

**THE POWER TO ADJUST AND THE UNITRUST-
THE NEW UNIFORM PRINCIPAL AND INCOME ACT**

**EXERPTS
FROM**

**TOTAL RETURN UniTRUSTS (TRUs)
MEETING HUMAN NEEDS AND INVESTMENT GOALS
THROUGH MODERN TRUST DESIGN**

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THE NEW PRINCIPAL AND INCOME ACT-- ACCOUNTING ALCHEMY

THE POWER TO ADJUST PRINCIPAL AND INCOME

A third version of a Uniform Principal and Income Act was approved by the National Conference of Commissioners on Uniform State Laws in July 1997, and approved by the American Bar Association in January of 1998. The primary purposes of this newest revision, reflecting six years of labor, is to update the prior Principal and Income Acts, *i.e.*, to recognize new forms of investments, to reflect the modern portfolio theory of investing, and to allow fiduciaries the means for making the best investment decisions parallel with the prudent investor rules in the *Restatement (Third) of Trusts* and in the Uniform Prudent Investor Act.¹

The Uniform Principal and Income Act reflects acceptance of total return investing and gives the trustee the power to reallocate or adjust returns between income and principal under certain circumstances. It has been adopted in the District of Columbia and 29 states and is under consideration in 4 others.²

Section 104 of the Act, titled "Trustee's Power to Adjust," addresses the tension between the duty of impartiality and the duty to give due regard to the interests of both the income and remainder beneficiaries.³ The critical language of Section 104 reads as follows:

- (a) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may

¹ UNIF. PRINCIPAL AND INCOME ACT, *supra* note 10 (prefatory note).

² Alabama, Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Florida (with a unitrust alternative), Hawaii, Idaho, Indiana, Iowa (without section 104, but with a unitrust alternative), Kansas, Maine (with a unitrust alternative), Maryland (with a unitrust alternative), Minnesota, Missouri (with a unitrust alternative), Nebraska, New Jersey (with a unitrust safe harbor), New Mexico, New York (with a unitrust alternative), North Dakota (without section 104), Oklahoma, Pennsylvania (with a unitrust alternative), South Carolina, Tennessee, Virginia, Washington (with a unitrust alternative), West Virginia, and Wyoming. See website at following address: <http://www.nccusl.org/nccusl/uniformact/factsheets/uniformacts-fs-upia.asp>. In addition, Louisiana has adopted a version of sections 104-105 without adoption of the rest of the Act. See La. Acts 520 (to be codified at La. Rev. Stat. Ann. Secs. 9-2158 to -2163 (effective Jan. 1, 2002)). For a survey of total return legislation, See *Lyman W. Welch, Progress in Total Return Legislation, supra n. 11*.

³ *Id.*

or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines that, after applying the rules in Section 103(a), the trustee is unable to comply with the rule in Section 103(b).

Section 103 of the Act provides that:

- (a) In allocating receipts and disbursements to or between principal and income, and in any matter within the scope of [Articles] 2 and 3, a fiduciary:
 - (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
 - (2) may administer a trust or estate by the exercise of a discretionary power of administration given the fiduciary by the terms of the trust or the will even if the fiduciary exercises that power in a manner different from a provision of this [Act];
 - (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
 - (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

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

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

The foregoing language should allow a trustee to distribute a portion of the total return arising from appreciation of principal by adjusting from principal to income under appropriate circumstances. The proposed Act also permits accumulation of income under other circumstances to be fair and impartial to both beneficiaries.⁴ If the document does not call for impartiality, the power might be used to best effectuate the intent of the settlor given the economic conditions and investment alternatives available.

⁴*Id.*

The proposed Act also attempts to preserve the critical tax benefits of the marital deduction and the annual gift tax exclusion on a gift of an income interest. These benefits still rest upon the distinctions between income and principal.⁵

Further, the trustee may need protection from the power if the power might make the trustee or the grantor subject to the grantor trust rules; or worse, if the power might cause a federal estate tax inclusion in the estate of either the trustee or one who has a removal and appointment power for the trustee. Hence, these situations are excluded as well.⁶

Section 104 of the revised Uniform Principal and Income Act would deny this power to a trustee who is an interested party to such an adjustment, whether the trustee is a beneficiary or otherwise. If the trustee is interested or the use of the adjustment power would result in an inadvertent tax result, Section 104 would deny this power to the interested trustee, but would allow a disinterested co-trustee⁷ to exercise the power if this approach would eliminate the difficulty.

Finally, the draft would allow the trustee to release all or part of the power provided by proposed Section 104, either permanently or for a specified period, including a period measured by the life of an individual.⁸

The terms of proposed Section 104 do not automatically apply to every trust retroactively, but this power of equitable adjustment would apply "unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment."⁹ It is unlikely that many trusts would have such clear language, and hence retroactive applicability will be almost universal.

The comments and examples following new Section 104 make clear that it is a power given in response to the evolution of the prudent investor rule and the Uniform Prudent Investor Act requirements of impartiality between beneficiaries in the context of total return investing. Examples 1 and 3 illustrate the particular importance of the ability of a trustee to compensate for a decrease in accounting income caused by an increase in the proportion of trust assets allocated to stocks in response to the prudent investor rule.¹⁰ Another example makes clear that during a

⁵ *Id.* § 104(c)(1), (2). Not for long, though. See Section X.D. discussing the new Proposed Regulations under Section 643 which unseat these distinctions for states which allow for the power to adjust and/or a unitrust alternative.

⁶ *Id.* § 104(c)(5), (6).

⁷ *Id.* § 104(d).

⁸ *Id.* § 104(e). Whether the power to release will give greater or lesser comfort to a trustee remains to be seen. If the trustee continues to retain some interest in the trust which might make the release a transfer with a retained interest, that trustee would not be able to effectively release a power of appointment considered to be general if the trustee is trying to avoid death tax includability. See Rev. Rul. 86-39, 1986-1 C.B. 301. For this reason, a disclaimer qualified under I.R.C. § 2518 might be needed within nine months of the creation of the power. See I.R.C. § 2518 (1997). Hopefully, the tax protective provisions contained in the current draft relative to death tax includability will be respected by the Service. The Service has taken a dim view of provisions drafted by a taxpayer who conditioned the lapse of a right of withdrawal on such lapse not resulting in federal gift tax. Tech. Adv. Mem. 89-01-004 (Jan. 1, 1989), *citing* Commissioner v. Proctor, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944). Surely, the Service would treat a local law, particularly one derived from a uniform law, more kindly than it did the taxpayer's drafting in the technical advice memoranda.

⁹ UNIF. PRINCIPAL AND INCOME ACT, *supra* note 10, § 104(f).

¹⁰ *Id.* § 104 ex. 1 & 3.

period of high inflation with high interest rates, a portion of the interest may be considered to be a return of capital and added to principal.¹¹ The purpose of the provision is clear enough:

The purpose of Section 104 is to enable a trustee to select investments based on the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest and dividends. Section 104 provides a power to adjust total return between principal and income in the limited circumstances specified after applying the terms of the trust and the provisions in other sections of this Act. It sets forth a default rule that a settlor can expressly set aside in the terms of the trust.¹²

As with seemingly everything in the trusts and estates field, the evolution of this section to allow an equitable adjustment between principal and income reflects a number of changes as a result of tax concerns.¹³ Hopefully, the specific examples agreed upon will give enough specific guidance to make this provision of real benefit to trustees. If a trustee does not know how to use Section 104, it will not be used.

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

The new UPAIA and Section 104 reflect a very significant development in the law of trusts. It may provide a very useful escape valve when the pressure and inflexibility of our income and principal rules becomes too great. ***But the need for Section 104 itself, after the application of all of the detailed income and principal rules contained in the updated Act, is an implicit recognition that the concept of income and principal, at least as it has been traditionally defined, is a failed concept. And this is because the concept does not take into account inflation and the need to preserve real value.***

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

Let us take a concrete example that is not specifically addressed in the comments to Section 104 and see how it applies. Let us assume that we had a trust that directs the trustee to hold the principal and pay the income to the beneficiary with no discretionary powers to distribute principal. Let us assume further that the trust had been invested entirely in equities, so that the overall investment performance had been very good, but the income return as of the present time is relatively small. We then are informed as trustee that the current beneficiary's need for income has dramatically increased because of health care issues. Let us assume we have a \$1 million trust and it is invested entirely in equities with the characteristics of the S&P 500. This means that we would have current income distributable of about \$13,000 after some portion of the trustees' fees is allocated to income. We are then faced with a need for a much higher level of income, as, for example, \$50,000 a year. The traditional way to address the problem would be to try to readjust the type of securities to produce the accounting income necessary. This would necessarily involve sale of all of the equity securities with resultant capital gains tax taking away

¹¹ *Id.* §104 ex. 2.

¹² *Id.* §104 cmt.

¹³ Some (including the author) might say that we have been overly preoccupied with the tax aspects of trust design, and not enough with the needs of our clients. *See, e.g.,* Hoisington, *supra* note 11, at 5-3.

perhaps one-fifth of the portfolio. Even reinvestment entirely in fixed-income investments would not solve our problem, even in the short term. The \$1,000,000 in the trust could become \$800,000 after we pay the capital gains taxes requiring a net reinvestment yield of 6.25% after trustees' fees. Before the capital gains tax bite, we only needed 5%. And of course in the long term the result would likely be even worse for both the current and remainder beneficiaries.

