has been relatively tame, this has not always been the case nor should one assume it will be so in the future. Because of this potential for inflationary pressures, it is no longer sufficient to merely preserve the same nominal value in a trust. Instead, it has become critical that investors preserve the real (i.e. after inflation) value of the principal and of the income stream it produces.[32] Moreover, studies of long-term investment returns, both in current income and in principal value growth, show that only equity investments that represent an ownership interest in assets and income producing property have kept pace with inflation.[33] Because of this, even despite their far greater volatility level, investments in equity securities became favored for their capital

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[29] From 1990 to the present the return on intermediate government bonds has averaged around 6%, which is in stark contrast to the 8 – 10% returns enjoyed from the late 1970's until 1990.

[30] Today stock dividend yields are at an all-time low, hovering around the 1% level which is in stark contrast to the approximate 4% yield enjoyed from the mid-1950's until around 1990.

[31] Examples of market leaders without dividends include Cisco Systems, Microsoft and Oracle. This is not to say that they had no return however, as Cisco, Microsoft, and Oracle had total returns of 110%, 224% and 182% respectively over the last five years even after the tremendous sell-off of technology stocks over the last two years. Under income rule trusts, trustees would be unable to invest in such companies stock because of their lack of dividend distributions.

[32] See Patti S. Spencer, "Total Return Trusts: Trusts in the New Millennium," Presented to Pennsylvania Institute of Certified Public Accountants: Estate & Personal Financial Planning Conference, November 11, 1999. Available at http://leimberg.com/tapes/spencer.html.

[33] See Ibbotson Associates study which shows that investment returns and inflation annual averages from 1926-2000 where: inflation 3.10%; treasury bills 3.80%; government bonds 5.30%; and, large stocks 11.0%. Thus, when taking inflation into account real returns for these investments were: treasury bills 0.70%; government bonds 2.20%; and, large stocks 7.9%. Noteworthy is the fact that these figures are before taking into account expenses and taxes. After taking into consideration those factors, only equities provided any "real" returns.

appreciation in principal value and the increased income streams they produced. A dollar of principal was noted to be just as valuable as a dollar of income, and this recognition gave birth to the concept of total return investing.[34] With the traditional notions of trust investment crumbling around them, where are trustees to turn under such economic conditions?

Section Two: The "New Guard" - the foundation for a new Trust investment paradigm?

A. Prudent Investor Rule

In order to keep pace with the changing investment climate of the late twentieth century, trust administrators needed to be able to change their methods of investment. The enactment by many states of the prudent investor rule allowed just that.[35] The prudent investor rule, which derives from modern portfolio theory,[36] is set forth in sec. 2(a) of the Uniform Prudent Investor Act ("UPIA"). The rule sets forth several basic components as its foundation: (1) Trustees should invest for total return; (2) a trustee may acquire any type of investment, and each investment is considered as part of an overall investment strategy (3) the entire portfolio must be examined, rather than an asset by asset valuation, in determining whether the trustee has acted with prudence; (4) delegation of investment functions is permitted;[37] (5) preservation of capital is replaced with risk/return objective as the trustee's primary concern, and (6) the investments made by the trustee must be suitable for the underlying purpose of the individual trust.[38]

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[34] See Robert B. Wolf, "Total Return Trusts: Meeting Human Needs and Investment Goals Through Modern Trust Design," 36 Real Prop., Prob. & Tr. J. 170 (2001).
[35] As of this writing 30 states and the District of Columbia have adopted this standard.
[36] Modern portfolio theory is discussed infra on page 11.
[37] Conversely, a trustee with special skills or expertise has a duty to use those special skills or expertise.
[38] See Alvin J. Golden ""Total Return": Is this How Trusts Are to Be Structured in the New Millennium? Can You Afford Not to Recommend Them?" (2000). Available at http://leimberg.com/tapes/total_return.html. More specifically, the new rule provides that "a trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversification." Also, the prudent investor standard still holds the trustee to a duty of prudence; however, it has redefined just exactly what constitutes prudence.

Furthermore, under the prudent investor standard, trustees are still bound by their traditional duties of loyalty and impartiality to the trusts beneficiaries.[39]

i. Modern Portfolio Theory

The nexus of the prudent investor rule is the modern portfolio theory, which was considered to be important enough to warrant Nobel Prize awards for several economists.[40] By looking at portfolios as a whole rather than just individual investments the new theories are credited with ushering in a whole new era in trust investment doctrine.

This aggregate of economic theories is based upon the notion that financial markets are efficient and investors will choose investments based upon the degree of risk and overall diversification. While these are principles that the estate planner has not traditionally dealt with, they are concepts that drive the debate over the use of TRUs in estate planning.[41] Modern portfolio theory was first proposed by Harry Markowitz in 1952. The principle is a variation of the concept that the whole is greater than the sum of the parts. In short, the theory proposes that an efficiently combined group of stocks can be selected to create a portfolio that will lead to a lower risk than the average of the risk of the same stocks held separately.[42]

Traditionally, investment philosophy has revolved around the notion that a sophisticated investor could find undervalued stocks, or stocks that were about to increase in value because of the growth potential of the company, to stay ahead of the markets by studying past performance and analyzing relevant data.[43] Diversification of the portfolio, however, was not an overriding concern. Under modern portfolio theory, however, diversification is a central theme. Modern

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[39] Restatement (Third) of Trusts Sec. 227 (1990).
[40] Harry M. Markowitz, an early developer of Modern Portfolio Theory, won the 1990 award in economics.
[41] See Golden, supra note 39 at 6.
[42] Richard A. Brealey, An Introduction to Risk and Return from Common Stocks. Cambridge: M.I.T. Press, 1969, p.117. Also, see Schaengold, supra note 17 at 2.
[43] The leading authority on value investing is by Benjamin Graham, Security Analysis (1934).

portfolio theory is also based upon the concepts that the market is "efficient"[44] and to some degree a "random walk."[45] Therefore, under the theory, a successful investor does not just pick and choose individual investments, but rather diversifies which leads to a reduction in overall risk and volatility.[46]

Diversification is a key component of modern portfolio theory because investments that individually may be risky can, in combination, actually lower overall risk of a portfolio. Thus, one can increase return or decrease risk without having to pay for it in overall portfolio performance. The theory states this is possible because many investments have a "negative covariance," which in layman's terms means that when one goes down the other goes up, or at least doesn't go down.[47] Accordingly, combining investments that perform differently over time, such as stocks and bonds or diversified individual stocks within a portfolio, will actually eliminate much of the company specific risk associated with security selection.[48] However, market risk, risk that applies to the entire market, will still exist.[49]

Recent studies have demonstrated that over 90% of long-term portfolio returns are attributable to proper asset allocation and that only modest returns are attributed to security selection, sector selection, and market timing. Therefore, under modern portfolio theory, the

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[44] Here efficiency is used in regards to the "Efficient Capital Market Hypothesis" which stands for the proposition that a market is efficient if the prices of the goods sold in that market fully reflect all available information about those goods. In other words, when new information becomes available such new information is immediately reflected in the price of goods.
[45] The "random walk" theory holds that past performance is not an accurate predictor of future price performance. This does not mean that stock prices are random, rather it means that an investor cannot make a profit by using past performance to determine future value.
[46] For a more in depth discussion of modern portfolio theory see Golden, supra note 39 at 6.
[47] An often-noted example of this phenomenon is where an investor owns both oil stocks and utility stocks as they generally move in opposite directions. For example, when the price of oil goes up so does the value of oil stocks whereas utility stocks go down because their operating costs increase. Conversely, when the price of oil decrease so does the value of oil stocks whereas utility stocks increase in value because of lower operating costs.
[48] See Macy, supra note 4 at 28.
[49] For a more in depth analysis of this concept see Wolf, supra note 35.

asset allocation selection of a trustee is critical for the trust to have a risk/reward efficient diversified investment portfolio.[50]

B. The Revised Uniform Principal and Income Act

The advent of trustees now being able to invest pursuant to the notions of modern portfolio theory, by virtue of the prudent investor standard, allows trustees to invest for total return which can lead to increased levels of investment return. However, this alone does not help eliminate the tension between income beneficiaries and remainderman. Moreover, investing for total return would result in capital appreciation at the expense of trust income. Thus, further trust administration reform was necessary to allow trustees to somehow make up the difference to the trusts income beneficiaries in this "brave new world" of total return investing. The revision, and corresponding state adoption thereof, of the Uniform Principal and Income Act ("UPIA") allowed just that.[51]

The primary objectives of the 1997 Act were to revise the 1962 Act, by adding provisions to the Act that would facilitate trustees adoption of the techniques set forth in the modern portfolio theory, which are now permitted under such legislation as the Uniform Prudent Investor Act.[52]

Section 104 of the UPIA authorizes a trustee to adjust between principal and income to the extent they consider necessary if the: (1) trustee manages and invests trust assets as a prudent investor, (2) terms of the trust describe the amount that may, or must, be distributed to a

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[50] Brinson, Singer, and BeeBower, "Determinants of Portfolio Performance II: An Update," 47 Financial Analysts Journal 40 (May/June 1991). An individual portfolio is deemed "efficient" if there is no other possible portfolio that at the same level of risk has a greater return, or if there is no other possible portfolio that at the same level of return has less risk.

[51] The Principal and Income Act contains a host of changes to the existing statutory regime. However, an exhaustive treatment of these changes is beyond the scope of this paper, which will rather focus only on those that have the greatest potential impact upon the way lawyers draft and administer trusts in the future. For a more complete discussion of the entire Principal and Income Act see James Gamble, "If It's The 1990s, It Must Be Time For Another Principal And Income Act," 32-8 UMLCEP 800 (2000).

