TRU or FALSE: AN ANALYSIS OF THE TOTAL RETURN UNITRUST

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TRU or FALSE: AN ANALYSIS OF THE TOTAL RETURN UNITRUST

I. INTRODUCTION

In conceptualizing the structure of a trust, draftsmen have pictured an income interest followed by a remainder interest, even though the income recipient and the remainderman may be one and the same. Thus, traditional trust drafting has long concentrated on the distinction between income and principal, and has often set different standards for the disbursement of each. This traditional approach has been adopted in the tax laws also.[1] Subchapter J of the Internal Revenue Code relies in many instances on the concept of trust accounting income. The QTIP rules mandate that the spouse has a right to receive all the income and the QSST rules likewise require the distribution of all income. State statutes also rely on the distinction between income and principal; *e.g.*, the rules set forth under the Uniform Principal and Income Act, whether the 1962 or the 1997 version. Equally as important, trustees traditionally have made investment decisions to produce a certain level of income. However, in this brave new world of modern portfolio theory, the investment gurus preach overall return without regard to such time-honored distinctions. This approach is indeed adopted in Restatement of the Law of Trusts, Third, and the Uniform Prudent Investor Act ("UPIA").

II. PURPOSE AND SCOPE

Most of the literature dealing with total return unitrusts is written by persons with a bias in favor of the use of unitrusts and, while sometimes attempting to be somewhat even-handed, they still lean heavily toward the perceived advantages of the TRU. While this paper (which is

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[1] However, the tax laws are adapting to the need for investing for overall return as reflected in the proposed regulations under §643(b).

now in its seventh iteration and still developing) attempts to present a balanced approach, I would be less than honest if I did not admit up front that I have, as my thinking has evolved, developed a definite viewpoint. Thus, this paper takes the position that the fixed return unitrust should not be the *default* drafting method for dealing with the sufficiency of distributions to the income beneficiary. More importantly, however, is the feeling (expressed throughout the paper) that the real solution is for the lawyer to spend more time talking to the client in depth about what the client is trying to accomplish with the trust, and then draft to accomplish that goal. Hopefully, then, this discussion will also cause practitioners to rethink the manner in which trusts are drafted and to encourage draftsmen to cause the client to focus more sharply on the client's desires rather than lapsing into the automatic formulations -- all income and HEMS principal, total trustee discretion as to either income, principal or both, unitrusts or annuity trusts.[2] Particularly in these times following the passage of EGTRRA in which the possibility of repeal of the estate tax looms, it becomes even more important that documents reflect the desires of the

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[2]Professor Dobris at the University of California Davis Law School has noted the same necessity:

> In the past, the garden variety trustee of an "income to *A* remainder to *B*" trust would create a conservative portfolio, enabling him to pay the traditional income to *A* and when *A* died, pay the remainder to *B*. The more conscientious trustee might try to come to an understanding of what the settlor intended and what the income beneficiary wanted, and structure the investments accordingly. Modern Portfolio Theory notwithstanding, trustees will likely continue to operate in the way described. There will be, however, more pressure on lawyers to discuss with the clients the clients' ideas about what kind of income stream the trust is expected to provide for the life tenant and what kind of value is to go to the remainder beneficiary. *To the extent that lawyers currently steer clear of discussions of investment return and the financial role of the trust in the beneficiaries' lives, that is likely to change over the next decades.* (Emphasis added)

Dobris, *Changes of the Role and the Form of the Trust in the New Millennium, Or, We Don't Have to Think of England Anymore*, 62 Albany L.R. 543 (1998), at 570, *fn.* 125.

testator or grantor as well as tax considerations. This outline will examine some of the various options available for the design of private (as opposed to charitable) unitrusts[3], as well as the considerations of reconciling traditional trust concepts with modern portfolio theory. It will delve briefly into modern portfolio theory, prudent investor standards, and some comments on the 1997 Uniform Principal and Income Act ("UPAIA"). It will also discuss the new proposed regulations under Internal Revenue Code §643(b) as they impact the availability of unitrusts and the application of UPAIA §104. The broader question which this paper will attempt to answer is, "Is the unitrust the answer to the problem in the current investment environment, or is it a technique to be used only sparingly and after much thought?"