Would Section 104 help us out here? First, we would look at the terms of the trust and administer the trust in accordance with its provisions using any discretionary powers. Since we have none, we would have to make a finding that distribution of the net dividend income was such that the trustee is unable to administer the trust or estate impartially based on what is fair and reasonable to all of the beneficiaries. If we could tell from the instrument that the current beneficiary was to be favored, we would not have to be impartial. Certainly one can make the case that distributing only the net dividend income from an all-equity portfolio is not fair and reasonable to the current beneficiary at today's yields and total return. But would it allow us to adjust the net income from 1% to 5%? That is what we would need to do in order to satisfy the beneficiary's need.¹⁴

We should keep in mind, however, that Section 104 was not specifically designed to satisfy the beneficiary's need, but rather to avoid the conflict between acting as a prudent investor with due regard for *both* the current and remainder beneficiaries and following the old income and principal rules. It would appear that there is no clear standard offered by Section 104 as to how much of an adjustment the trustee might make or how one would measure it. Clearly one could hypothesize such standards, based perhaps on historical real returns or even year by year inflation adjusted returns, but we will not find it in the Act.

Since the adoption of the Uniform Principal and Income Act, a new section, Section 105, has also been added to deal with the judicial control of discretionary powers under the Act, and particularly the discretionary powers given under Section 104(a). This section attempts to codify what the authors consider to be the normal rules governing a fiduciary's exercise of discretion.¹⁵

¹⁴ James Gamble, Co-Reporter of the UPAIA, was asked about this hypothetical at the 1999 ACTEC Fall meeting in Boston. His response was that Section 104 could stretch this far if the need were there. While he did not expand on the answer, the rationale might be that a trustee would otherwise be forced to convert to an almost all bond portfolio and it is the income from that portfolio which might be used as a benchmark in this case.

¹⁵ **"SECTION 105. JUDICIAL CONTROL OF DISCRETIONARY POWERS.**

- (a) A court shall not change a fiduciary's decision to exercise or not to exercise a discretionary power conferred by this [Act] unless it determines that the decision was an abuse of the fiduciary's discretion. A court shall not determine that a fiduciary abused its discretion merely because the court would have exercised the discretion in a different manner or would not have exercised the discretion.
- (b) The decisions to which subsection (a) applies include:
 - (1) A determination under Section 104(a) of whether and to what extent an amount should be transferred from principal to income or from income to principal.
 - (2) A determination of the factors that are relevant to the trust and its beneficiaries, the extent to which they are relevant, and the weight, if any, to be given to the relevant factors, in deciding whether and to what extent to exercise the power conferred by Section 104(a).
- (c) If a court determines that a fiduciary has abused its discretion, the remedy is to

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

It is interesting to note that the exercise of the power to adjust is sometimes described as similar to the traditional duty to determine asset allocation between stocks and fixed income securities. It is specifically inserted in the comments to proposed Section 105:

restore the income and remainder beneficiaries to the positions they would have occupied if the fiduciary had not abused its discretion, according to the following rules:

- (1) To the extent that the abuse of discretion has resulted in no distribution to a beneficiary or a distribution that is too small, the court shall require the fiduciary to distribute from the trust to the beneficiary an amount that the court determines will restore the beneficiary, in whole or in part, to his or her appropriate position.
 - (2) To the extent that the abuse of discretion has resulted in a distribution to a beneficiary that is too large, the court shall restore the beneficiaries, the trust, or both, in whole or in part, to their appropriate positions by requiring the fiduciary to withhold an amount from one or more future distributions to the beneficiary who received the distribution that was too large or requiring that beneficiary to return some or all of the distribution to the trust.
 - (3) To the extent that the court is unable, after applying paragraphs (1) and (2), to restore the beneficiaries, the trust, or both, to the positions they would have occupied if the fiduciary had not abused its discretion, the court may require the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust or both.
- (d) Upon a petition by the fiduciary, the court having jurisdiction over the trust or estate shall determine whether a proposed exercise or nonexercise of the fiduciary of a discretionary power conferred by the [Act] will result in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income and remainder beneficiaries will be affected by the proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion." *NCCUSL: Review All Drafts,* visited September 23, 2001[<http://www.law.upenn.edu/bll/ulc/upaia/p&i105a.htm>]

In seeking the proper balance between the interests of the beneficiaries in matters involving principal and income, a trustee's traditional approach has been to determine the settlor's objectives from the terms of the trust, gather the information needed to ascertain the financial circumstances of the beneficiaries, determine the extent to which the settlor's objectives can be achieved with the resources available in the trust, and then allocate the trust's assets between stocks and fixed-income securities in a way that will produce a particular level or range of income for the income beneficiary.

The key element in this process has been to determine the appropriate level or range of income for the income beneficiary, and that will continue to be the key element in deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a). If it becomes necessary for a court to determine whether an abuse of the discretionary power to adjust between principal and income has occurred, the criteria should be the same as those that courts have used in the past to determine whether a trustee has abused its discretion in allocating the trust's assets between stocks and fixed-income securities.

This explanatory comment is a helpful contextual note with reference to Section 104 as a whole, though Section 105 does not appear to this author to provide great comfort to the trustee deciding to exercise or not to exercise the power to adjust.

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

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

The Pennsylvania Bill, which was signed into law almost a year later on May 15, 2002¹⁶ gives the trustee the ability to choose between the power to adjust and a statutory unitrust, in which case the power to adjust is expressly waived. The power to adjust and the unitrust statute are intended to be very broadly available in the Pennsylvania proposal, as the requirement that the trustee be acting as a prudent investor, contained in the uniform act was omitted as being unduly restrictive.¹⁷ Tax sensitive situations are excluded from the application of either of the two approaches, and in case of doubt, the power to adjust or the power to convert to a unitrust may be released, either permanently or for a specified period of time.

Pennsylvania's statutory unitrust option allows the trustee to convert an existing trust to a 4% unitrust by a simple notification process. If no objections were raised, the conversion would be complete. The relevant portion of the statute covering unitrust conversions is attached as

¹⁶ 20 Pa.C.S. §8101 et seq.

¹⁷ See *Id.*, Section 8104(a) and Section 8105(a). For a full pdf of the final version of the Bill which was enacted go to the following URL site:
<<http://www2.legis.state.pa.us/WU01/LI/BI/BT/2001/0/SB1014P1431.pdf>>

Appendix 8 to these materials.¹⁸ In concept, the Pennsylvania statute is similar to the one adopted in New York, with the exception that a less detailed approach is used, with more discretion given to the trustee to make decisions concerning many of the conventions and rules affecting the administration of the trust, such as the effective date of the conversion, the frequency of distributions during the calendar year, the selection of valuation dates, the treatment for a short year, treatment of personal use property, and other less critical matters.¹⁹

Pennsylvania's proposal puts no time limits on the conversion, and would allow the trustee with court approval to select a payout percentage different than 4%, to provide a distribution of net income (as if the trust were not a unitrust) in excess of the unitrust distribution if such distribution were necessary to preserve a tax benefit, to adopt a smoothing period different from 3 years, or to reconvert from a unitrust.²⁰ This tax sensitive provision to require the distribution of net income with court approval, if larger than the unitrust amount, is important and is different from some of the other statutes, such as New York, in which the "net income" requirement is imposed for marital trusts automatically. The net income requirement will generally not be necessary once the Proposed Regulations, discussed in Section X. D., become final.

Importantly, the Pennsylvania statute reflects the ordering rule set forth in the author's forms that is favorably treated by the Proposed Regulations.²¹ This means that the 4% payout should carry out with it short term capital gains and then long term capital gains to the extent needed to comprise the full unitrust payout. For this reason, the 4% Pennsylvania payout may be considered to be more conservative than the New York statute allowing the same rate, and closer to the 3% rate set as a minimum for Missouri, because the New York and Missouri statutes do not contain an ordering rule. Depending upon the cost basis of the trust investments, and the degree of turnover in the portfolio, a 4% unitrust distribution would be the equivalent to a 3.3% (for a low basis portfolio) to 3.75% (for a high basis portfolio) distribution in which the capital gains taxes were entirely paid by the trust because capital gains were excluded from DNI.²²

The Pennsylvania statute incorporates most of the language from the Uniform Act's Section 105 into its Section 8106, which sets forth the standard of review as abuse of discretion, and generally directs the remedy towards reversal of the prior action by the trustee, such as a higher distribution if the distribution were too low, or future withholding from distribution if the prior distribution were too high, only referring to surcharge if none of the other remedies are sufficient.²³

¹⁸ See also, Joint State Government Commission, Advisory Committee on Decedents' Estates Laws Recommendations to Legislative Task Force, May 4, 2001 at 22-29 (on file with author).

¹⁹ 20 Pa. C.S. Section 8105 (e).

²⁰ See *Id.*, §8105 (g).

²¹ See *Id.*, §8105 (f)(2).

²² Based upon the author's extensive computer modeling of such scenarios. There are too many variables to succinctly state all of the differences, but the variables include the asset allocation between stocks and bonds, the current accounting income of that asset allocation as compared to the unitrust amount, the turnover in the portfolio, and the cost basis of the investments in the portfolio. To take a simple example, a 4% unitrust payout with a 2% portfolio yield comprised of taxable interest and dividends would after 1% trustee's fees be able to distribute 3% capital gains per year to the beneficiary. At a 20% tax rate, this equals 60 basis points (6/10ths of 1%).

²³ See 20 Pa. C.S. §8106.