[52] See Beckwith, supra note 12 at 561.

beneficiary by referring to the trust's income, and (3) trustee determines that they are unable to administer the trust impartially by applying the terms of the trust and under the provisions of other UPIA sections.[53]

The power to adjust found in UPIA section 104 has been a "bone of contention" for many groups considering the adoption of the UPIA in their states and, in some instances, the section 104 provisions have been eliminated prior to the state's final adoption of the UPIA.[54] As a result, Section 105 of the UPIA was enacted which provides that a court is not to change a fiduciary decision to exercise, or not to exercise, any discretionary power conferred by the UPIA, unless the court determines that the decision was an abuse of the fiduciary's discretion. Further, a court may not determine that a fiduciary has abused their discretion merely based upon the fact that the court would have exercised the discretion in a different way, or would not have exercised the discretion at all.[55]

Section 105 is applicable to all discretionary decisions made under the UPIA, which thereby codifies the notion that a court will not interfere with a trustee's exercise of discretion, except where they have abused it. Noteworthy, is that a court will not change a determination under Section 104(a) of whether, and to what extent, an amount should be transferred from income to principal or from principal to income.[56]

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[53] See id at 562, where Beckwith discusses the following examples of section 104 application: (1) If the trust property does not produce sufficient income, the trustee can transfer funds from principal to income, (2) if trust property produces significant income, a portion can be transferred to principal, and (3) if the character of an investment's return is unclear, the trustee can allocate it among Principal and Income as he deems necessary to produce a fair and reasonable result.

[54] See English, "The California Principal and Income Act," California Trusts & Estates Quarterly, Spring 2000 at 4. Professor English advises that Iowa and North Dakota both dropped the Section 104 power to adjust from their adoption of the UPIA.

[55] Section 105(a) of the UPIA; also See McCue, "How to Greet New Uniform Trust and Estate Acts?: With Rational Exuberance," 35 Phillip E. Heckerling Institute on Estate Planning 1103 (2001). Ms. McCue further states that if a court determines that the fiduciary has abused its discretion, the Section 105 remedies are designed not to punish the trustee, but rather to restore the trust and the income and remainder beneficiaries to the positions they would have occupied if the fiduciary had not abused its discretion.

[56] Section 105(b) of the UPIA.

Because trustees could now adjust between income and principal, they are more likely to utilize the investment principles of modern portfolio theory, which are allowed under the Prudent Investor Rule, because the trustee can now compensate an income beneficiary for a loss of investment income due to an increase in the portfolio's capital appreciation.[57] In turn, this could lead to both greater income payments and remainder principal, due to increased investment returns on the trust assets, which should also assist the trustee in fulfilling the trustor's intent. With these new provisions, the only remaining question was how to best implement these changing investment notions to meet the trustor's intent more fully?

Section Three – State Action: Using The Prudent Investor Standard And Revised UPIA to Better Meet The Trustor's Intent and Beneficiaries Needs

With the altered investment climate and changing dynamics of trust administration, states sought to enact legislation that would allow trustees to utilize these new planning tools to help better meet the trustor's intent and financial needs of the beneficiaries.[58] States have in turn borrowed from the long-standing principle of charitable unitrusts[59] and have extended this idea into the realm of non-charitable trusts. As a result, TRUs were born.

In its most basic form, a TRU might provide: *Pay A x% of the value of the trust each year, remainder to B*. Under such a drafting model, the tension between current yield (sought by the current beneficiary) and long-term growth (favored by the remainder beneficiary) is muted.

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[57] This would occur because a trustee investing for total return would have a larger percentage of the trust's assets invested in equity securities which would potentially offer larger returns through stock price appreciation at the cost of lower traditional income components such as interest and dividends.

[58] As of this writing, 12 states (Delaware, Florida, Illinois, Iowa, Maine, Maryland, Missouri, New Hampshire, New York, Pennsylvania, South Dakota, and Washington) have adopted laws allowing for total return unitrusts (TRUs), plus New Jersey and Louisiana have unitrust Safe Harbors. Also, Wisconsin and Alaska have legislative proposals in various stages from legislative committee drafts to bill form regarding TRUs.

[59] An example of a charitable unitrust is the charitable remainder unitrust, which provides, in essence, "pay x% of the trust value annually to non-charitable beneficiary, remainder to charity at non-charitable beneficiary's death." Such trusts are creatures of the Internal Revenue Code and allow the settlor to deduct the remainder value for income, gift, and estate tax purposes. TRU's use the same concept to define the current beneficiary's income stream, but have no charitable component.

Further, the trustee of a TRU can now pursue a single cohesive investment objective: *total return*, as opposed to worrying about balancing investment performance between current income and long-term growth. In a sense, all of the trust's players are on the same page for once: *maximizing trust asset returns*. After all, as a matter of economic reality no matter whether you characterize it as "income" or "principal," *a dollar is still a dollar*.[60] Furthermore, consistent with this economic reality, trustees of TRUs are no longer "handcuffed" by the archaic principal/income dichotomy.[61] This paper shall now take a brief look at some of the various state TRU legislation and discuss some of their unique characteristics:[62]

Delaware

On June 21st, 2001, Delaware became the first state in the country to enact a statute that expressly allowed trustees of income trusts to convert their regime to one using the TRU concept.[63] Delaware's TRU statute grants a trustee the ability 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 is given, the change can be made without court involvement.[64] Delaware's flexible TRU statue is intended to be available to virtually all trusts, even those moved to Delaware.[65]

A provision unique to the Delaware statute is that a trustee has a choice to set the payout rate between 3% and 5%.[66] In making their decision as to the rate, the trustee is instructed to

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[60] Except for income tax purposes, where a dollar of principal growth is arguably worth more than a dollar of income, because (1) you don't have to pay taxes on principal growth until you realize it by selling an asset, and (2) capital gain rates are preferential to ordinary income rates.
[61] See Diamond, supra note 11 at 2.
[62] For a more complete discussion of this topic see Nenno, supra note 18 at 18-28; and, Wolf supra, note 35 at 26-30.
[63] 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."
[64] 12 Del. Code sec. 3527(b)(2).
[65] This is discussed in the statutes legislative notes.
[66] This range is probably in response to the range specifically noted to be acceptable in the Proposed Regulations that are discussed in Section Four, *infra*.

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 of the trust, and (4) projected inflation and its impact on the trust.[67] The trustee also is granted[68] the discretion to determine the effective date of the conversion, the timing of distributions, and the valuation dates or the averages of valuation dates as are deemed appropriate. Further, the Delaware statute specifically grants the trustee the power to allocate short and long-term capital gains to income for purposes of determining distributable net income ("DNI").[69]

The Delaware law gives the trustee significant flexibility in administration of their new TRUs, especially in the flexibility of choosing a unitrust rate between 3 and 5%, which is favorable presuming trustees don't mind making such important choices in the process. It is debatable, however, whether the trustee should be given this annual power or whether this should be determined solely by the trustor. Another key difference between the Delaware statute and those of New York and Missouri is that Delaware does not include the option of the power to adjust between income and principal.

Missouri

The Missouri Statute[70] differs from Delaware's, by permitting a trustee to elect to convert an income trust to a unitrust, with notice to the settlor and the beneficiaries but their consent is not necessary. Missouri's law also grants the trustee the power to adjust between principal and income.[71] Both of these provisions are protected by short two-year statutes of limitations after which either the unitrust conversion or the act of an adjustment becomes uncontestable.

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[67] 12 Del. Code sec. 3527(f).
[68] 12 Del. Code 3527(i).
[69] This will be discussed later in connection with Proposed Regulations on pages 26-27 of this paper. This is significant in that it may both lower the total tax burden and makes a higher payout rate prudent.
[70] Mo. Rev. Stat. Sec. 469.411.
[71] Mo. Rev. Stat. Sec 469.403 and 469.405.

Perhaps the most unique portion of the Missouri law is that the unitrust percentage must be set at a minimum of 3%, but has no upper limit. Furthermore, there isn't any ordering provision[72] or express power in the trustee to allocate short- or long-term capital gain to the unitrust amount. These two provisions could prove to be problematic to trustees as they may result in unreasonable demands being placed upon them from income beneficiaries seeking higher payout percentages. Also, the potential limitation regarding capital gains could eliminate the trustee's flexibility in making tax planning distribution decisions, as they might be forced to distribute more principal in the payout than they might otherwise have desired. Perhaps, not coincidently, it is only the trustee who has the power to make the unitrust conversion and set the payout percentage under the Missouri law. These powers could lead to much pressure being placed upon trustees to exercise their discretion under the Missouri statute.

New York

The New York law, similar to Missouri's, contains both the unitrust provision and the power to adjust. The New York Statute[73] requires a trustee of a trust, in existence prior to January 1, 2002, to elect to convert the trust to a unitrust and all sui juris beneficiaries to approve the conversion by December 31, 2005. If the trustee does not elect to convert an income trust to a unitrust, or if a beneficiary withholds consent to the conversion, a court may later convert the trust to a unitrust. Also, the reconversion of a unitrust to an income trust requires a court order.