III. THE ROLE OF THE ESTATE PLANNER

In the immediately following portions of the paper, modern portfolio theory and its underlying economic theory will be discussed. The rationale behind the growth of unitrusts will also be explored and critically analyzed. What, you may legitimately ask, is the relevance to me as an estate planner to develop an understanding of the basics of underlying financial theory and the arguments for and against unitrusts? "Why should I care about efficient markets when I do not advise clients about their investments?" The answer could be that we should all thirst for knowledge, but it really is not. The answer is that, as competition increases from financial planners, CPAs and other professionals (and some not so professional), the focus of the attorney must change and increased skills must be brought to bear. And, if you are to use unitrusts in drafting, you should understand some of the effects that are not readily apparent when reading articles by the advocates of that technique.

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[3]While "private unitrust" may be a more descriptive term, the technique to which I am referring is commonly called a "total return unitrust" or "TRU", and that is the term I will use throughout.

A. Qualities to be Possessed by the Draftsman

In his Heckerling Institute article,[4] William Hoisington, a California lawyer who was one of the first and is still a leading advocate for fixed return unitrusts, lists five skills the estate planner must have to develop a successful distribution formula:

(1) a reasonably clear understanding of the settlor's human and financial objectives for the trust,

(2) a reasonably clear understanding of the personal circumstances and financial needs of the trust beneficiaries (present and future),

(3) some understanding of modern financial principles and the supporting empirical data,

(4) a reasonably clear understanding of the investment strategies that are likely to be employed by the trustee and of the probable financial consequences of each of those strategies, and

(5) expert level knowledge of the alternative distribution designs and constituent distribution formulae that may be used to implement the settlor's human and financial objectives for the trust.

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[4]Hoisington. "Modern Trust Design: New Paradigms for the 21st Century," 31st University of Miami Heckerling Institute on Estate Planning ¶603 (1997)

B. Determine the Needs of the Client

For too many years, the focus of estate planning attorneys has been more on complying with tax statutes and less on really analyzing what the client is trying to accomplish with the trust. In fact, many practitioners did, and still do, steer their clients to the use of trusts solely because of the necessity of their use in tax planning. Mechanical compliance with the tax rules is given more attention than how the trust might implement client's desires. In some cases, such as a QTIP trust with the surviving spouse as trustee, the desire of the client is easily manifest. It is not so easy in a second marriage situation with a non-spousal trustee, especially if the trustee is a child by the first marriage. It is also not so easy to determine the desires of the client when the beneficiary is a child or other descendant. Many clients today worry that their children will have no incentive to be productive citizens if they can rely on the trust, and those clients desire that the trust be designed to avoid that result to the extent possible, while still providing some benefits. And, the last example is exactly the point, trusts have a very valuable place in family planning even if there were no tax effects.

C. Determine How Those Needs Can Best Be Accomplished

If the estate planner is truly to meet the needs of the client as far as payouts (distributions) from the trust, the attorney must understand the economics which will be necessary to produce those returns, and the economic effects of the approach employed, whether it be discretionary, ascertainable standard, unitrust, annuity trust, *etc*. Does this mean that the attorney must (or even should) also take on the role of the investment advisor? ABSOLUTELY NOT! It has long been accepted that the attorney must understand the various insurance products and the different

purposes each serves without any thought that he was replacing the life underwriter. The same is true of the relationship with the financial planner or investment advisor.