**XIX. SO YOU FINALLY HAVE A TOTAL RETURN STATUTE
- NOW WHAT? EXPLORING THE NEXT STEPS**

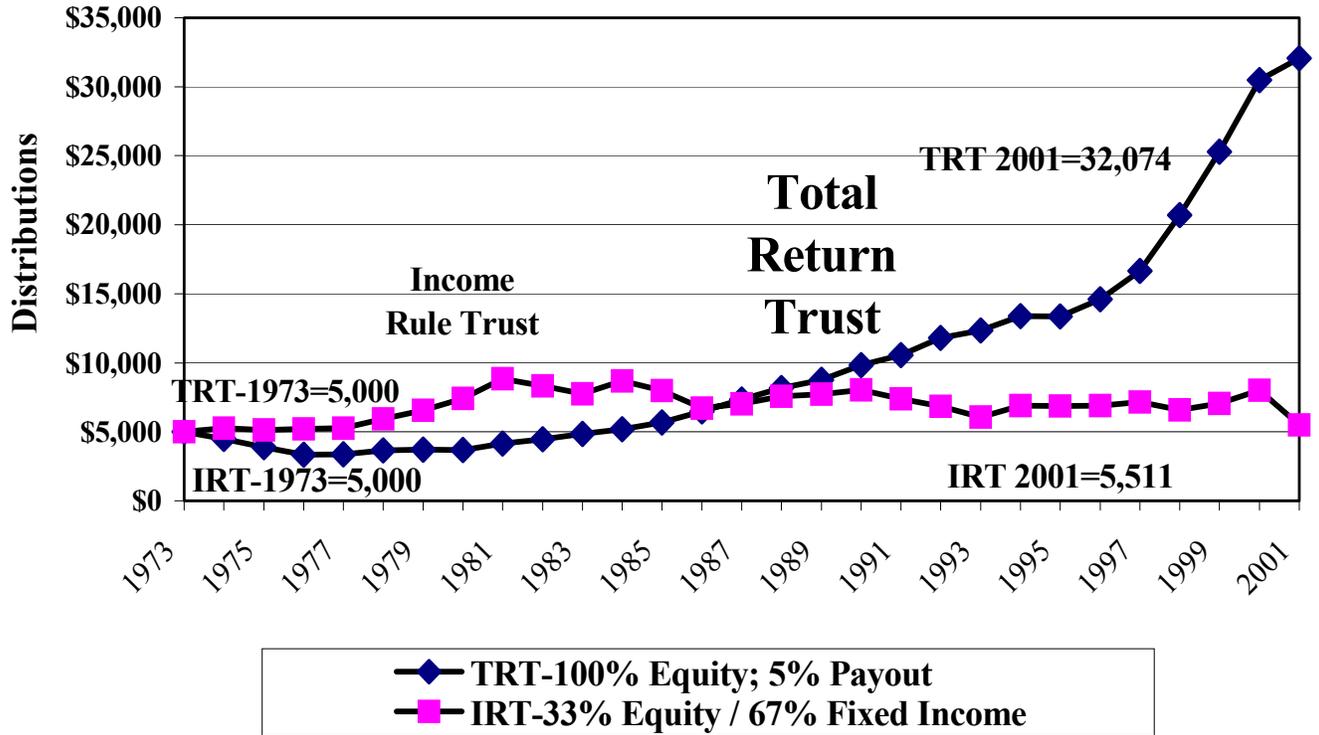
A. WHO NEEDS A TOTAL RETURN TRUST WHEN THERE IS NO TOTAL RETURN? WHAT GOOD IS IT IN A BEAR MARKET?

Writing this new section of the materials on July 20, 2002, the S & P 500 closed at 847.75, with the market generally closing out its 9th losing week in a row. This broad market indicator is off 44% from its highest close on March 24, 2000 at 1528.63. The NASDAQ Composite closed at 1319.15, off 74% from its high close of 5048.63 on March 10, 2000. Why would anyone want to consider a total return trust in general and equity investing on July 20, 2002?

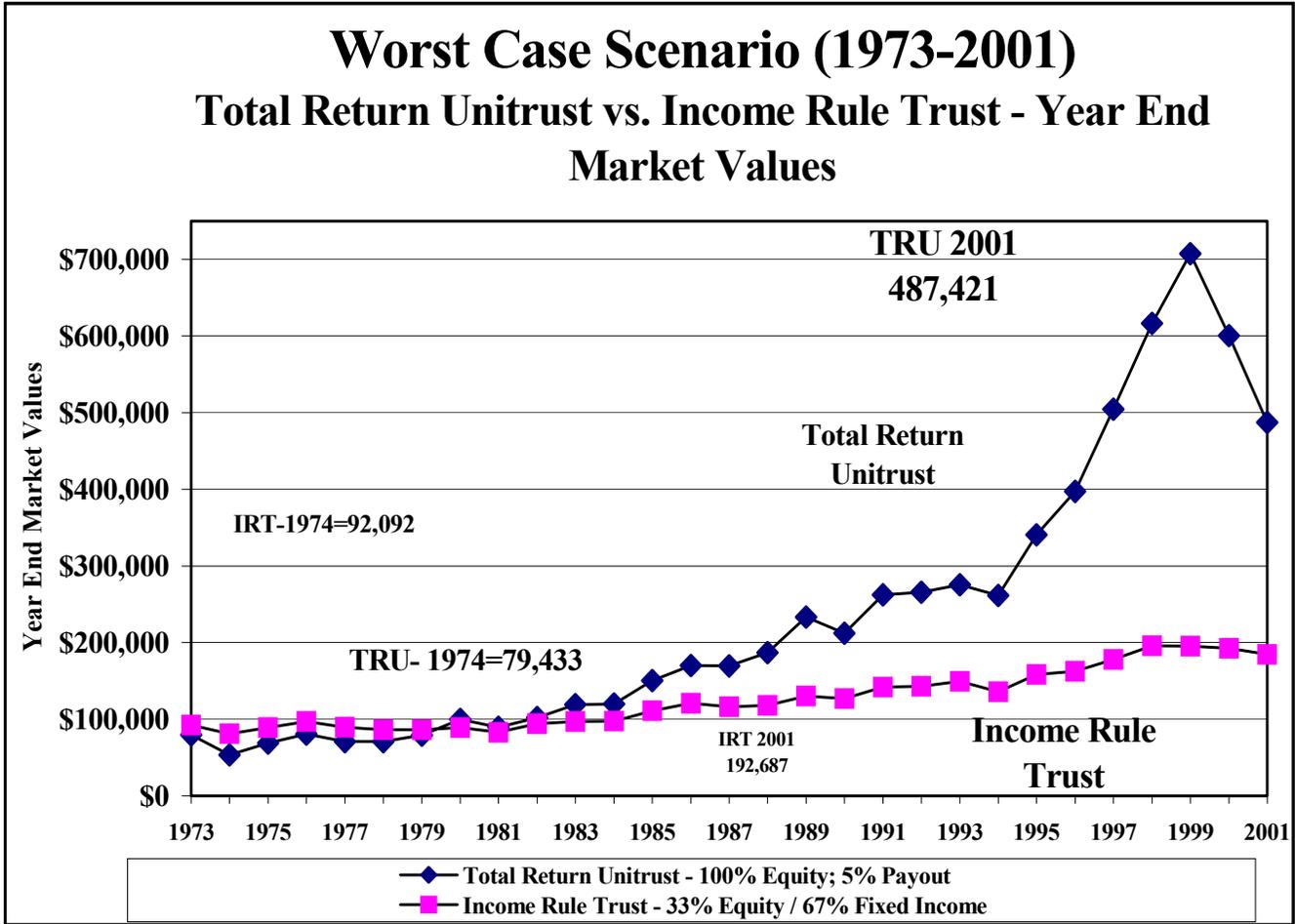
To answer that question, let's review again the results of starting a total return trust at the worst possible time—just **before** the onset of a bear market. Here we assume an all equity portfolio and a high 5% payout for the TRU and an income rule trust with an equivalent yield of 5% at that time, which would have required a 2/3ds bond and 1/3 stock portfolio at that time. For the next two years the market would suffer its worst decline since the depression, and an all bond portfolio would be better than all stock for 10 years. The following graph shows the distributions from the two portfolios during that worst case period.

Worst Case Scenario (1973-2001)