The New York Statute contains several key unique provisions. The unitrust payout percentage is a fixed 4% and may not be changed by agreement or by a court. After the first

[72] Ordering provisions, discussed infra on page 23, deal with allowing the trustee to allocate capital gains as a part of DNI.
[73] N.Y.E.P.T.L. sec. 11-2.4.

three years, the trustee must apply a three-year "smoothing rule."[74] Finally, the New York law does not contain anything expressly dealing with the ordering rule or granting express discretion, as does the Delaware law. It is debatable if this lack of an ordering rule will actually allow New York trustees more flexibility in their method of allocation of capital gains to DNI, because there is no set standard, or whether the inclusion of capital gains in the unitrust payout would be honored by the IRS in the absence of such a provision in the law.[75]

New Jersey

New Jersey takes a unique, albeit questionable, approach to allow TRUs by granting the trustee a safe harbor for the use of the power to adjust under its new Uniform Principal and Income Act.[76] It appears, however, that all the statute does is create a presumption that the adjustment is both fair and reasonable. Thus, the provision is not a true safe harbor as the adjustment is only *presumed* to be fair and reasonable to the beneficiaries. In essence, the law merely gives guidance as to the range of adjustments, which is thought to be prima facia reasonable. It is not, however, conclusively presumed to be fair and reasonable. [77]

It is not clear how the New Jersey law fits within the framework of the Proposed Regulations, as discussed in Section Four of this paper. It should clearly qualify as "income" as an exercise of the trustee's power to adjust. However, the 6% ceiling is above the guidelines set forth in the Proposed Regulations. Noteworthy, is the fact that it has been argued that such a safe

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[74] A three-year smoothing rule, discussed infra on page 22, would change the income beneficiary's payout by basing it upon the current three-year average of the trust's value as opposed to an annual figure. This is implemented to smooth out fluctuations in trust value based upon market fluctuations. Such a provision makes sense as under total return investing most of the trust assets would be invested in corporate stock, which can be volatile.

[75] See Robert B. Wolf, Stephan R. Leimberg, "The Latest State Legislation Governing Total Return Unitrusts," 28 Est. Plan. 474 (2001).

[76] N.J.S.C.3B:19B-4. Which in part states, "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).

[77] See Wolf, supra note 35 at 182-183.

harbor approach may take away most desirable characteristics of both the power to adjust and the unitrust as it would reduce the flexibility of the power to adjust, while also reducing the predictability of the unitrust thereby causing less certain benefits for future trusts drafted as unitrusts.[78]

What approach works the best in helping meet the trustor's intent?

This is a question that could be debated at great length, but would be beyond the scope of this paper. However, this is an important and timely question because interest in similar legislation has been shown in several jurisdictions. Additionally, 30 states plus the District of Columbia have adopted the 1997 Uniform Principal and Income Act. Only time will tell which approach works best, however this author believes that it would be wise to include the following aspects in every state law:

(1) **Have both unitrust provisions and the power to adjust**: Flexibility can often be a key in meeting the trustor's intent, especially in light of changing needs of beneficiaries[79] and changing market conditions. A unitrust provision would give the income beneficiary predictability of payout as they know they would receive a set percentage of the trusts value. Granting the trustee the power to adjust would provide added flexibility that would allow the trustee to potentially make distributions in a more tax-efficient manner for both the trust and beneficiaries. Accordingly, states would be wise to include both provisions in any legislation as this added flexibility could better insure the trustor's intentions are being met.

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[78] See id.

[79] See Beckwith, supra note 12 at 569. Mr. Beckwith raises the potential for fluctuating needs such as: (1) Will the current beneficiary need all of the unitrust amount each year, (2) will the current beneficiary have predictable extra needs, such as tuition, (3) should emergencies such as extraordinary medical expenses be addressed, and (4) should life events such as marriage, births, employment status, be taken into account. Beckwith further states that the way to deal with such uncertainties would be address with caps and minimums on beneficiary payouts, and by granting the trustee powers of invasion.

(2) **Include a "smoothing provision"**: As previously noted, a unitrust provision would give the income beneficiary predictability as to the set percentage of the trusts value they would receive annually. However, recent market fluctuations bode well for the need of a smoothing provision so that the volatility of payout amounts could be reduced.[80] A beneficiary could benefit from such a provision because in down markets their payout would be increased by virtue of prior up markets. This might help met the trustor's intent more fully as they may have wanted the beneficiary to get a more steady stream of income rather than income being dictated by current market performance.

(3) **The ordering provision debate: Are statutes better with or without such a provision?** The ordering rule specifically grants the trustee the power to allocate short- and long-term capital gains to income for purposes of determining DNI. Thus, an ordering rule can have a great impact on a particular payout rate. This is because if the trust pays the taxes on short and long-term capital gains then the rate that can be paid out is lower (likely 30-40 basis points lower over the long term) than if the gains are pushed out to the beneficiary. Better yet, the difference could be twice as much for a low basis trust.[81] Is it possible that a lack of an ordering rule might give a trustee even more flexibility because a trustee can alter his distribution methods of capital gains to an income beneficiary as they deem fit, or is it more likely that such treatment of capital gains will not be respected by the IRS as not specifically part of DNI? It is arguable that a consistent practice by the trustee of paying out capital gains as part of the unitrust would be honored by the IRS, but where does this leave a trustee who, without an ordering rule, is distributing capital

[80] The following is an example of how a three-year smoothing provision would operate. Assume the trust is created with $1 million of corpus. After year 1 the trust's value is $1.1million, after year 2 it's value is $1 million, and after year 3 it's value is $900,000. Under a three year smoothing provision, in year 3 the income beneficiary would receive a payout based the prior 3-year average of the trusts value, which here is $1 million. Thus, the income beneficiary would receive (assuming a 4% payout percentage) $40,000 in year 3 as opposed to the $36,000 they would have receive without the three year smoothing provision.
[81] See Wolf and Leimberg, supra note 76 at 75.

gains as part of DNI for the first time? Doing something for the first time would not be consistent with the notion of a "consistent practice" and thus arguably not honored by the IRS. Thus, although this author believes that a reasonable exercise of the trustee's discretion to allocate capital gain to income should be an adequate anti-abuse standard, if a state wishes to ensure that capital gains can be distributed as part of DNI they should likely have an ordering provision as a part of their statute as it is not entirely clear that the IRS would honor such distributions without one.

Section Four – Federal Action: The TRU affect of the Proposed Regulations definition of income

On February 14, 2001, the Internal Revenue Service issued Proposed Regulations[82] that dramatically revise the definition of trust income under I.R.C. Section 643(b) and amend the rules regarding income distributions made by several categories of trusts.[83] This was done to take into account changes in the definition of income under state laws, as a Treasury Department official publicly stated that this Regulation was drafted to take into consideration how total return trusts and the equitable adjustment provision of the UPIA[84] will affect federal tax provisions.[85] Additionally, the Proposed Regulations clarified some uncertainty that had existed regarding when capital gains are includable in DNI under Section 643(a)(3).[86] In short, the Proposed Regulations appear to be a very positive and helpful reaction to the movement by many states

[82] REG-106513-00, 66 F.R. 10396-10400 (2/15/01).
[83] "Trusts: IRS Proposes New Definition of Trust Income to Reflect State Law For Total Return Trusts," 32 Daily Tax Report G-1, 2001. The trusts affected by the proposed regulations include: ordinary trusts, pooled income trusts, charitable remainder unitrusts, trusts qualifying for the marital deduction under estate and gift tax law, and trusts exempt from the generation-skipping transfer (GST) tax.
[84] As previously noted, Section 104 of the UPIA grants a trustee the power to make an "equitable adjustment," under certain circumstances, and recharacterize principal as income and income as principal when the trustee determines that such an adjustment is needed to treat beneficiaries impartially.
[85] For a more complete discussion of this beyond the scope of this paper see, Laura Howell-Smith, "How Proposed Regulations On The Definition Of Income Affect Total Return Trusts," 28 Estate Planning 308 (2001).
[86] The Proposed Regulations would broaden the circumstances when a trustee may allocate capital gains to income for federal tax purposes the IRS has said, but to avoid undermining the tax code's basic definition of trust income they would not allow trustees to exercise unfettered discretion.

towards total return investing and their corresponding revisions to the definition of trust income and principal.

Definition of income under the Proposed Regulations

Section 643(b), the primary source of authority for the definition of income in the Proposed Regulations, offers considerable flexibility as it looks solely to the terms of state law and the governing instrument.[87] Prop. Reg. 1.643(b)-1 provides that for the purposes of the taxation of trusts (except grantor trusts) and beneficiaries the definition of income continues to be determined under traditional principles of income and principal. However, if state law permits different allocations, trust provisions following such law will be respected for tax purposes if state law provides for a reasonable apportionment between income and remainder beneficiaries of the total return of the trust of that year.

The Proposed Regulation indicates, as an example, that a local law providing for a unitrust payout amount that is between 3% and 5% of the trust's annual FMV is a reasonable apportionment.[88] Prop. Reg. 1.164(b)-1 also expands the ability of a trustee to include realized capital gain in trust accounting income by granting that such an allocation will be respected if made pursuant to the terms of local law or the governing instrument, or made as a reasonable and consistent exercise of a discretionary power granted to the trustee by the governing instrument or local law, if not consistent with local law. Finally, another example deemed reasonable is a state law allowing the trustee to make equitable adjustments between income and remainder beneficiaries as would be permitted under UPIA section 104.

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[87] The statute provides that "…the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law."

[88] Although this reference to a unitrust payout between 3% and 5% as being a reasonable apportionment of the trust's total return is merely an example it does, however, provide a safe harbor. It would seem unlikely that any state would enact a provision outside of this range (however, see New Jersey's statute).