D. Assist the Client in Choosing a Trustee

A critical choice in this process is the choice of the Trustee.[5] There are many factors involved in deciding whether to choose a family member, a close friend (almost never a good idea) or an institution, or some sort of co-trustee arrangements. The choice of trustee will affect, or in many cases dictate, the distribution formula and the availability of UPAIA §104. Removal and replacement powers are also of utmost importance. *No third party trustee should ever be appointed that someone does not have the right to remove.*

IV. SOME INTRODUCTORY MATTERS

A. Definition of Total Return Unitrust

The inclination is to think of total return unitrusts in the same terms as charitable unitrusts; *i.e.,* a trust with a fixed return to the current beneficiary.[6] However, for purposes of this paper, a total return unitrust is any trust other than a trust which draws a distinction between income and principal in establishing a distribution standard. The most common trust which is not a unitrust is a mandatory income distribution trust with or without any power to invade principal.[7] As discussed below, unitrusts can be used as a primary distribution formula, or to

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[5] *See,* Akers, "Trustee Selection: Retaining Strings Without Getting 'Strung Up' *OR* 'The Fancy Stuff is Fun – But This Is What I Wrestle with Every Day'", State Bar of Texas Advanced Estate Planning Strategies 2003, Chapter 2.4.

[6] When used generically, "unitrust" also includes an annuity trust.

[7] It could be argued that a mandatory income trust which allows distributions of principal based upon a health, education, maintenance and support standard is a unitrust in that the beneficiary is provided for irrespective of the income of the trust. However, the fact that the beneficiary has a right to all the income (and, conversely, that all the income must be distributed), argues against this kind of

supplement all income trusts. Unitrusts can be as simple as a pure discretionary trust, or as complex as a trust in which the distributions are dependent upon market performance by tying distributions to earnings, such as a percentage of the average dividends paid by companies listed on the Standard & Poors 500 Index. In actuality, the use of §104 of UPAIA converts a standard all income trust to a unitrust, but not necessarily one in which the return is determined by a fixed percentage which cannot vary from year to year.

B. A Brief History

1. Prudent Man[8] Theory

The development of the all-income standard probably descends from an agrarian society in which wealth was the land and, after putting back funds needed for next year's crop (plus perhaps a reserve against weather and other natural disasters), the remaining money could be spent without diminution of capital. In line with that, one of the leading aphorisms in regard to investing, "spend income but protect principal," was embodied in the prudent man rule adopted by Restatement of the Law of Trusts, Second, in §227, which mandated a trustee:

> ...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 the regularity of the income derived therefrom. [Emphasis added.][9]

The Texas Prudent Man Rule, adopted in 1983 with the codification of the Texas Trust Code, §113.056(a), is a hybrid of the prudent man rule, since it commands a trustee to invest:

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trust being treated as a unitrust.

[8]With apologies for not being politically correct (*i.e.,* referring to the rule as the "Prudent Person Rule)", I simply use the term utilized in the statutes and Restatement.

[9]It might be possible to argue that preservation of capital includes protecting it from inflation, but it is doubtful that was the meaning contemplated by the Restatement.

> ...not in regard to speculation, but in regard to the permanent distribution of their funds, considering the probable income from, as well as the *probable increase in value and the safety* of their capital. [Emphasis added.]

2. Prudent Investor Rule

In an increasingly service oriented and information driven society, and in an environment in which the returns (dividends) on stocks are low, along with relatively low interest rates on fixed income securities, a different philosophy has taken hold. This theory, which derives from modern portfolio theory, is known as the prudent investor rule[10] and is set forth in §2(a) of the Uniform Prudent Investor Act ("UPIA"). The rule has three basic tenets as its underpinnings:

1. Trustees should invest for total return;

2. The investments must be suitable to the purposes of **the** trust (emphasis added);

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[10]This rule is set forth in the completely revised §227 of Restatement, Third as follows:

> The trustee is under a duty to the beneficiaries to invest and mange the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.
>
> (a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.
>
> (b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.
>
> (c) In addition, the trustee must:
> (1) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§171); and
> (2) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§188).
>
> (d) The trustee's duties under this Section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute.

and

3. In determining whether the trustee has acted with prudence, the entire portfolio must be examined, rather than an asset by asset valuation.