Total Return Trust vs. Income Rule Trust - Distributions

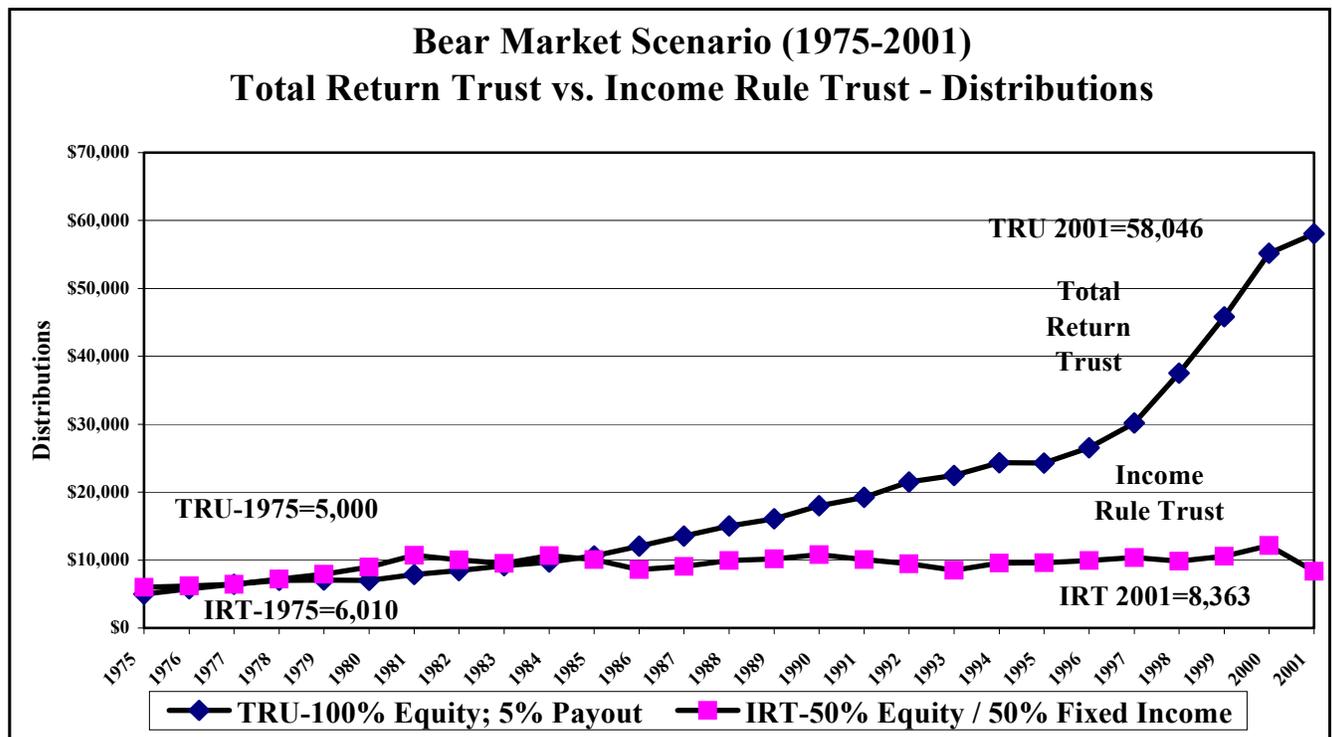


The bottom line is that the all stock portfolio did make the beneficiary suffer during this severe bear market. Let's look at the market values of the same two portfolios:

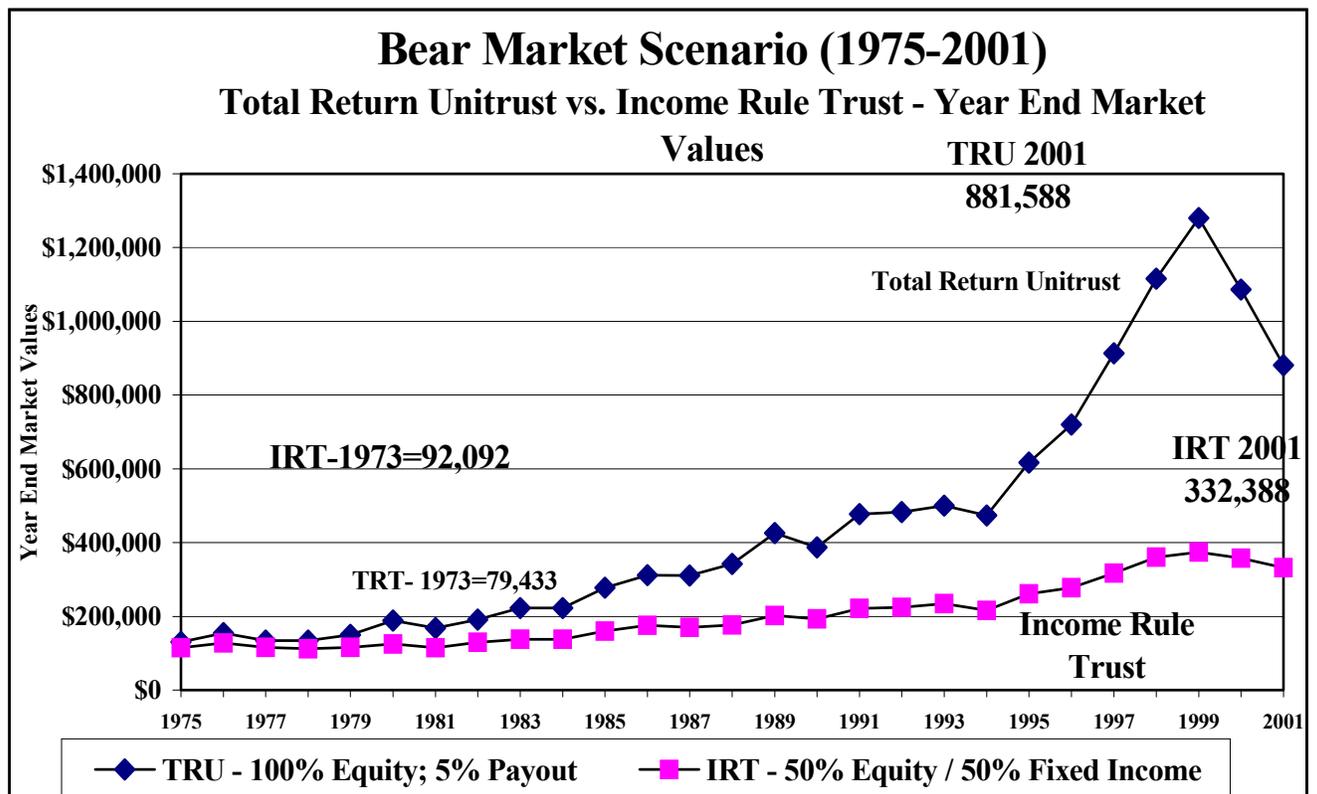


While the market value of the all equity TRU significantly lagged the mostly bond portfolio for a number of years, the long term results are much superior, and will likely be much superior even after the year 2002 is written into the record books. It would take a 60% decline in 2002 for the all equity TRU to come out worse than it's competitor, and that is frankly very unlikely.

But we are clearly not at a point just *before* a bear market, we are deep in the middle of it. What would the results look like if we did the same comparison starting in 1975 - two years after the start of the severe bear market of the 1970's? Let us compare the results of an all equity TRU paying out 5% with a 50/50 income rule trust and examine the distributions and the market values. First the distributions:



While there was a small period in which the trust beneficiary would have been better off with the income trust and the more conservative asset allocation, that is clearly not the message these results convey, is it? Now how about a comparison of the market values?

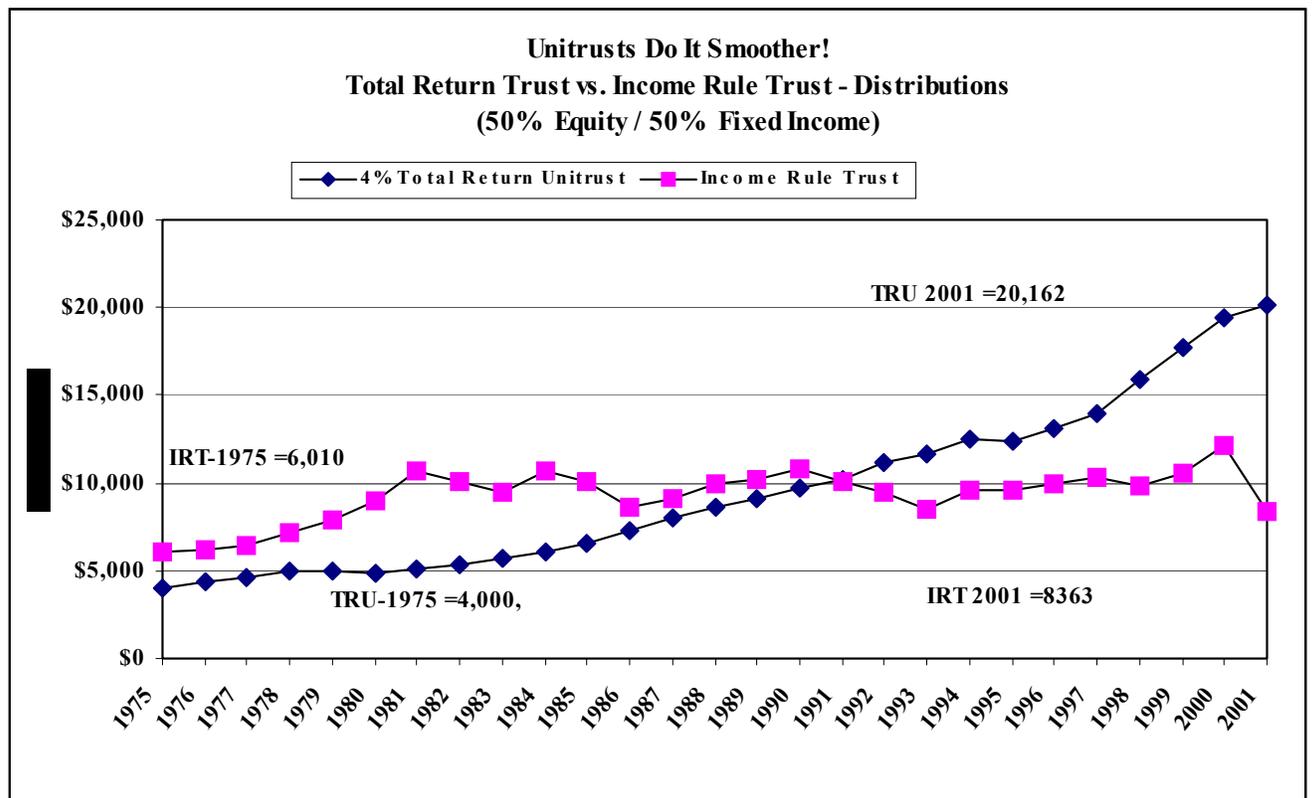


The market values of the two trusts do not favor the income rule trust and the more conservative portfolio in any of the 27 years since 1975. Could that mean that a bear market is the best time to convert to a total return trust, with the most aggressive asset allocation? Yes, very probably the smartest thing to do is the most difficult, as it often is in this world.

But perhaps even more importantly, the total return trust does not have to be invested aggressively to make sense. The primary point of the design is to allow the trustee to invest for total return and to manage the trust most effectively, whether that means mostly stock or mostly bonds, or a mixture of the two. By utilizing the total return trust, the trustee is able to weather the storm of a bear market by investing anyway she chooses, without the same degree of pressure that the income rule trust provides.