In essence, the clear intent of Prop. Reg. 1.643(b)-1 appears to be to allow a trustee to invest in a manner consistent with Modern Portfolio Theory without shortchanging either the income or remainder beneficiaries. The Proposed Regulations (assuming local law permits) grants a trustee four methods to define income in a trust: (1) As ordinary income under traditional notions, (2) as a unitrust interest, (3) as ordinary income modified under the exercise of the trustee's equitable adjustment power, and (4) as ordinary income plus capital gain where authorized by a state statute or trustee discretion, using a reasonable and consistent allocation of realized capital gain to income.[89]

Capital Gains and Distributable Net Income under the Proposed Regulations

Based upon this dramatic change in the definition of income under Prop. Reg. 1.643(b)-1, the Proposed Regulations needed to also deal with the inclusion of capital gain in DNI for when trust accounting income is in excess of ordinary income. This became necessary because such a situation would require the distribution of some form of traditional corpus to the income beneficiary.

Prop. Reg. 1.643(a)-3(a) clarifies the circumstances in which capital gains are includible in distributable net income ("DNI") for the year. Generally, capital gains will be includible in DNI to the extent they are, pursuant to the terms of the governing instrument or local law, or pursuant to a reasonable and consistent exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by the governing instrument or local law): (1) allocated to income; (2) allocated to corpus but treated 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 utilized by the

[89] For a more complete discussion of the definition of income under the Proposed Regulation see, Barbara A. Sloan, T. Randolph Harris, and George L. Cushing, "When Income Isn't "Income" – The Impact Of The New Proposed Regulations Under Section 643," 94 Journal of Taxation 325 (2001).

fiduciary in determining the amount which is distributed or required to be distributed to a beneficiary.

This is followed by eleven examples that describe how the trustee will include capital gain in the amount that flows through to the income beneficiary in various situations. Several of these examples make it clear that an ordering rule within a state statute will be respected. Example 9 deals with 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 net long-term capital gain, and finally from return of principal. Such an ordering rule is specifically approved by this example. Examples 10 and 11 deal with situations where neither state law or the governing instrument has an ordering provision rule for the character of the unitrust payout, but rather leaves such a decision to the trustee. Taken together, these two examples allow a trustee to adopt to either include capital gains in DNI, or exclude them from DNI, providing that such exercise of discretion is done consistently on a year-to-year basis.[90]

Other Important Provisions of the Proposed Regulations

Although an in depth discussion is beyond the scope of this paper, a few other provisions are vitally important and warrant brief consideration:

Marital Deduction Trusts:[91] One requirement of each of these type trusts is that the spouse must be entitled to receive for life all of the income from the trust property. The Proposed Regulations would provide that a spouse's interest would satisfy this requirement if: (1) the spouse was entitled to income as defined by state law, and (2) it is done in a way that makes a

[90] See Wolf, supra note 35 at 51-53.
[91] Certain transfers of property in trust, at death or during life, qualify for the marital deduction for estate or gift tax purposes. Transfers that qualify include a trust in which the spouse has a life estate and general power of appointment and qualified terminable interest (QTIP) trusts.

reasonable apportionment of the total return of the trust between the current and remainder beneficiaries. Therefore, if allowed under state law, a trustee can convert a marital trust to a unitrust or make adjustments between income and principal without risk of losing the marital deduction.[92]

Grandfathered GST Trusts:[93] Prop. Reg. 26.2601-1(b)(4)(i)(D)(2) specifically provides that administration of a trust using a unitrust definition of income or using an equitable adjustment provision "will not be considered to shift a beneficial interest in the trust, if the state statute provides for a reasonable apportionment between income and remainder beneficiaries of the total return of the trust and meets the requirements of [Prop. Reg.] 1.643(b)-1…" Thus, in states that have adopted a unitrust statute or UPIA, trustees of grandfathered trusts can take full advantage of total return investing without affect on their grandfathered status.

Because of the positive reinforcement effect the Proposed Regulations have upon the potential use of total return investing and use of state unitrust, their enactment clearly solidifies the use of such local laws in helping attorneys meet a trustor's intent by drafting such provisions. However, the Proposed Regulations are not as straightforward in regards to the Trustee's Power to Adjust.[94] A transfer of principal to income made under the Trustee's Power to Adjust provision is not expressed as a transfer of a specific event such as a realized capital gain rather the transfers are transfers of cash. Thus, it is not entirely clear whether the Proposed Regulations

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[92] Noteworthy is that extra care must be exercised when using a TRU to the QTIP rules of Internal Revenue Code section 2056. The QTIP rules reflect an income rule trust bias by providing that the surving spouse must be entitled to all of the net income of the trust at least annually if the trust is to qualify for QTIP treatment. In order to draft a QTIP trust as a TRU, the trust must provide the trustee to pay the surviving spouse the greater of net trust accounting income or the unitrust amount. Such a trust should meet the QTIP requirements since the surviving spouse will always receive at least the entire net income of the trust. For a further discussion, see Diamond, supra note 11 at 4.

[93] These types of trusts are grand fathered so as not to be subject to the generation-skipping tax enacted in 1986. They include a trust (1) that was irrevocable on September 25, 1985 (a Grandfathered Trust); and (2) to which all or a portion of an individual's GST exemption has been applied for (an Exempt Trust).

[94] As this provision is set forth in section 104 of the UPIA (1997).

would view such a provision as a power granted to the trustee conferring discretion to include capital gains in DNI. Therefore, for the majority of trusts in states that have adopted the UPIA, there remains a question as to whether the trustee can establish a policy of distributing capital gains in conjunction with exercising a power to adjust.[95] Hopefully, the Final Regulations will address this issue in a taxpayer friendly manner.

Section Five – The TRU Debate: Pros and Cons Surrounding The Use of Total Return Unitrusts

Several commentators have recently identified a number of positive and negative aspects in regards to the TRU model. As this paper seeks to determine the overall viability of the TRU model, the following section pairs up these positive and negative aspects surrounding the use of unitrusts and analyses these arguments in a debate-like forum. Additionally, this section will discuss simple variations to the basic TRU model.

Where TRUs work: Total return unitrusts work in many situations. However, this author sees them working best in generally the same situations where portfolios consisting of a large allocation of equity investments would work. This is because TRU portfolios may consist of as much as 80% to 100% equity securities. Risk tolerances of the trust parties should also be considered before recommending TRUs since risk adverse clients would likely not be well suited for the potential fluctuations inherent in equity markets.

Generally, TRUs are best suited for a trust whose corpus consists of financial assets because they are better suited for annual valuation and distribution. Just as with equity portfolios, TRUs are best suited for longer time frames. Moreover, the longer the time frame the better, in order to allow the effect of compounding interest to take effect. This author would generally prefer trusts with time horizons of ten years or longer. TRUs could also be used,

[95] See Sloan, supra note 90 at 332; Schaengold, supra note 17 at 265-66.

however, for trusts of greater than five-year durations, although this author would then advise for less than 80% equity allocation in such a short time frame. Finally, total return investing should only be made for parties who understand the potential volatility and are willing to "sit tight" in down markets.

Where TRUs don't work: Generally, TRUs do not work best in situations dissimilar to those where they do work such as with: short time horizons; non-financial assets; and, risk adverse clients. However, there are also a number of more complex trust scenarios that also do not lend well to the total return unitrust paradigm, and they include the following:[96]

- Spendthrift trusts designed to shield creditors from its assets. This would not work since a mandatory unitrust distribution would be attachable by creditors under most state laws.
- Generation skipping trust's where distributions are made for life to a non-skip person and then to skip beneficiaries. This would appear to be poor planning since any unspent portion of the annual payouts to non-skip parties would be taxed earlier than necessary under the mandatory unitrust distribution.
- Credit shelter trusts where the surviving spouse is still alive and the beneficiary. Here, this would also be poor planning since any mandatory unitrust payout would remove assets from the trust's shelter and would subject any unspent portion to tax in the estate of the surviving spouse.

(1) Pro: Can overcome the problems encountered under the "all income" requirement[97]

Certain trusts require the trustee, under applicable tax law, to actually distribute (QSSTs) or make all income available (marital deduction trusts) to the beneficiary. Such a requirement puts the trustee in the position of making his investment decisions based upon producing a

[96] See Edwards, supra note 9 at 15.
[97] See generally Wolf, supra note 28; and Golden, supra note 39.

reasonable return for the income beneficiary. As previously noted, such investing is at odds with the overall return philosophy of modern portfolio theory.[98] Further, in today's market place of failing interest rates and low dividend yields, the trustee is placed in the unenviable position of providing reasonable income while at the same time warding off the effect of inflationary pressures eating away at the trust's true value.[99] Because investing heavily in income producing investments produces inferior returns to a more equity based portfolio,[100] trustees faced with such investment constraints will not be able to maximize the returns realized by the trust assets. Total return unitrusts can alleviate these problems by allowing the trustee to invest for total return instead of bifurcating between making some investments solely for the income beneficiary and others for the remaindermen.

Con: But what about bear markets?