Under the prudent investor standard, the trustee is still bound by the duties of loyalty and impartiality. *See* Restatement of the Law of Trusts, Third §227, and the comments thereunder. Restating the obvious, the prudent investor standard still holds the trustee to a duty of prudence, while redefining what constitutes prudence.

C. Modern Portfolio Theory[11]

The driving force behind the rise of the prudent investor rule is the advent of modern portfolio theory. This aggregate of economic theories is based upon the idea that the financial markets are efficient (a term of art) and that the investor will choose investments based upon diversification and degree of acceptable risk. While these are concepts in which the estate planning attorney has not usually dealt, they are concepts which drive the debate over the use of unitrusts in estate planning.

1. The General Rule

Traditional investment philosophy was that a sophisticated investor, by studying past performance and analyzing relevant data, particularly price data, could find undervalued stocks or stocks that were about to increase in value because of growth of the company, and stay ahead of the market averages. While some portfolios may have been diversified, diversification was

[11]Much of the material in this section is based upon Macey, *An Introduction to Modern Financial Theory,* 2d Edition, published by the American College of Trust and Estate Counsel Foundation. A copy may be obtained from the Foundation at 3415 S. Sepulveda Blvd., Suite 330, Los Angeles, CA 90278.

not a central concern. But diversification is one of the centerpieces of modern portfolio theory. In addition to an emphasis on diversification, modern portfolio theory posits that the market is "efficient," and to an extent a "random walk" (both theories discussed below), and thus the successful investor does not get that way by picking and choosing individual issues, but rather by diversification, reduction of risk, and reduction of volatility.

2. Diversification and Risks

One of the guiding principles under modern portfolio theory is that investors, particularly institutional investors, are risk averse. This does not mean that investors do not take risks; rather that the intelligent investor determines the amount of risk the investor is willing to take, and then structures the investments in the portfolio to that level of risk. The balancing of risk and return is what determines the price an investor is willing to pay. There are basically two kinds of risks, firm specific risk and systematic risk.

a. Firm Specific Risk

Firm specific risk can be almost entirely eliminated with diversification, which is nothing more than following the old adage about not putting all of your eggs in one basket. Enron is a perfect example of firm specific risk; *i.e.,* that any particular company's value can be influenced by factors peculiar to that company. Firm specific risk theory can also be applied to industry groups. For example, if your investments are all in oil stocks, and the price of oil drops, then the value of the portfolio will drop also. But if your portfolio also contains utility stocks, which are likely to improve if the cost of fuel drops, then you have substantially reduced firm specific risk because the loss in value of part of the portfolio is offset by the rise in value of another part. Studies have shown that it does not require a great deal of diversification to almost eliminate

firm specific risk. As few as ten stocks, properly diversified, will eliminate 88.5% of the firm specific risk, while twenty stocks will eliminate 94% of such risk.

b. Systematic Risk

Systematic risk cannot be diversified away nearly so easily. This is the type of risk which occurs because the system itself reacts to an external force; for example, an increase in interest rates by the Federal Reserve or a general economic downturn. Diversification into non-U.S. markets can, to some extent, reduce systematic risk.

c. Balancing Risk and Return - The Capital Asset Pricing Model

Again stating the obvious, an investor will insist upon a greater return (or the chance of a greater return) in direct proportion to the risk assumed. Macey, *supra,* refers to this as "incremental happiness." For instance, a gift of $100 to you now, while appreciated, is less appreciated than a gift of $100 to you while you were student. Suppose you had $1,000,000 and someone offered to bet you $500,000 on a flip of a coin or a cut of the cards. Most people would probably not take that wager, since the loss of half your wealth is more terrifying than a 50% increase in your wealth is rewarding. However, if the wager were to double or triple your wealth on the upside, and still only lose half on the downside, the proposition becomes more attractive. That, basically, is how stocks are priced -- the investor determines that the reward to be received is sufficient to risk his capital.

d. Volatility

Diversification can also be used to reduce volatility of the overall portfolio. As counter-intuitive as it may seem, adding a dash of highly speculative stocks or foreign stocks to a portfolio may reduce overall volatility because those stocks may well run opposite to the

domestic market as a whole. Reducing volatility is simply another way of reducing risk.