For example, the highest return asset class during 2002 thus far has been bonds. With current interest rates very low, the trustee might very well not want to invest in the bond market despite its relative safety, while the use of a money market fund in the present market lowers the income materially, as contrasted with a bond fund. But if the distribution depends upon the total return, rather than the income return, such funds can be easily used as a total return management tool, along with any other appropriate investment. If an investment strategy is best for total return, it will be the best for both the current and remainder beneficiary.

If we had started two trusts, each with a 50/50 investment mix in 1975, one distributing on an income basis and the other a TRU, the distributions from the TRU are both smoother and more likely to increase the value of the trust, because of the negative dollar averaging of the income trust which we have discussed previously.



So whether we are in a bear or a bull market, it is always better to be able to invest for total return, and the unitrust formulation will generally produce a smoother and steadier distribution to the beneficiary, particularly if bonds are a significant portion of the portfolio, because it eliminates interest rate volatility as a primary source of volatility.

B. WHERE WE GO FROM HERE—A DETAILED ANALYSIS IN THE CONTEXT OF THE PENNSYLVANIA TOTAL RETURN STATUTE

It may be helpful to review the question from the point of view of a specific statute in order to review the choices and the considerations in reacting to a total return statute. Obviously, the statutes are different from one another, and this will make a difference, but a more detailed analysis of these factors in the context of the Pennsylvania statute may be in order, particularly because a number of states have used the total return unitrust provisions in the Pennsylvania statute in the drafting of their own total return legislation.

1. What are the fundamental choices for the trustee?

First of all, what are our choices? Under the Pennsylvania version of the Uniform Principal and Income Act, the trustee generally has the option of either using the power to adjust or the unitrust in order to implement a prudent investment and fair distribution program. There

are trust situations that are excluded from both alternatives, but with one exception, all of those situations are tax sensitive. In a nutshell, both remedies are intended to be available to all trusts that may need them, except where the possession of the power or the conversion will or may cause a tax problem, or where the power or the conversion would contravene the grantor's intent. With the exception of the excluded situations described below, or where there is *uncertainty as to the possibility of a tax problem* if the trustee were to have the power to adjust or the power to convert may allow the trustee to release one or the other or both of the options, the trustee will have both powers. If they take no action, they will have the power to adjust, but would continue to have the power to convert to a unitrust as well should the trustee decide later that the unitrust is preferable.

2. What Trusts are Excluded from the Power to Adjust or the Power to Convert to a Unitrust?

(a) For the Power to Adjust Only-No Adjustment to Reduce Marital Interest. The power to adjust protects the marital deduction with the following language:

The adjustment would diminish the income interest in a trust which requires all of the income to be paid at least annually to a spouse and for which a Federal estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment.²⁴

While literally this language could apply to a credit shelter all income trust for the spouse, it should not be applicable unless the trust is one for which the marital deduction is intended to, or has been, claimed. This is helpful exclusion, in that it protects the marital deduction by not allowing it to be reduced, without the necessity of court action, which would be needed for the unitrust until the Proposed Regulations are final and in effect.²⁵

(b) For the Power to Adjust Only-if it may reduce the actuarial value of an income interest where annual exclusion intended. The powers are not allowed where they will reduce the actuarial value of an interest for which the annual exclusion is intended to be taken:

The adjustment would reduce the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a Federal gift tax exclusion.²⁶

So in short the trustee may not exercise the power to adjust to reduce an income interest in a trust for which the income interest is the feature that qualifies it for the annual exclusion. While the language could be applied to include a *Crummey* trust, where the annual exclusion depends not on an income interest but on the right to withdraw, it should not be so applied in the author's opinion.²⁷

²⁴ 20 Pa.C.S. §8104(c)(1).

²⁵ See discussion at nn . 193-194.

²⁶ 20 Pa. C.S. §8104(c)(2).

²⁷ The Pennsylvania statute does not apply this to the power to convert to a unitrust, no doubt because the assumption is that the unitrust interest will increase the income interest, which in most cases it will, but actuarially, income interests are overvalued at the present time, because for valuation purposes, the income interest is assumed to pay out the Section 7520 rate, 5.1% for August. This of course is unrealistic, and overvalues the income interest, whereas the unitrust interest is valued based upon its actual payout, using

(c) ***For Both the Power to Adjust and the Unitrust-Where it Would Change an Annuity or a Fractional Payout.*** Where the instrument describes what the beneficiary is to receive as a fixed annuity or a fixed fraction of the trust, the granting of the power to adjust would be a clear contravention of what the grantor had in mind, since the distributable amount was a definite sum, in the case of a fixed annuity, or what amounts to a unitrust, in the case of a fixed fraction of the trust. As a result, this situation is excluded from both the power to adjust and the power to convert to a unitrust.²⁸ This is the only exclusion that is not based upon tax considerations.

(d) ***For both the Power to Adjust and the Unitrust—Split Interest Trusts.*** Where the adjustment might reduce or the unitrust distribution might be paid from a charitable interest, the adjustment or conversion power is not allowed, unless both the principal and income of the trust are held for charitable purposes. The Pennsylvania provision differs from the UPAIA language here, in that it applies the exclusion only where the charitable deduction has been taken:

[an adjustment may not reduce or a unitrust distribution be taken from] any amount which is permanently set aside for charitable purposes under the governing instrument and for which a Federal estate or gift tax deduction has been taken, unless both income and principal are so set aside.²⁹

The Pennsylvania Power to Adjust and the Unitrust are therefore available for a trust with a partially charitable remainder for which a charitable deduction was not available, or was not taken.

(e) ***For Both the Power to Adjust and the Unitrust--Where the Possession of the Power would Make the Trust a Grantor Trust Where it Would Not Be Otherwise.*** For both, if possessing the power would make someone the owner of the trust for income tax purposes, and the trust would not otherwise be, then the power is denied.³⁰ It is not clear how this can apply unless the trustee is a beneficiary, which is covered separately.

(f) ***For Both the Power to Adjust and the Unitrust-Where the Possession of the Power would Make the Trust Taxable in Someone's Estate.*** Where the possession of the power to adjust or the power to convert to a unitrust would make the trust taxable in a person's estate, where it would not otherwise have been so taxable, the powers are denied.³¹ It is again most likely that this could apply where the trustee is a beneficiary, but this is of course of primary importance, and thus is broadly excluded.

(g) ***For the Unitrust—Where Conversion Would Deny the Marital Deduction.*** The authority to convert to a unitrust is denied where the conversion would cause a loss of the marital deduction:

the Section 7520 rate as the total return and the discount rate. A unitrust rate should qualify for the present interest deduction in any event, particularly once the Proposed Regulations are made final.

²⁸ 20 Pa.C.S. §8104(c)(3), §8105(i)(1).

²⁹ *Id.* §8104(c)(4), §8105(i)(2).

³⁰ *Id.* §8104(c)(5), §8105(i)(3).

³¹ *Id.* §8104(c)(6), §8105(i)(4).

If the conversion would result in the disallowance of a Federal estate tax or gift tax marital deduction which would be allowed if the trustee did not have the power to convert.³²

This is intended to preclude a conversion to a unitrust until the Proposed Regulations are made final and in effect, unless an “income if greater” interest is included as provided in Section 8105(g)(2). This is important since a power in a third party to effect a change in a marital trust which would disqualify the trust, may itself disqualify the trust for marital deduction purposes.

(h) For Both the Power to Adjust and the Unitrust-Where the Trustee is a Beneficiary. This is the most obvious exclusion where one would be concerned with the trustee exercising this authority, when he or she is a beneficiary of the trust.³³

(i) Where a Co-trustee May Exercise Without Difficulty, the Power to Adjust and the Power to Convert is Preserved. For both the power to adjust and the power to convert to a unitrust, if one of the tax problems noted above would apply to one of the trustees, but not another, then the other trustees, presumably the disinterested trustee or trustees, may exercise the power to adjust or the power to convert.³⁴

(j) For the Power to Convert Only-If no Disinterested Trustee, Court may Decide. If the concern is that the power may cause grantor trust status, inclusion for estate tax purposes, if the only trustee is a beneficiary, the trustee may still petition the court for conversion to a unitrust.³⁵ For the power to adjust, there is no court process that will cleanse the discretionary power, and of course one would not want to go to court every time an adjustment was desirable anyway, whereas a petition for the court to decide on a unitrust conversion issue should cleanse the process from a tax point of view for the trustee, since it is the court, rather than the trustee, that is making the decision. Even without the court process, the requirement that current and remainder beneficiaries be given notice and may block the conversion without court action should provide in most situations an “adverse party” helpful for some situations, as in a Section 2041 power of appointment concern.

(k) Release of Power to Adjust or Power to Convert When Tax Problem a Concern. Perhaps in an excess of caution, the drafters of the Uniform Act provided that if any of the tax problems described above would, or even might apply, then the power to adjust may be released, either permanently or for a period of time, and such a release may be only the power to adjust principal to income or income to principal.³⁶ They further broadened the application not only to the tax problems feared and listed in the statute, but also any concern that the power might deprive the trust of a tax benefit or impose a tax burden.³⁷ This broadening was copied in the Pennsylvania statute for the unitrust as well, so the trustee can release either of these powers for virtually any tax concern.³⁸

If the trustee wants no parts of this brave new world, she will have to find a tax reason to do it, and if there is one, she can release either or both of the powers under the new act.

³² *Id.* §8105(i)(5).

³³ *Id.* §8104(c)(7), §8105(i)(6).

³⁴ *Id.* §8104(d), §8105(j)(1)

³⁵ *Id.* §8105(j)(2)

³⁶ *Id.* §8104(e).