"Bulls make money, bears make money, and pigs get slaughtered," is an old saying on Wall Street, which might also be appropriate in unitrust investing. Bear markets are a reality all investors must face. Moreover, even traditional income rule trusts are effected by bear markets although less severely than portfolio's consisting almost entirely of equity investments.[101] Aside from lower investment returns, and thus lower trust fair market value and income payouts, trustees must also prepare beneficiaries psychologically for such investment losses. However, this author does not see this as a reason to disregard potential higher investment returns for trust assets through application of total return investing pursuant to the modern portfolio theory. Such

[98] See Golden, supra note 39.
[99] As noted supra in Section One on pages 9-10, inflation can eat away at the true future "purchasing power" of the trusts underlying assets. For example, assuming 2.5% annual inflation over a 10-year period, a trust with a $100,000 fair market value both today and in 10 years would only have the purchasing power of approximately $75,000 in today's dollars.
[100] Discussed infra at pages 40-42.
[101] The reason for this is that an income rule trust would have a sizable portion of their investments in fixed income securities, which are more stable that equities and the fixed income returns would offer such a trust a cushion in down markets.

an investment plan would seek to maximize gains while minimizing risk. Accordingly, a trustee would not have invested all of the trust assets in a NASDAQ composite-like index that would have suffered losses of approximately 60.5% over the last two years.[102] Some proponents of unitrusts have recommended index investing as opposed to individual security selection. However, this author questions the validity of such investing as it does not truly follow the risk minimization principles of modern portfolio theory. Moreover, even the much more conservative S & P 500 index is down approximately 36.8% over the last two years. Generally speaking, the bear market of today leads to the bull market of tomorrow[103] and, over time, equities have significantly outperformed all other investments.[104] However, opponents might counter by stating that the "random walk theory" of modern portfolio investing professes that yesterday's results do not accurately predict tomorrow's returns. While that may be true, it is used more so in the context of individual securities as opposed to market indexes. Moreover, a track record encompassing over 70 years (1926-2002) of numerous bull and bear markets, although not perfect, is as reliable an indicator as anything else currently available.

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[102] This figure is as of November 3, 2002. See http://www.smartmoney.com.

[103] Source data: http://www.mutualfundreporter.com/articles/2001_issues/mfr170.htm#article2. The following 6 and 12-month post bear market recovery statistics will help show that the bear market of today often leads to the tomorrow's bull market run.

TSE 300 Index

				Subsequent Returns	
Start Date	Duration	Magnitude	End Date	6 Months	1 Year
01-Feb-74	9 Months	-32%	01-Nov-74	21%	10%
17-Jul-81	11.7 Months	-43%	08-Jul-82	53%	84%
14-Aug-87	2.5 Months	-29%	28-Oct-87	18%	20%
06-Oct-89	12.3 Months	-25%	16-Oct-90	18%	15%
17-Apr-98	5.6 Months	-29%	05-Oct-98	26%	31%
01-Sep-00	6.4 Months	-31%	TBA	TBA	TBA
Average	8.2 Months	-31.60%		27.10%	31.80%

[104] See Ibbotson Associates, supra note 34.

Even when taking into consideration the U.S. bear market of the last 2 1/2 to 3 years, when one looks at returns over the last 5 years stock returns more closely resemble their historic norms.[105] Thus, trustees must use common sense when considering TRUs total return investing and consider the old adage "bulls make money, bears make money and pigs get slaughtered" because TRUs are not a cure all. Trusts of short duration, just like any investment of such a time frame, should not make considerable investment in volatile equity markets. Conversely, this author believes that trusts with long timer horizons and financial assets would be foolish to allow occasional bear markets to impede their use of modern portfolio investing because over time such an investment program will likely produce significantly higher returns thereby benefiting both income and remainder beneficiaries. Furthermore, adopting a "smoothing rule" will reduce the variability of the income recipient's payments in bear markets and also allow for more predictable income distributions.[106]

(2) Pro: Eliminates the friction between the income and remainder beneficiaries and trustee[107]

Both income and remainder beneficiaries benefit from a higher total return on trust assets. This point is true regardless of how much of the overall higher return is attributable to income or capital appreciation, because the income beneficiary gets paid out a fixed percentage (generally 3-5%) from the trust's assets fair market value. The remainder beneficiary also benefits from a higher total return on trust assets because there will likely be a larger remainder amount available. Thus, the total return unitrust paradigm should eliminate the traditional friction

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[105] Over the last five years (as of March 26, 2002) the Dow Jones Industrial average has returned 54.33%, the S & P 500 has returned 46.9% and the more volatile NASDAQ index has returned 46.15%. While this does not match historic equity returns of 12%, it does show that even when taking bear markets into consideration returns tend to return to historic norms over time. See http://www.smartmoney.com.

[106] Literature suggests that use of a three-year rolling average will produce a smoother stream of distributions than will a simple annual payout, and has historically not resulted in more years of declines than if a five- or ten-year rolling average were used. See Wolf, supra note 28 at 57.

[107] See generally James L. Dam, "Should Estate Planners Be Revising Their Trusts?" (2000). Available at: http://leimberg.com/tapes/revise.html; and, Spencer, supra note 33.

between the parties, which had income beneficiaries seeking more investment towards income production and remainder beneficiaries seeking capital growth investments. It can be argued that the problems surrounding the trustees duty of impartiality are also solved as the trustee no longer needs to satisfy two investment needs, income and capital appreciation, but can focus their efforts on the overall total return of the trust's assets. It can also be argued that such a paradigm would reduce the potential of trustees being surcharged by remainder beneficiaries who claim the trustee invested too heavily in income producing assets. While at the same time such a model should diminish the lawsuit threat of income beneficiaries suing the trustee for investing too much of the trust's assets being invested for long term growth. Such a "kinship" between income and remainder beneficiaries and the trustee would be unprecedented and would relieve the parties of much of the psychological struggle that has traditionally plagued modern trust design. In this regard, the total return unitrust seems almost too good to be true, and very well might turn out to be just that.

Con: What happens if the needs of a beneficiary change or market fluctuations have reduce trust payments below their income needs?[108]

In any trust that spans significant periods of time, the likelihood that a beneficiary's needs may change is significant. A beneficiaries needs for income might change as often as year to year, in one year they might not need all of the income, in other years they might require more. Also, emergencies, as well as unforeseen life events, could occur at any time and significantly increase the needs of the income beneficiary. Furthermore, income beneficiaries might need more income in inflationary times to maintain their purchasing power.[109]

At the same time, the very nature of total return investing dictates that income payments to an income beneficiary may change from year to year. This can be detrimental to the

[108] See generally Beckwith, supra note 12; and, Dam, supra note 108.
[109] See Beckwith, supra note 12 at 570.

beneficiaries, and the trust itself, in both bull and bear markets. In bull markets, the total return of the trust would be significantly higher than a 3 – 5% income payout. While the income beneficiary might certainly not mind the additional income, such a scenario might run counter to the trustor's intent as they might have preferred retaining the additional assets for future generations. Thus, the trust's overall purpose could suffer from an undesired increase in income beneficiary's payouts. Conversely, in bear markets, the total return of the trust assets could be significantly lower than the 3 – 5% income payout. Here the income beneficiary could be significantly impacted especially if they are dependent on the trust income in meeting their living expenses. One problem facing unitrust drafting is that the income payout is based upon a fixed percentage of the trust's assets fair market value. Thus, the question then arises, "what's a planner to do to accommodate the trustor's intent and beneficiary's needs under such circumstances?"

Handling such variables ties in with the trustor's overall intent when they created the trust. In a trust drafted to leave as much as possible to remainder beneficiaries, the grantor may wish to limit the payout to the income beneficiary. On the other hand, where the overriding intent of the grantor is to provide for the income beneficiary, the grantor may wish to somehow allow the trustee to accommodate the beneficiary's every need. In such scenarios, flexibility is a key in allowing the trustee to perform the trust overriding mission in an optimal fashion. This author believes there may, in fact, be several methods that could accommodate such variables and at the same time allow for using the total return unitrust paradigm.

The simplest way to plan for such contingencies when using a total return unitrust would be to vest in the trustee discretion to pay additional income to a beneficiary to meet scenarios not

met by the unitrust's 3 – 5% annual payout.[110] Such power of distribution could be defined as broadly or narrowly as the drafter and client may desire. This could protect the overall trust purpose in either retaining more assets for the remaindermen or in meeting the needs of an income beneficiary. This author would suggest a 3% payout (or lower if would be respected for tax purposes) as this amount would minimize the automatic income payout to the beneficiary and thereby maximize the trustee's discretion. Such a plan would seem to allow for the best of both by granting trustee discretion and using the total return unitrust paradigm.[111] The benefits of allowing trustee discretion could be met because the trustee would be allowed to payout additional amounts to cover emergencies, while at the same time they could deny additional distributions if the trustor's intent dictated such action. At the same time, a trustee could enjoy the many unitrust advantages like using a simplified investment strategy and still enjoying significant harmony between the trust parties because of a mandatory floor for distributions being set by the governing instrument. This harmony would likely suffer somewhat because of the trustee's newfound discretion. However, if the power of distribution is guided by an ascertainable standard such as "health, education, maintenance and support" such loss of harmony amongst the parties might be lessened. Besides, perhaps some friction between the parties is necessary for the trust to accomplish its goals in the most efficient manner.

(3) Pro: Simplifies investment decision making and distributions for the trustee[112]

As has been previously noted in this paper, under the traditional income rule trust, a trustee was under a duty of impartiality to the income and remainder beneficiaries. Because of this duty, the trustee was forced to make investments that could somehow satisfy the needs of both providing income for the current beneficiary and making sure the trust corpus maintained its

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[110] See generally Edwards, supra note 9; and, Diamond, supra note 11.
[111] See id.
[112] See generally Wolf, supra note 28; and, Spencer, supra note 33.

purchasing power for the remainderman. Thus, the character of the investment return was a critical consideration of the trustee. As has been previously discussed, this task is next to impossible under current market conditions and, more often than not, led to both beneficiaries being disappointed.[113] Under total return investing, however, trustees are no longer bound by the archaic principal and income dichotomy, but instead are free to invest in a manner that maximizes the overall return on trust assets. An additional benefit of total return unitrusts is that income distributions are easily determinable because they are based on a fixed percentage of the fair market value of the trust's assets as set forth in the trust's governing instrument.