3. The Efficient Capital Market Hypothesis (ECMH)

Modern portfolio theory depends upon the efficiency of the market. ECMH holds that a market is efficient if the prices of the goods sold in that market fully reflect all available information about those goods; *i.e.*, when new information becomes available, such new information is immediately reflected in the price of goods. In these days of the Internet and rapid communication, if ECMH is correct, the markets will become even more efficient.

a. Weak Form Efficiency

Weak form efficiency holds that past price performance is not a predictor of future price performance. This is the "random walk" theory, which does not mean that stock prices are random, but rather means that an investor cannot make a profit by using past pricing to determine future value. As Professor Macey describes it,

> If you leave a drunken person in a field and you want to find him later, how should you go about looking for him? If the assumption is that the drunk will wander in a random pattern, then the best place to begin a search is where the drunk was last seen. That position will produce an unbiased estimate of the drunk's future position.

Macey, *supra,* at 40.

In other words, ascertaining where the stock price has been is not helpful since it does not predict where it is likely to go.

b. Semi-Strong Form Efficiency

While weak form efficiency relies only on one form of available data (price), semi-strong form efficiency posits that the price immediately reflects all publicly available data. Thus, an analyst, using such data, cannot find "undervalued" stocks, because such data is already reflected

in the price of such stock. There is strong empirical evidence that the weak form and semi-strong form efficiency are valid hypotheses. The emphasis on better accounting standards and reporting will strengthen semi-strong efficiency.

c. Strong Form Efficiency.

Strong form efficiency takes the ECMH to its logical conclusion. It holds that all information, both public and private, is immediately reflected in the price of the stock. If this form of efficiency were true, then even insiders could not out perform other investors. There is little empirical evidence that this form of efficiency exists, but with the increase in both amount and speed of available information, it will become increasingly difficult for someone to possess private information, and thus the markets will become more efficient. A recent SEC rule requiring public disclosure of certain data to the public at the same time it is disclosed to analysts and mutual fund managers is a move in this direction.

> **AUTHOR'S NOTE:** Does all this market efficiency mean that the professional money manager is obsolete? No. While there is little reality in the hope that a money manager will find undervalued stocks on a consistent basis, there is still a certain amount of skill and experience required to assemble the properly diversified portfolio for each individual investor.

V. THE ARGUMENTS FOR AND AGAINST THE USE OF UNITRUSTS

A. Some of the Principal Players

As noted earlier, there are several attorneys involved in this discussion (by way of example and certainly not be way of limitation: William Hoisington, Robert Wolf, Steve Leimberg, and Mark Edwards) all of whom are leading advocates for the use of total return unitrusts. Jerry Horn has also written on this matter, but, as will be discussed below, his viewpoint differs markedly from that of the other attorneys who have written on this subject.

There are several economists and academicians involved in this debate also. Most prominent, in its earliest stages, were David Levine, former chief financial analyst for Sanford Bernstein & Co., and James P. Garland, an economist with the Jeffrey Company in Ohio. It is interesting to note that most of the lawyers writing on this subject favor the fixed return unitrusts while the economists who have weighed in on this matter believe that such trusts present serious problems.

B. The Arguments for the Unitrust

Two factors combined to create the impetus to seek a nontraditional form of drafting for trust distributions -- the rise of modern portfolio theory and the diminution of income in relation to increases in value caused by the incredible bull market of the second half of the 1990's.[12] This discussion continues on three levels -- (i) the drafting of total return unitrusts, (ii) legislation, in those states which have adopted UPAIA, to allow the conversion of existing trusts which use income as a distribution standard to unitrusts (but not annuity trusts) and/or allowing the trustee greater flexibility in allocating between receipts between income and principal, and (iii) the almost lemming-like rush to adopt legislation which will permit an existing "income rule" trust to be converted to a unitrust. There are, as nearly as I can discern, three principal arguments for the use of unitrusts.