³⁷ *Id.*

³⁸ *Id.* §8105(k).

Otherwise, the default situation will be that the trustee will have the power to adjust, if the terms preconditions of the power to adjust apply.

3. *When to Hold and When to Fold.*

If the trust is not excluded or the powers released as discussed above, the trustee will have at least the power to adjust, if by its terms it is applicable. And it is applicable if the trust describes what is or may be distributed in terms of income and if using the discretionary powers contained in the trust instrument, the trustee is unable to treat the current and remainder beneficiaries impartially, except to the extent that the governing instrument indicates that the trustee shall or may favor one or another of the beneficiaries.³⁹ Stated more simply, can the trustee without the power to adjust invest the trust sensibly⁴⁰ and distribute fairly?

(a) *Factors, Factors Everywhere, But What Am I to Do?* The uniform act and the Pennsylvania statute lists lots of factors to take into account in making the decision to exercise either the power to adjust or the power to convert to a unitrust:

- (1) The size of the trust.
- (2) The nature and estimated duration of the trust
- (3) The liquidity and distribution requirements of the trust.
- (4) The needs for regular distributions and preservation and appreciation of capital.
- (5) The expected tax consequences of an adjustment.
- (6) The net amount allocated to income under the other sections of this chapter and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available.
- (7) The assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor or testator.
- (8) To the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the government instrument.
- (9) Whether and to what extent the governing instrument gives the trustee the power to invade principal or accumulate income or prohibits the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.
- (10) The intent of the settlor or testator.

³⁹ *Id.* §8104(a), §8103(b).

⁴⁰ The Pennsylvania statute did not include the express requirement that for the power to adjust to apply, that the trustee must invest as a “prudent investor”, a term which to some imports too much investment opinion into the equation, such as the efficacy of the “efficient markets” theory, and so forth. It is intended that the Pennsylvania power to adjust would apply to any trustee trying to invest sensibly and distribute fairly.

- (11) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.⁴¹

Factors 6 and 7 are only contained in the section covering the power to adjust, and not the unitrust. The exclusion of item 6 is clear enough, while the exclusion of item 7 in all likelihood stems from the provisions under the unitrust section to give trustees discretion as to how to handle the listed types of assets. While the foregoing list is certainly extensive, it is not intended to be exclusive of what the trustee may consider in the process. But what are the key factors in making these determinations?

(b) Concrete Trust Factors in Selecting Candidates for Exercising the Power to Adjust and the Power to Convert to a Unitrust. In a broad sense, neither remedy is needed or appropriate if, under the terms of the trust and all of the conditions and factors the trustee is able to invest sensibly and distribute fairly. So if a trustee is not constrained in administering the trust either from a distribution standpoint or an investment standpoint, then neither remedy is needed or appropriate. So, for example a fully discretionary trust would be free to invest and distribute as the trustee deems advisable, and the power to adjust would not be needed. Since the trustee could implement a unitrust distribution methodology without a formal conversion to a unitrust, the statutory unitrust conversion would not be needed either. There are factors, however, which to the author tend to press one towards one or the other remedy.

(1) Factors Favoring the Power to Adjust. The factors which might press the decision in favor of the power to adjust rather than the unitrust could include the following:

(a) Need for flexibility from year to year. If given the overall circumstances of the trust and the family, it is likely to be desirable to be able to vary the distribution from year to year, to fine tune it to the needs and opportunities presented, then the power to adjust is the better vehicle, if the discretionary powers of the trust are not sufficient to address the situation.

(b) Harmonious relationship among beneficiaries. The power to adjust, like any discretionary power, works best when everyone is on the same page. Just as a fully discretionary trust works best within the context of a happy trust family, so the power to adjust is most likely to be advisable in the long run where the trust beneficiaries are in harmony with one another, and are therefore less likely to attack the trustee who exercises a discretionary power.

(c) Where the trustee is comfortable with relatively frequent exercises of discretion. Depending upon the experience and predilection of the trustee, the trustee may be more or less comfortable with exercising discretion on a relatively frequent basis. Some professional trustees very much prefer the highly discretionary model and find that it works for them very well. Others find that the exercise of discretion impairs the relationship with the beneficiaries, and would prefer to limit discretion to where it is most needed.

(d) Where the nature of the assets, their liquidity, and the variability of their income may better suit a discretionary power. While the Pennsylvania statute does not include the nature of the assets as a factor for the unitrust conversion, it is a factor

⁴¹ *Id.* §8104(b), §8105(c).

for the power to adjust, and where liquidity or sporadic cash flow needs may make flexibility more important, the power to adjust may be the better approach.

(e) A caution—Adjusting up is easy—Will you adjust down when needed? It is a relatively easy thing for a trustee to decide to adjust from principal to income if the circumstances warrant it, but with the power to adjust, there is no mechanism for lowering the distribution absent the affirmative exercise of discretion. So if in a bull market, the trustee will adjust from principal to income, will they refrain or even adjust from income to principal in a bear market? Will they have what it takes to make the hard decision? Remember the unitrust does this automatically, so distributions would have decreased in 2002, a good thing I should think. The trustee has to decide whether it can go whatever direction is proper, whether the decision is popular or not.

(2) Factors Favoring the Unitrust—Factors favoring the unitrust might include the following:

(a) Where there is a need for more income on a continuing basis than can be satisfied by the income, without the continuing exercise of discretionary distribution powers under the instrument, if available. The most obvious place where the unitrust would be the most desirable would be where the income need is significantly in excess of what can be satisfied with accounting income. If a 4% or 5% income need is anticipated for the indefinite future, the power to adjust may be the tough way to go, since it would require a virtually continuous exercise of the power, and while the statute allows the needs of the beneficiary to be taken into account, it may be easier to simply convert to a unitrust.

(b) Where the beneficiaries do not get along well. The classic case here is the second family and a QTIP trust, with remainder to the children by a first marriage. While one can use the power to adjust to address the conflict, it simply puts the trustee more directly into the conflict, rather than as a sideshow to the choice of asset allocation. In these situations, and indeed in situations where there is little conflict, but the trustee would prefer to keep it that way, the unitrust would be the best answer.

(c) Where the unitrust is more desirable as the simpler, more straightforward process. In many cases, the unitrust may just be simpler than deciding when and how to use the power to adjust, and where the trustee is more inclined to a method that everyone will understand more easily, the unitrust may be the better answer. In trusts which are not of the multi-million dollar variety, the trustee may not feel as though they have the time and resources to devote to the power to adjust.

(d) Where the unitrust will allow the trust beneficiaries to plan their finances better. One real advantage with the unitrust is that it brings with it a sense of stability and understandability greater than the power to adjust. There are those who think that the power to adjust really can't be employed until the end of an accounting period, although that is probably an unduly narrow reading of the power. The unitrust distribution will likely be used so that at the beginning of a year, the beneficiary will know her trust "salary" for the entire year. It can easily be made payable quarterly or even monthly, and this may be of significant benefit to the trust beneficiary in her financial planning. In fact, it may encourage financial maturity in the beneficiary if the beneficiary can budget a certain amount coming in at the beginning of the year,

as opposed to simply asking the trustee for the exercise of its discretion, which may encourage trust dependency.

4. The Conversion Process in Pennsylvania

The process of conversion of a trust to a unitrust may be divided into the private process, without court involvement, and the public process, with court involvement. The preference in the statutory model was to provide for the private process as widely as possible.

(a) The Private Conversion Requirements. The private conversion process is fairly simple, once the trustee decides that the trust is not excluded for tax reasons as discussed previously, and that the conversion is a good idea.

(1) Is it a good idea? The statutory phrasing for the conversion being a good idea is as follows:

"The trustee determines that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust."⁴²

(2) Give Notice of Substance of Conversion Decision. Once having decided this central question, the trustee is required to give written notice that he intends to release the power to adjust and convert the trust into a unitrust.⁴³ And not just that the trustee wishes to convert to a unitrust, but how the unitrust will operate, which would presumably include the unitrust rate (always 4% in a private conversion), the dates for distributions, the method and dates used to value trust property, any assets to be excluded from the valuation computation, and any other decisions pertinent to the operating of the trust. This is important so that the beneficiary really understands the way the trust will operate if converted.

(3) To all sui juris current and remainder beneficiaries. The written notice must go to all of the sui juris beneficiaries in the class of current and remainder beneficiaries, defined as all sui juris beneficiaries who

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

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

There must be at least one beneficiary in each of the two classes, so that the current and the remainder beneficiaries are represented in the process.

(4) No one objects within 60 days. If no one objects within 60 days of the notice, then the conversion is complete.

A fairly simple process for conversion in most cases. Now let's look at the procedure for the process in court.

⁴² *Id.* §8105(a)(1)

⁴³ *Id.* §8105(a)

(b) The Court Conversion Process. The statute lists a number of situations where the parties must seek judicial approval for the conversion:⁴⁴

1. Where one of the beneficiaries objects within 60 days.
2. If there are no sui juris current beneficiaries, or no sui juris remainder beneficiaries.
3. Where the beneficiary requests a conversion, but the trustee does not convert.
4. Where the trustee suggests a rate other than 4%.⁴⁵
5. Where the trustee requests that net income, determined as if the trust were not a unitrust, be distributed if greater than the unitrust amount, if needed to preserve a tax benefit.⁴⁶
6. Where the trustee wishes to choose a smoothing rule other than three years.⁴⁷
7. Or in order to reconvert from a unitrust, and revive the power to adjust.⁴⁸

(c) Whom to notify, and what to say in the notification. The statute reads well enough in defining the current and the remainder beneficiaries. In the situation where the trust is to A for life, and then to B, the application is simple enough. But there are lots of trusts that may present a more difficult situation for application of the above notice rule. For example, if the trust is multigenerational, to Mom for life, and then to children for life and then to grandchildren outright, then if the trust were to terminate in the expected way, the grandchildren would be the remaindermen and the children would neither be current beneficiaries nor remainder beneficiaries, yet the author believes that they should receive notice. If advising a trustee, it is unlikely that there is a good reason for excluding anyone who has a vested interest in the trust, and it is likely that the statutory language may be refined to include at least those beneficiaries who would be eligible to receive distributions if those beneficiaries who are currently eligible were to die. This seems all the more compelling where the statute requires court approval.