Con: Overprotection of the Trustee[114]

A trustee gets paid for maintaining the trust. As a part of these duties, the trustee must oversee the trust's investment and distribution decisions unless the trust provides otherwise. In essence, the only person benefiting by a simplification of investment and distribution decisions is the trustee. Likewise, elimination of friction between the beneficiaries and the trustee is not what the trustee gets paid for and may run contrary to the trustor's wishes. Someone generally has to exercise some discretion over the decisions that are required regarding the trust performance, and that someone is the trustee. To somewhat insulate the trustee from liability by making his job easier or less adversarial only serves the trustee and could turn out to be detrimental to both beneficiaries and the trustor's intent. Thus, this author questions the viability of taking the trustee "off the hook" to any extent because that is what they get paid for.[115]

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[113] See generally Wolf, supra note 28. The underlying premise is that under the strict income rule trust trustees would generally invest some percentage of corpus for the income return and another for long term capital growth. Because such an investment allocation oftentimes led to an underperformance by the trust assets this caused for both smaller income distributions and less capital appreciation.

[114] See generally Golden, supra note 39. This also applies to the prior notion of "eliminates the friction between…beneficiaries and trustee."

[115] See id.

However, if a trustor sought to avoid such a scenario where the trustee is too insulated from liability they could use something akin to the prior recommendation of using a 3% unitrust payout coupled with trustee discretion for the beneficiaries "health, education, maintenance and support." While such discretion would cut away at any "warm and fuzzy" relationship between beneficiaries and the trustee, it would also serve to administer the trust in a more efficient manner by avoiding the income beneficiary from receiving either too large or too small an income distribution. This would be accomplished because a 3% payout is generally believed to benefit the remainder beneficiary,[116] thereby making sure the income beneficiary does not receive too large a distribution. Conversely, the trustee having discretion to make additional distributions (provided they exercise such discretion) would protect the income beneficiary from receiving too small a distribution.

While it may be true that only the trustee benefits from his investment and distribution decisions being made easier, certainly all parties to the trust benefit if this in turn leads to better investment performance by the trusts assets. Accordingly, while this author does not like the idea of any "overprotection" of the trustee, this writer does not see this is as being a death knell to the total return unitrust model. Moreover, any grantor concerned about this in a total return unitrust could merely vest discretion in the trustee to make distributions based upon a desired level of discretion. Therefore, although a "naked unitrust"[117] might serve to simplify a trustee's job and reduce his potential for liability, it will be just as easy for practitioners to put the trustee "back on the hook" by using clever draftsmanship, and still be able to enjoy the benefits of the total return unitrust paradigm.

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[116] See Dam, supra note 108; and, Diamond, supra note 11, which state that Bill Hosington has viewed a 3% payout as benefiting the remainder beneficiary, a 4% payout equalizing income and remainder interests, and that a 5% payout benefiting the income beneficiary.

[117] Here the author refers to a stand-alone unitrusts written without any clause vesting discretion in the trustee.

(4) Pro: Simple to understand and explain to clients[118]

Because of the simple nature of the basic total return unitrust, it is easier for clients to understand the way the trust works. If the trust grows, the annual distributions to the income beneficiary will be larger because their distributions are based on the same payout percentage of a larger pie. At the same time, the share left over for the remainder beneficiary will grow as well. Conversely, if the trust decreases in size, the income beneficiary's payout will be reduced, as will the size of the remainder interest. Because of its simple nature, the basic total return unitrust will also be easier for practitioners to explain to their clients than scores of more complexly drafted trust documents. Thus, in the circumstances where a basic unitrust design can accomplish what before required a more complex drafting scheme, it would seem to behoove practitioners to use the unitrust and enjoy its many advantages.

Con: Inflexibility[119]

An oftentimes corollary to simplicity is inflexibility. Opponents of TRUs might argue that they are inflexible by their very nature of mandating the trustee to pay a fixed percentage of the trust's fair market value to the income beneficiary. Furthermore, flexibility can be a key in allowing a trustee to adjust their practices to accommodate the changing circumstances presented to them in carrying out the trustor's intent. Thus, lack of flexibility could lead to what, in hindsight, might appear to be bad planning.[120] This is a critical point, as no one knows what tomorrow may bring and drafting a document that maximizes flexibility increases the likelihood of being able to deal with unforeseen changes that might arise in the future. Additionally, this very lack of flexibility could drive a stake between otherwise harmonious classes of TRU

[118] See generally Wolf, supra note 35.
[119] See generally Golden, supra note 39.
[120] See id.

beneficiaries. Thus, this author would advise practitioners to think long and hard before recommending a basic unitrust in situations where more complex planning might be required.

Total return unitrusts are not a panacea for all the problems estate planners face, rather they are a dynamic new paradigm that, for a great number of trusts, will allow higher asset returns and larger distributions for beneficiaries. Trust design is not a "one size fits all" practice, nor should it be. However, just because TRUs might not be ideal in all situations does not mean they will not be the right choice in many circumstances. Furthermore, this inflexibility is only a major consideration in the basic unitrust. As will be discussed later,[121] several variations to the basic TRU format have been already been suggested that would alleviate much of this perceived inflexibility in the basic TRU form. Accordingly, although this writer does not view TRUs as being the right trust in every case, their benefits will outweigh their detriments in most circumstances. Moreover, by using creative drafting, a trust can still enjoy the many benefits of TRUs and avoid any underlying inflexibility.

(5) Pro: Potential for greater return on trust assets and increased beneficiary interests[122]

Perhaps the most compelling advantage of TRUs is the potential for significantly greater returns on trust assets over time. The historical performance of large cap stocks when compared to all other assets classes is impressive. Annual returns for large cap stocks from 1926 – 2000 averaged 11% a year, government bonds 5.30%, and U. S. treasury bills 3.80%. During this seventy-five year period inflation averaged 3.10%.[123] Several computer hypotheticals have been constructed using these averages, and the result of compounding interest over a period of time is nothing short of astounding. In a case study presented for the January 2002 Heckerling Institute

[121] Pages 46-48 of this paper discusses some of these TRU variations.
[122] Richard Nenno, "Delaware Total Return Unitrust: Bringing Together the Interest of Current & Future Trust Beneficiaries," 36 U. Miami Inst. On Est. Plan, Special Session III-A materials (2002) (see Exhibits A – C for the three examples this paper discusses); and see generally Dam, supra note 108.
[123] Source Data: Ibbotson Associates

Conference,[124] Richard Nenno of the Wilmington Trust Company showed the profound effect a change in an investment strategy can have upon a trust over a period of time. In his assumption, Mr. Nenno compared the trust investment allocation of 74.89% stock, 13.29% cash and 11.83% tax-exempt bonds to a 3% total return unitrust allocation of 90% stock and 10% tax-exempt bonds. This hypothetical assumed a 7.98% return on stocks in a trust with an approximately $5 million value over 35 years. Over the time period, the TRU allocation paid out almost $4.5 million more in after tax dollars to the income beneficiary than the other allocation.[125]

In another hypothetical, Mr. Nenno compared a trust with an allocation of 35% taxable bonds and 65% stock to a 4% total return unitrust allocation of 90% stock and 10% cash. This hypothetical assumed a 9.00% return on stocks in a trust with approximately $2.5 million value over 10 years. Over this time period the TRU allocation paid out over $350,000 more in after tax dollars to the income beneficiary.[126]

In his final hypothetical, Mr. Nenno compared a trust with an allocation of 50.40% tax-exempt bonds, 42.67% stock and 6.93% cash to a 4.25% total return unitrust allocation of 85% stock and 15% tax-exempt bonds. This hypothetical assumed a 9.00% return on stocks in a trust with approximately $8 million value over 21 years. Over this time period the TRU allocation paid out almost $4.5 million more in after tax dollars to the income beneficiary and the remainder interest was increased by over $1 million.[127]

Such numbers don't lie! Returns, even below historic rates, applied to the above allocations do in fact return significantly larger amounts to the trust, which results in larger

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[124] See Nenno, supra note 123.
[125] See Exhibit A. The unitrust allocation paid out a total of $10,378,090 whereas the other allocation paid out $5,592,366 to the income beneficiary. Both trusts ended with the same $41,339,669 remainder balance.
[126] See Exhibit B. The unitrust allocation paid out a total of $928,360 whereas the other allocation paid out $573,870 to the income beneficiary. Both trust s ended with the same $4,225,102 remainder balance.
[127] See Exhibit C. The unitrust allocation paid out a total of $10,243,605 whereas the other allocation paid out $5,836,262 to the income beneficiary. The unitrust had a remainder interest of $24,786,212 whereas the other allocation had a remainder interest of $23,717,648.

income payouts and/or remainder interests. While TRUs might not be perfect, these hypotheticals paint a compelling picture of what TRUs can accomplish in terms of increased asset returns and beneficiary distributions.