1. <u>The Unfairness of the "All Income" Requirement</u>

The tax statutes have for some time required, and still require, that all of the income be available (marital deduction trusts), or be actually distributed (QSSTs) to the beneficiary of certain kinds of trusts. This directs the Trustee, in effect, to invest the trust in such manner as

[12]Note that a decline in value has not produced an increase in income in relation to values in the new millennium. If the present market conditions continue for any substantial period of time, will the unitrust appear nearly as attractive?

to produce a reasonable return for the income beneficiary. The restriction on investments created by this approach is in direct conflict with modern portfolio theory which mandates investment for overall return. Further, in the current environment, with low dividend yields and falling interest rates, it is very difficult for the Trustee to invest in such a way as to produce a reasonable return and still maintain the real[13] value of the trust. The TRU is thus seen as a method to assure that the current beneficiary receives a reasonable distribution. There are other, and I believe better techniques which should be considered in trying to obtain a fair distribution for the current beneficiary.

2. Simplifies Investment Decision Making and Distributions

Since the trustee does not have to be concerned as to the character of the return produced, the trustee may simply look for the best investment return, and thus its decision making process is simplified because the goal is straightforward. In fact, the underlying argument here is that the trustee can take a greater position in equities because, as everyone knows, in the long run equities produce a better return than any other investment. As an additional benefit, distributions are fixed by the instrument and therefore (at least theoretically) easily determined.

3. Elimination of Friction

The unitrust approach is advocated as a "win-win" (or perhaps even "win-win-win") approach in that it eliminates friction between the current beneficiary and the remainder beneficiary, while a trust with any real trustee discretion has the possibility (and perhaps even the probability) of creating friction every time the trustee makes a distribution or investment

[13]"Real" as used herein means adjusted for inflation, while "nominal" means that no time value is taken into account and dollars are expressed in constant terms.

decision. In a unitrust environment, so the argument goes, a trustee may invest for overall return without regard to archaic distinctions between income and principal. Thus, if the trustee is successful in increasing the value of the trust, the current beneficiary gets larger distributions, the value of the remainder interest increases, and everyone lives happily ever after. And, if the value goes down, both classes of beneficiaries suffer equally, thus providing company for everyone's misery (and a common enemy in the trustee who ought to "do better" no matter what the market). Also, the argument goes, the duty of impartiality is automatically satisfied.

The annuity trust is also designed to provide a fair return to the current distributee and usually is designed to maintain the purchasing power of the distribution through indexing. While the annuity trust eliminates friction also, it does not have the same effect of a rising tide lifting all ships. Whether the value of the trust goes up or down, the annuity amount remains constant, except as it may be adjusted for changes in economic indices. Thus, if the value of the trust increases at a pace greater than the index used, the annuity distribution is a smaller portion of the trust. On the other hand, if the value of the trust decreases, the annuity distribution becomes a larger portion of the trust. In a steep, prolonged decline, this formula could seriously affect the viability of the trust. In almost any environment, an annuity trust is counter-cyclical.

C. The Arguments Against the Routine Use of Unitrusts

The caption for this portion was carefully chosen. As noted earlier, unitrusts and annuity trusts are not *malum in se.* Rather, they are an arrow in the estate planner's quiver to be used in those situations in which they meet the testator or grantor's carefully considered goals, but only in those situations. However, they should not be used routinely as the preferred default technique for the following reasons.