The notification should spell out the conversion decision contemplated, and that the conversion will require the release of the power to adjust, as well as the details of the unitrust operating decisions on valuation and distributions. It should note that as required by the statute, once a conversion is accomplished the trustee must invest the trust for total return, rather than separately for income and principal. And if this author were to be drafting such a notice for a trustee, it would likely contain broad language noting that while investing for total return allows the trustee to do the best it can to invest the trust prudently, there is no guarantee that a total return strategy, or any strategy, will be effective to preserve the real or even nominal value of the trust, or to make it grow. That should be easy enough to remember in the midst of a bear market, but it should be included in the notice in this author's opinion.

The statute is short enough that it could be included in the notice to the beneficiary.

⁴⁴ *Id.* §8105(b). This subsection covers the first three listed situations.

⁴⁵ *Id.* §8105(g)(1).

⁴⁶ *Id.* §8105(g)(2).

⁴⁷ *Id.* §8105(g)(3).

⁴⁸ *Id.* §8105(g)(4).

(d) When to Go to Court—Tax Considerations in the Conversion Process.

There are two general categories of trusts that require special consideration in the conversion process because of their tax status:

The marital trust

The trust which is grandfathered for GST purposes

If the Proposed Regulations were final and in effect, there would be no special problem for these trusts, but because of the extreme importance of the marital deduction and the preservation of the generation skipping tax grandfathering, both situations should be approached with caution.

(1) The Marital Trust. In the case of a marital trust, the trustee has the option of going to court and requesting that the conversion be made subject to the proviso that the income or the unitrust amount, whichever is greater, be distributed. This should clearly protect the marital trust from difficulty, but in the case of a high interest rate market, it might someday in the future create some of the same conflict that is currently engendered by the income rule trust. One way to get around this would be to have the court order reflect that the “income” requirement would disappear whenever it became unnecessary under the applicable tax regulations.

A second approach would be to simply use the power to adjust until the Proposed Regulations are final and in effect. The power to adjust cannot be used to decrease an income interest anyway where the trust is a marital trust, so it should be safe enough. Then as soon as the Proposed Regulations are final and in effect, the conversion can be accomplished without the court process.

(2) The GST Grandfathered Trust. For the GST grandfathered trust, the court could provide that the income or unitrust interest be distributed, whichever is the greater, as in the marital trust, and this should qualify to protect the grandfathering⁴⁹ but care must be taken that the trust is not a multigenerational sprinkle trust. If an increased amount can be paid to a skip person, the conversion may not be safe without a private letter ruling. The alternative of using the power to adjust to increase distributions made to non-skip persons only ought to be safe in the meantime, but hopefully the Proposed Regulations will be put in final form soon so that this issue can be addressed easily. Once the regulations are final and in effect, the conversion can be made without the court process or any particular worry concerning the all-important grandfathering.

(3) When a rate other than 4% is best. A 4% rate was selected because it represents a reasonable proxy for the traditional notion of “income” without tying the trustee’s hands on the investment of the trust portfolio, but that is not to imply that it is best for all situations. Clearly there are situations where the need may be higher than 4%, as for example in a trust for an elderly surviving spouse, where the discretionary powers are not adequate. At the same time, the trustee of a long term GST exempt or grandfathered trust may be best advised to use a lower rate, if adequate to meet the needs of the beneficiaries. In such cases, a court petition will be required, but as long as the lower or higher rate is acceptable to all of the sui juris beneficiaries, the court should not have a hard time with the request. Obviously, though, a long term trust where a high rate such as 7 or 8% were requested might well be dangerous to all

⁴⁹ Treas. Reg. 26.2601-1(b)(2).

concerned, since the probabilities of maintaining the real value of the trust with that range of payout is less sanguine.

(4) Consider the whole portfolio of trusts for the family. Just as modern portfolio theory instructs us to look at any one investment within the context of its effect on the entire portfolio, a trustee may wish to look at the “portfolio” of family trusts in making its decisions about how to treat each trust under the new Pennsylvania statute, taking into account the needs of the beneficiaries of each trust and the tax characteristics of each trust. Clearly one can employ the same principles that are used in the chapter of these materials covering estate planning with total return trusts to approach the decisions in an existing set of family trusts. For example, if a family had a marital and credit shelter trust, the use of the unitrust conversion or the power to adjust on the marital trust to enable a higher payout from that trust would be more desirable than increasing the payout from the credit shelter trust, which might best be left to grow as much as possible, both by choice of asset allocation and by choice of application or non-application of the power to adjust or the power to convert to a unitrust. The statute might easily be used to provide a more aggressive investment mix and a lower payout from the credit shelter and a more conservative mix and a higher payout from the marital trust. And this type of approach can be just as easily adapted to the GST exempt and non-exempt trusts employed in other plans.

(5) What to include in a court petition to convert. Judge Drayer of the Montgomery Pennsylvania Orphans’ Court Division issued a preliminary memorandum to the Bar of that county as to what he might expect in a petition to convert. As one of the most highly respected Pennsylvania jurists in this field, his suggestions may be instructive, though they are obviously preliminary:

1. How and when the trust was created (a copy should be attached)
2. Facts supporting venue.
3. How funds received (gift, award by prior adjudication etc.)
4. Description of dispositive provisions of the trust.
5. Term of the trust.
6. Beneficiaries currently eligible to receive income, and those who would be eligible if current beneficiaries were to die, and those, in the absence of the exercise of any power of appointment, who would receive any principal if the trust were to terminate and distribution were to occur as of the time of the filing of the petition.
7. Current market value of the principal
8. Current accounting income and yield without the application of the power to adjust.
9. Asset allocation percentages.
10. Averments of facts in support of proposition that the conversion will enable the trustee to better carry out the purposes of the trust.
11. Copies of notices sent to beneficiaries should be attached.
12. The reason or reasons why court approval is necessary.

One of the reasons stated in the memorandum why court approval might be necessary is a lack of a sui juris beneficiary in either class of current beneficiaries and remaindermen. The definitional section 8102 in the Pennsylvania statute provides broadly that a sui juris beneficiary can include a minor represented by his or her parents, an agent for incapacitated person or a guardian appointed for either one. It appears unlikely that this breadth of

representation will hold with the judiciary, particularly since the parents of a minor may well be in a different class of interest in a trust, and a related agent may often have a conflict of interest in these situations, so it may be unwise to rely upon such representation. This may suggest that in some of these cases literally within the statute, the trustee will be better advised to obtain the court order, unless there are other indisputably sui juris members of each required class.

(e) ***The fine points – Trustees’ discretionary decisions.*** There are a number of points where the trustee is given discretion under Section 8105(e) of the Pennsylvania statute. Each is discussed briefly:

(1) **Provisions for prorating a unitrust distribution for a short year.** Simply using the unitrust rate times the fair market value of the trust assets at the time of conversion may be an attractive alternative, particularly if the unitrust conversion occurs during a bear market such as the market at the present time. The statute requires the use of a 3-year smoothing rule, but one would expect that this discretionary power for a short year might allow the distribution to be based on the initial starting value at the time of conversion. This would have the advantage of not using historical values which are not there anymore in the trust. The smoothing rule is not as helpful at the beginning of a unitrust regimen, through conversion, where the current beneficiary's income stream is being increased anyway, though it would work well enough during a bull market period.

(2) **Frequency of Payments.** The trustee can choose whatever is most comfortable for the trustee and the beneficiaries, whether quarterly or monthly. Liquidity and cost considerations aside, monthly distributions are often favored by beneficiaries.

(3) **How Contributions or Distributions other than the Unitrust Amount Affect Calculations.** The forms set forth in these materials have adjustment language that allows the three-year smoothing apparatus to operate reasonably in light of additional contributions to the trust or material distributions. Other approaches could deal with only such contributions or distributions which are material to the calculations.

(4) **Frequency of Valuation.** The calculations in these materials assume an annual valuation, though rolling valuations on a quarterly basis would make the distributions smoother in theory, if less predicible. Most beneficiaries would prefer to know their income in advance for an entire year, rather than having it vary quarter to quarter.

(5) **Selection of Valuation Dates.** We have used the end of the year or the beginning of the year as the valuation dates on the theory that it is nice to know where one stands at the beginning of the year. If the first date of conversion is one date used, and then the first date of the next year is the next date used, it accelerates obtaining multiple valuation dates for smoothing purposes. In the context of conversion, particularly in a bear market, it will help by providing reasonably current values as quickly as possible, so as not to over distribute during a down market.

(6) **How frequently to value non-liquid assets and whether to estimate their value.** If non-liquid assets are included in a unitrust, it is important to be practical in the valuation method and process. That is the reason for the reference to an estimate of value. It would be unduly burdensome to require an appraisal of real estate every year just to compute the unitrust distribution in most cases, unless the value were to be ascertained frequently for some other purpose. If there are many non-liquid assets in the trust, the unitrust may be less than ideal in any case.