Con: Such projections are misleading[128]

It has been argued by some that such computer hypotheticals are misleading and that certain economic realities and problems must first be considered.[129] One reality, it is argued, is that history is an inadequate predictor of tomorrow's results, as set forth in the random walk theory of Modern Portfolio Theory. While this argument has merit, as posited against the prior hypotheticals it losses some of its luster. Sure, history cannot be fully relied upon for being totally accurate as far as predicting future returns, however, the above examples used rates below historic averages, which make it seem even more achievable. Furthermore, the above examples only increased stock allocations on average from 61% to 87%. Thus, any inaccuracies would not be as significant as they might be for more significant reallocations.

Another criticism is that the use of averages in projections is misleading, since growth will not be steady but rather will be cyclical.[130] Such opponents of TRUs would prefer projections containing some periods of higher return and some of lower than the average anticipated long-term growth in order to fully understand the effects of the unitrust. This author agrees that averages will be misleading to potential clients, however, if past results cannot predict future results what returns should a computer model use? Certainly, making clients aware that results will not be exact is necessary, and clients should be prepared for these potential ups and downs of market fluctuations. Clients could also be advised to put aside some of the fruits from increased payouts to help offset down years. Furthermore, this author believes

[128] See Golden, supra note 39.
[129] See id at 12.
[130] Id.

that a majority of clients would be quite pleased with the previous hypothetical increased returns even it they were not in a steady stream.

A final criticism of such computer projections is that the return is always higher with an 80% or greater equity mode, but is also a good deal more volatile.[131] The argument further states that volatility can be better tolerated in up markets. However, in a sustained drop involving a basic TRU, with the only payout based upon a fixed percentage of value, inevitably problems would develop. Again, practitioners must prepare clients for market swings, and draft measures to lessen their effect. Surely, use of a three year smoothing provision would help alleviate some of the volatility problem. In other instances, practitioners should avoid the unitrust model altogether for those clients with a very low risk tolerance, or short time horizons, because TRUs are not for every trust in every circumstance.

These objections raise legitimate concerns and show again that TRUs are not for every trust, especially the risk adverse ones. However, this author does not see these critiques as a reason not to write some form of TRU for clients in situations where they are appropriate. While clients might be concerned about these objections to the use of computer hypotheticals, this author believes most clients would be quite happy even if the above examples turned out to be only half right, as any extra purchasing power will be beneficial to clients.

(6) Pro: Potential for more tax efficient income stream[132]

TRUs possess potential for significant income tax advantages. In a traditional "income only" trust, beneficiaries pay ordinary income rates on the payouts received. However, with proper planning, a TRU should allow a substantial part of the income payout to be taxed in a

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[131] Id.
[132] See Michel W. Nelson, "In Support of a Unitrust Distribution Concept." For presentation at 127th Annual Convention Iowa State Bar Association, June 22, 2000. Available on: http://leimberg.com/tapes/edwards.html.; and, Wolf, supra note 35.

beneficial manner. With TRUs, the beneficiary's income distribution will first be taxed as accounting income; then short term capital gains; then long term capital gains; and, finally receive tax free return of principal treatment. In a total return investment portfolio, very little of the distributions will be comprised of traditional income. Instead, much of the distribution will be comprised of capital appreciation derived from "pruning" the underlying portfolio.[133]

"Pruning" involves the sale of just enough of the securities to pay the amount needed to meet the projected distribution level. This requires separate sales of securities, to supplement any current yield, in addition to normal trust portfolio turnover. As a result, more of each distribution will consist of capital gains and non-taxable return of cost basis as opposed to ordinary income.[134]

Such a planning approach will significantly reduce the current beneficiary's reportable income, thereby significantly increasing the beneficiary's after-tax purchasing power when compared to the classic trust's fully ordinary income distributions.

Con: Assumes the use of financial assets[135]

Experts tend to agree on one thing about TRUs, that they work best with portfolios of stocks, bonds and other liquid, market-traded investments. Accordingly, a drawback of TRUs is that such trusts generally do not work well when real property or other tangible assets make up a big part of the corpus. This is because such assets will generally not produce the funds required to make distributions. Moreover, the income tax advantage would be diminished because any earnings generated would produce largely ordinary income. Real property annual valuations would be costly and difficult in arriving at the annual distribution amount. Also, the trustee

[133] For a more complete discussion of pruning see Robert B. Wolf, "Total Return Trusts: Can Your Clients Afford Anything Less?" 24 ACTEC Notes 45, 46 (1998).
[134] See id.
[135] See generally Golden, supra note 39; and, Dam, supra note 108.

could not prune such assets, as they could with stocks or bonds, in order to sell off just enough to make annual distributions. Other assets that do not lend well to TRUs include closely held business interests, limited partnership interests, and oil and gas interests.[136]

This author does not necessarily see this as a negative regarding TRUs, rather this is a limiting factor. As stated earlier, TRUs are not for every trust. Thus, trusts that would be funded largely with non-financial assets would be well advised not to try and place them under the TRU umbrella. Bill Hoisington, a leading proponent of TRUs, has said under some circumstances it makes sense to include such assets in the unitrust but to exclude them from the annual payment calculation.[137] Robert Wolf, another leading proponent of TRUs, has said where real estate makes up to 20% of the trust there might not be a problem, however, the more hard to value or illiquid the assets are the better it is to just place them in a separate trust.[138]

(7) Alternatives to the basic Total Return Unitrust

The basic TRU would place a fixed percentage (likely between 3 – 5%) on the fair market value of the trust to be paid out to the income beneficiary annually. Some practitioners have complained that such a structure is too inflexible to satisfy the needs of every beneficiary, which is a notion that this author is in agreement with. As such, many simple variations of the basic TRU model have been suggested. This portion of the paper shall briefly discuss some of these alternatives. Each of the following alternatives should be considered being supplemented with a provision authorizing discretionary distributions of principal in addition to the unitrust

[136] See Golden, supra note 39.
[137] See Dam, supra note 108 at 10.
[138] See id.

amount.[139] Also, a three-year smoothing approach should be adopted in each alternative in order to smooth out income flows in periods of high equity market volatility.

"Give Me Five" Unitrust: Jerold I. Horn proposes a unitrust form which does not require a fixed payout, but rather gives the beneficiary the right to withdraw up to the unitrust payout amount annually.[140] Mr. Horn suggests that his model makes sense for a credit shelter trust in which the surviving spouse has enough resources for their support and would rather let the credit shelter accumulate and grow for the remainder beneficiary. Because of Internal Revenue Code section 2041(b)(2), the lapse of that power, if unexercised, would not be a taxable transfer. A planner could also use this model with a smaller percentage than 5%, if such was desirable. However, before using this model, a planner should seriously consider the income and gift tax consequences of such a withdrawal power.[141]

The "Flip-TRU" Plan:[142] In this variation on the traditional marital trust/bypass trust combination, the marital trust (QTIP) would provide for payment of a 3% to 5% amount or net accounting income, whichever is greater to the surviving spouse, and allow discretionary distributions of principal for the surviving spouse's health, education, maintenance and support. Additionally, the credit shelter trust would be a "give-me-x%" unitrust *unless and until* the marital trust is exhausted, at which time the credit shelter trust would "flip" to a mandatory unitrust payout. Such a scheme would encourage exhaustion of taxable (at second death) assets before tapping into the non-taxable bypass trust.

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[139] See Diamond, supra note 11, which states such a provision should also be subjected to an ascertainable standard if the beneficiary is also the trustee.

[140] Jerold I. Horn, "Prudent Investor Rule: Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the "'Give Me Five' Unitrust," Real Property, Probate & Trust Journal, Vol. I, No. 4 (Spring 1999). Mr. Horn's suggestion should not be confused with simply adding a five-and-five power to an income rule trust.

[141] See Id at 46-53 for a discussion of the tax complexities where the IRS has suggested that the 5% of the trust included in the power holder's taxable income might be cumulative each year, and the payment of that mandated tax might be a gift back to the trust.

[142] This alternative, and the remaining variations, are taken from Diamond, supra note 11 at 4.

The "345" TRU: This alternative might be useful in a generation-skipping tax-exempt trust for a child. Distributions would be entirely discretional until age 30, with an independent trustee. The child would become trustee, at age 30, and the trust would convert from a fully discretionary trust to a TRU with a 3% annual payout during the child's 30s, a 4% payout during the child's 40s, and a 5% payout beginning at age 50 and continuing at that rate until the child's death. Because of the lower payout rate in the early years combined with the "magic of compounding interest," the distributions in later years would be much greater. Such a plan is often consistent with the wishes of most trustors who prefer smaller payouts while beneficiaries are younger and larger payouts in the beneficiary's later years.

The "10% Solution": Perhaps a more elegant version of the "345" model would be a trust that is completely discretionary until the child reaches age 25 or 30, which would then convert to a TRU with a payout equal to the child's age divided by 10, with a maximum payout percentage of 5% beginning at age 50. For example, when the child reaches 30 the payout would be 3.0%, 3.1% the next year (at age 31) with the distribution percentage gradually increasing with the child's age.

Section Six – The Survey: If Total Return Unitrusts Are So Good, Then Why Have They Not Been More Widely Accepted By Practitioners?

As a part of this paper, the author conducted a survey of estate planning practitioners in four of the states that currently have unitrust legislation in place: New York, New Jersey (unitrust safe harbor), Delaware and Missouri. Somewhat surprisingly, although states have been acting quickly in enacting TRU legislation, practitioners have not been as quick to embrace them as part of their practice. This section of the paper will examine some of the potential reasons why TRUs may not have not already been more widely accepted by practitioners. This section will also discuss some variations of the basic TRU form and discuss the possibility that

failure to seriously consider the use of unitrusts could potentially lead to professional negligence in the not so distant future.