(7) Whether to omit from calculations trust property used or occupied by the beneficiary. Where the beneficiary is able to get the use of the property as for example living in a piece of residential property, it may make the most sense to simply exclude that property from the unitrust calculation, since the use of the property may be the equivalent of the income or unitrust interest within the context of such A recent Private Letter Ruling illustrates the need for continued guidance from the Internal Revenue Service regarding these new changes in the definition of income for state law purposes and on the effect the modification of trusts has on the trusts and their beneficiaries. “use” property. This could be the case with tangible personal property as well, but the variety of the circumstances led the drafters not to require a particular method, but to give the trustee discretion as to how to treat these “use” type assets.

(f) A Cautionary Note about PLR 200231011. A recent Private Letter Ruling illustrates the need for continued guidance from the Internal Revenue Service regarding these new changes in the definition of income for state law purposes and on the effect the modification of trusts has on the trusts and their beneficiaries. In PLR 200231011, decedent created a trust for his grandson, giving him an annuity interest for life, and leaving the remainder at his death to 3 charities.⁵⁰ Within a year after decedent’s death, the trust was restructured with the consent of the court and the beneficiaries to provide annual income distributions to the grandson instead of the annuity set forth in the will, but with a minimum and maximum yield as specified in a “performance chart” agreed to by the parties, in part in exchange for partial payments from the trust to the charities. Differences arose among the parties as to the continued administration of the trust, and a global settlement was reached, whereby the charities’ interests in the trust were cashed out, and grandson’s interest in the trust was significantly reformed. He would now receive a 7% unitrust distribution; the trustee would have authority to distribute additional funds to him if needed for his “reasonable support”. In addition, he was given a general power of appointment over the trust corpus exercisable by will, the latter inserted in order to obtain a favorable ruling for generation skipping transfer tax purposes. Grandson then applied for a private letter ruling that there was no loss of GST exemption, that there was no taxable gift as a result of the transaction, and that the implementation of the proposed agreement and court order would not result in capital gain or loss or taxable income to any party to the order.

The ruling was favorable for purposes of generation skipping transfer tax, since the general power of appointment assured that no beneficial interest of a transfer to a skip person would be increased, nor the transfer extended.⁵¹ The gift tax part of the ruling was also favorable, since the dispute and resolution of the differences concerning the interests of the charities and grandson were based on arms-length negotiations. But the income tax part of the ruling was highly unfavorable to taxpayer, with a holding that grandson’s interest in the trust had been “exchanged” in a taxable transaction pursuant to *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991). *Cottage Savings* involved the exchange of mortgage loans made to different obligors and secured by different homes that in the opinion of the court embodied sufficiently different legal entitlements that the taxpayer was entitled to realize losses when it exchanged interests in the loans.

The ruling contrasted *Evans v. Commissioner*, 30 T.C. 798 (1958) where an exchange was held to occur when the taxpayer exchanged her income interest in a trust for an annuity, with *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969), where annual payments from a trust were exchanged for equivalent payments from the remainderman of the trust. The

⁵⁰ The trust apparently was not a charitable remainder annuity trust, however.

⁵¹ Treas. Reg. § 2601-1(b)(4)(i)(D).

letter writer found the ruling request situation closer to *Evans* than to *Silverstein*, because taxpayer's interests in the trust were fundamentally changed from what they were previously. And indeed they were: prior to the change on which guidance was requested, the taxpayer had an income interest with a maximum and a minimum in accordance with the performance chart, had no right to any additional principal, had no control over the property at his death, and shared his interest with the charities as parties in interest in the trust. After the modification he was the only party to the trust, he had a unitrust, rather than an income interest in the trust, the trustee was empowered to distribute additional portions of the trust as were needed under certain circumstances, and the trust was his to dispose of under his will. He really couldn't have changed the character of his interest in the trust much more thoroughly. Other than the names, one would hardly recognize the new trust from the old trust, but the ruling held that the interest he received was a taxable exchange under Code Section 1001, and that since his interest was a term interest, he would have no basis in that interest under Section 1001(e)(1).

The question raised by the PLR is whether conversions to a unitrust under the express provisions of a state statute, and as approved in the Proposed Regulations under Section 643 could attract an argument that there has been a gift transfer or that there has been a sale or exchange under *Cottage Savings*? Could the mere passage of a state statute granting the trustee the power to adjust entail such a risk? It is submitted that either treatment would be improper and is an unlikely position for the Service to take, but worthy of mention to the practitioner advising trustees and beneficiaries. This PLR is highly distinguishable from a state law authorized unitrust conversion for the following reasons:

(1) The effect of a unitrust conversion statute and a unitrust definition of income are to give the unitrust interest a legal equivalency. For example, under the Pennsylvania statute, after the conversion,

“The term “income” in the governing instrument shall mean an annual distribution (the unitrust distributions) equal to 4% (the payout percentage) of the net fair market value of the trust's assets, whether such assets would be considered income or principal under the provisions of this chapter [averaged over the lesser of the last three years, or the period during which the trust has been in existence]”.⁵²

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

(2) Under the Proposed Regulations, as discussed previously at some length, a state law which allows an election into a unitrust definition of income will be

⁵² 20 Pa.C.S. §8105(d)(3).

respected for marital deduction purposes both for federal estate tax and gift tax purposes⁵³ The premise of the Proposed Regulations in this regard is that the marital interest is not affected in such a way that it is no longer a fair income interest entitled to the marital deduction and “consistent with the value of the trust corpus and with its preservation.”⁵⁴ So for this tax policy purpose, the marital interest, if converted into a unitrust interest, particularly within the range of 3-5% mentioned specifically in the Proposed Regulations, has not been diminished in such a way as to cause its character for tax purposes to be changed.

(3) Under the Proposed Regulations, a state law which allows an election into a unitrust definition of income will not cause a previously grandfathered trust for generation skipping transfer tax purposes to lose its grandfathered status. In Proposed Regulation 26.2601(b)(4)(i)(D)(2) the administration of a trust in conformity with a state statute that grants the power to adjust or the power to convert to a unitrust will not be deemed to constitute a shift of a beneficial interest in the trust. Examples 11 and 12 thereunder specifically provide that if an adjustment or if a trust is converted pursuant to such a state statute providing for a 4% unitrust payout, with the consent of all of the beneficiaries, that there is no shift of beneficial interest. Since the application of this Proposed Regulation could be to provide a unitrust interest to either a skip person *or* a non-skip person, this portion of the Proposed Regulation even more clearly indicates Treasury’s view that the unitrust option, at least within the limits noted in the Proposed Regulations, produces no shift of beneficial interest. If there is no shift of beneficial interest, there is clearly no exchange of a beneficial interest, at least from a tax policy point of view.

(4) Under the Proposed Regulations, if an income distribution is now defined as a unitrust interest or is subject to the power to adjust under applicable state law, and if that income distribution requirement is satisfied with property in kind, a gain or loss is realized by the trust under Proposed Regulation 1.661(a) 2-(f). Here again, and this time for income realization purposes, the unitrust interest is proposed to be the legal and tax equivalent of the prior income interest.⁵⁵ If the trust interest of the income beneficiary were exchanged at the inception of the unitrust conversion, by the application of the *Cottage Savings* doctrine, this section in the Proposed Regulation would cause an incongruous engrafting of a second realization event. It would be strange indeed if this minor realization event were included without reference to a realization of the entire unitrust interest!

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

It is therefore highly unlikely that the reasoning of PLR 200231011 would be extended to attack a state law sanctioned unitrust conversion, or the passage of the power of adjustment without a release of that power. Several additional points will help to round out this discussion, however:

1. The Proposed Regulations will not be in effect except for calendar years beginning during the year after final regulations have been published. This means that while the tax policy is clear enough, and

⁵³ See text at nn. 183 and following.

⁵⁴ See n. 190, *supra*.

⁵⁵ Whether this actually makes sense, in light of the fact that a unitrust distribution, in essence, is more fractional by its inherent nature, than truly pecuniary, is less clear. But the Proposed Regulation in this regard is clear enough.

there is no better available guidance as to Treasury's attitude towards these changing state law definitions of income, the Proposed Regulations, by their terms, are not conclusive guidance on which we can rely at this time.

2. Literally speaking, the Section 642(c) definition of income does not necessarily apply to what could be more broadly viewed as a Section 61 definition of income question, so that additional guidance is needed and should be issued either in the final regulations, by Revenue Ruling or other advice, so that the question can be put to rest.
3. Note that in states where there is no unitrust definition of income, the foregoing reasoning and arguments are unlikely to apply, so that in non-unitrust states, the *Cottage Savings* issue is a considerably larger issue.
4. Note also that in situations in which there is a unitrust conversion statute, but the conversion allows a unitrust payout that is not between 3-5%, such as 2% for a long term GST trust, or a 6-7% return, for a marital trust, the situation is less obvious, and the comfort of a Private Letter Ruling might well be advisable, at least until the outlines of Treasury's position in this regard are more visible.

The entire concept of applying the *Cottage Savings* doctrine to the modification of trusts is highly problematic from a conceptual, as well as from a practical, point of view. If a unitrust conversion were a realization event, how would one measure the gain? Would it be based upon the actuarial value of the unitrust interest? And if so, even if there were a realization event, the beneficiary would not have received the value, and presumably would receive it for recognition purposes only a little at a time, each year, as an installment sale under Section 453.⁵⁶ And with those installments would presumably come imputed interest under Section 483 based upon the Applicable Federal Rates. And if that were not bad enough, in this context, how would the trustee report the trust's income, deductions and distributions under Subchapter J? Would the beneficiary be taxed twice on the income, once as an installment sale with imputed interest, and once as a recipient of DNI? If not, where would the DNI go?

⁵⁶ Professor Kenneth Joyce of the University of Buffalo, one of the early unitrust pioneers, provided this insight.