Why change in the first place?

Total Return Unitrusts offer practitioners many benefits, and although there may be some drawbacks, clever draftsmanship can usually get around most limitations. Perhaps the most compelling benefit is that, by following a TRU approach, investment returns can be enhanced considerably as can both income and remainder beneficiary's interests. However, even with the numerous advantages presented by the TRU model, some practitioners may question the need to change their approach. With the recent enactment of the Uniform Prudent Investor Act and Uniform Principal and Income Act, such resistance to change by practitioners could potentially come back to haunt these planners and trustees down the road.[143] Some of the potential reasons for this resistance by practitioner may include the following:

Inertia: There seems to be sluggishness on the part of many practitioners in embracing TRUs. Many practitioners might be proceeding under the old adage of "if it ain't broke don't fix it." While there is some merit in such thinking, this author believes that practitioners should change with the times when opportunities present themselves which might be beneficial to clients. Perhaps the most important part of an estate planner's job is in making sure the trustor's wishes are met. In many circumstances,[144] the TRU model would clearly seem to help clients in enhancing their corpus returns. Moreover, such enhancement will increase either the income and/or remainder interests, as determined by the trustor's intent. Planners should break through this inertia, and embrace the TRU in such circumstances, or possibly face being left behind by their competitors or worse yet a potential liability trap.

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[143] See Diamond, supra note 11.
[144] As discussed supra on pages 40-42.

Fear of the unknown: As with any new development, there will certainly be some fear of the unknown on the part of both practitioners and clients. This author agrees that it is a wise practitioner who proceeds with caution when dealing with something as important as drafting a clients estate plan. However, when breaking down the TRU model, it is not that radical a departure from other basic trusts. The major difference is its application of the new definition of income, which allows for potentially greater investment returns and beneficiary distributions. While there is definitely uncertainty regarding market returns, traditionally equities have outperformed other investments and, contrary to naysayers, there is no compelling reason to believe they will not continue to do so in the future. There is also some uncertainty as the only federal legislation has been Proposed Regulations. However, most experts do not expect radical changes in these Regulations, as their underlying purpose seems to embrace the TRU movement. Fortunately, the Final Regulations are scheduled to be released sometime this year. Perhaps this will alleviate some of the fear of the unknown that may be hindering some practitioners from embracing, what could be, the most exciting development in the trusts and estates arena in years.

Ignorance of the new developments: While this author does not believe this would be a widespread problem, there is the possibility that some practitioners, for any number of reasons, could be unaware of the recent developments involving TRUs. Perhaps some practitioners do very little estate planning and thus do not stay abreast of current developments. Or maybe other practitioners are so busy with their current trust practice they neglect to stay current. Finally, there could be practitioners who specialize in trusts where the TRU model does not work well[145] and, therefore, do not see the need of becoming familiar with this new development. While this author envies the practitioner who's practice is so busy they cannot stay current, there is no jealousy for the potential liability trap that could loom in the coming years to such professionals

[145] As discussed supra on page 27-28.

who fail to use the TRU model in appropriate circumstances. As every attorney knows, ignorance of the law is not a valid defense.

Practitioner does not like TRUs: Some practitioners may simply not like the TRU model. Certainly there have been negative articles written on the topic[146] as well as economic studies that find fault in the TRU model.[147] Because practitioners will only recommend estate plans which they deem to meet the trustor's intent most effectively, practitioners who do not like the TRU model would clearly not use it. Such practitioners might opt for fully discretionary trusts, which utilize total return investing and the UPIA section 104 power to adjust, in lieu of the TRU model. While such a model would seem to be a viable alternative, since the trustee has complete discretion and the portfolio and trust can be managed for optimal result, this author is reluctant of such a plan for the following reasons:[148]

- A fully discretionary trust will not work for marital deduction trusts. However, TRUs can be written in a qualifying manner.
- Trustors may prefer a more definite level in the governing instrument's distribution provision as without a base payout amount there is no knowing how much a beneficiary may ultimately receive.
- There may be reluctance on the part of the client to place full discretion in a corporate trustee. Also, prospective income beneficiaries may be apprehensive of the trustee's ability to "sprinkle" payments to other beneficiaries.[149]

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[146] For such articles, see J. Garland, "The Problems With Unitrusts," 1 J. of Private Portfolio Management no. 4 (1999); J. Dennis-Strathmeyer, "Are You Writing Noncharitable Unitrusts? Neither Am I," 21 Est. Plan. & Calif. Probate Rptr. 160 (2000); and see Golden, supra note 39.
[147] For such a study, see Roger Hertog and David Levine, Sanford C. Bernstein & Co., Inc., "Income Versus Wealth: Making the Tradeoff," The Journal of Investing 5 (Spring 1996), Volume 5, No. 1.
[148] For a more complete discussion of this topic beyond the scope of this paper, see Nelson, supra note 133.
[149] See id, which provided these three examples.

However, freedom of choice is one of the many things which makes our country such a great place to live. Accordingly, just as TRUs are not best suited for every trust, they also may not be best suited for every practitioner.

Reluctant to start an equity based portfolio in a bear market: Many practitioners may just be reluctant to put clients in a trust vehicle whose investment portfolio consists almost entirely of stocks while we are in the midst of the worst bear market in twenty years. This author fully sympathizes which such reluctance, as it would likely be a hard sell on a great many clients. If this planner had any reluctance to use the TRU model it might be for this very reason since giving up a fixed income portfolio cushion in today's market might not be in the best interest of the trust. However, if history has taught us anything it is that today's bear market will be the launching point of tomorrow's bull run. Thus, after a 2 ½ to 3-year bear market, there may be no better time to position a long–term trust assets into a Modern Portfolio Theory based equity portfolio. This author firmly believes the next bull market will alleviate much of today's potential reluctance to use the TRU model.

Could failure to use the TRU model potentially lead to professional negligence lawsuits in the future from unhappy income and remainder beneficiaries?

In order to avoid professional negligence, a lawyer is obligated to exercise "that degree of care, skill, diligence and knowledge commonly possessed and exercised by a reasonable, careful and prudent lawyer in the practice of law in [their] jurisdiction."[150] Thus, a practitioner is held to the standard used in their community. Obviously, in today's market there is no concern for professional liability for failure to use TRU since they are not yet the standard used in any community. However, once the economy turns around and financial markets pick up, this author believes that TRUs may forever change the way practitioners draft a great many trust documents.

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[150] Stephen Gillers, Regulation of Lawyers 699-700 (1998); citing Cook, Flanagan & Berst v. Clausing, 73 Wash. 2d 393, 395, 438 P.2d 865, 867 (1968).

Thus, if this author is correct, in three to five years TRUs could very well be the community standard in many communities. If so, it would very difficult for practitioners to defend themselves for not using TRUs in such instances as set forth in the three examples on pages forty to forty-two where the beneficiary's received an additional $4.5 million, $350,000, and $5.5million, respectively, by virtue of using the TRU model. This applies to both attorneys who fail to consider TRUs in the appropriate circumstances, and trustees who fail to use choice of law options that might allow them to use unitrust provisions.[151]

This author believes a parallel can be drawn between TRUs and limited liability companies (LLCs) in the corporate tax world. LLCs are likewise a relatively new phenomenon, which received much scrutiny at their beginnings. Further, there was reluctance on the part of many practitioners to initially use LLCs for many of the same reasons practitioners are currently reluctant to write TRUs. However, LLCs have become a commonly accepted tool for the corporate tax practitioner and may have forever changed the practice of corporate tax law.[152] Thus, in the coming years LLCs will likely become the community standard and failure to use them may result in professional liability. Likewise, this author can see the use of TRUs becoming a widely accepted tool for practitioners and, at least potentially, forever changing the practice of estate planning. If so, in coming years TRUs could become the community standard and failure to use them could result in professional liability. If such a vision of the future of estate planning is correct, this author's advice -- for those who fail to seriously consider the Total Return Unitrust paradigm in situations where it best suits the trustor's intent -- is to make sure they keep their malpractice insurance current.

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[151] For a more complete discussion of this topic, see Malcolm A. Moore, "Choice Of Law In Trusts: How Broad Is The Possible Spectrum?" 36 U. Miami Inst. On Est. Plan 600 (2002).

[152] Such is the view of corporate tax law expert Professor Martin Ginsburg, of Georgetown University Law Center, as stated in his Taxation II class on March 13, 2002.

Conclusion

Recent changes in trust investment law allow trustees to abandon the traditional notion of income rule trusts in favor of total return investing pursuant to the modern portfolio theory. Such a model will allow for potential greater returns on trust assets, which in turn can significantly increase the interests of both income and remainder beneficiaries. In many instances this will be a valuable arrow in the quiver of estate planners in helping to meet clients intentions.

Some have called the Total Return Unitrust a solution looking for a problem. However, this paper has shown that by using the TRU model many of the difficulties facing the traditional income rule trust can be overcome. Moreover, it is this author’s opinion that in time the TRU model may change forever the way a majority of trust instruments are drafted.

As this paper has shown, there are a great many instances where the TRU model will be beneficial to meeting client’s objectives. However, estate planning is not a “one size fits all” business and there are many instances where the TRU model is not an appropriate choice for clients. Accordingly, Total Return Unitrusts should not be viewed as a panacea for all the ills that a planner may face in drafting a clients estate plan, nor should we as estate planners want them to be, for if they were, clients might not be so dependent upon our advice.