1. Inflexibility

It is axiomatic that the best planning is the most flexible planning, allowing the trustee to adjust its actions (*both* as to investments and distributions) to fit the situations that changing times present so that the purposes of the trust may be carried out. The primary problem with the unitrust and annuity trust approach is the total lack of flexibility offered by such trusts. At least in the income-principal formulation, the trustee can affect the returns to the current beneficiary through investment choices. In the unitrust scenario, the trustee is mandated to pay a fixed percentage of the value of the trust to the current beneficiary; and the annuity trust mandates a fixed dollar amount without regard to the value of the trust. Ten years ago, it would have been impossible to have anticipated the state of the investment markets in the last half of the 1990's, although the decline in this millennium may have been more predictable (except as to timing). How can we advise our clients to establish long term trusts which are inflexible?

In fact, it is this inflexibility that could well negate the proposed benefit of easing friction among classes of beneficiaries.

> Although commentary implies that a total return trust design coupled with a unitrust or indexed annuity distribution formula mitigates the potential for conflict between current and remainder beneficiaries, such a result may not actually occur. Grantor selection and trustee implementation of irrevocable distribution formulae may create a level of antagonism between beneficiary classes equal to that found in the more traditional net income trusts. The antagonism arises not so much from the operation of the formula, but from its initial selection and the ensuing consequences.[14]

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[14]Collins, Savage, and Stampfli, *Financial Consequences of Distribution Elections from Total Return Trusts*, 35 REAL PROP., PROB. & TR. J. 243, 249 (Summer 2000). This is an excellent and well thought out article in which another group of economists conclude that fixed return unitrusts do not make economic sense. (Hereafter cited as "Collins.") *See also* Collins and Stampfli, *Provisions and Pitfalls of Total Return Trusts,* 27 ACTEC JOURNAL 205 (2002).

2. Discretion Is Usually Given Even in A Unitrust

To counter the inflexibility argument, leading proponents of the use of unitrusts also advocate that the unitrust be given some flexibility by giving the trustee discretion to make distributions in addition to the unitrust amount. The mere presence of this discretion, in many cases, will create the same friction as an "all income" trust with principal invasion powers.

3. Protection of the Trustee

This is a corollary to the lack of flexibility. One "virtue" of the unitrust, as noted above, is it puts all beneficiaries and the trustee on the same team, thereby taking the trustee out of the middle. I submit that the trustee is not paid to be taken out of the middle. The trustee is paid to exercise discretion in both the investment and distribution arena unless a *conscious* decision is made to limit discretion in one of those areas. If the unitrust becomes the default drafting technique, the decision to remove discretion with respect to distributions will cease to be a deliberate (*i.e.,* conscious) one. Note also that if there are allowable discretionary distributions in addition to the unitrust amount, the trustee is back in the middle.

4. Assumes a Financial Portfolio

All of the market formulae in the unitrust assume that the trust estate is primarily financial assets -- traded securities, bonds and cash. Many trusts have difficult to value assets which will not adapt to a fixed percentage of market value, and perhaps these assets will not even lend themselves to an annuity approach or a formula based on the S&P average return and bond returns (as discussed below). The valuation of non-financial assets must be dealt with in the trust and that may add a significant expense to the trust administration. Such expense will dramatically reduce return because of the compounding effect. One obvious consideration is that

a fixed return unitrust (regardless of the formula) does not work well with non-financial assets. This same problem is present with the Give-Me-Five Trust, discussed below.

a. Real Estate

If the trust contains income producing real property, then so long as the income remains relatively stable, the trust can meet its obligations (assuming that the return to the beneficiary was not set too high). In addition to the expense of reappraisals, a slump in the real estate market or the ranching or farming business, depending upon the nature of the asset, could make it impossible for the trustee to meet its obligations. And, as a practical matter, the trustee, in order to make required distributions, would then be forced to sell off all of the real estate (or at least all of one of the pieces of real estate) since there is no real market for undivided interests. Or, to make distributions, the trustee might try to borrow, when obtaining credit is very difficult, and borrowing to make distributions is of questionable prudence.[15] The problem is even greater if the trust has a large percentage of non-income producing realty.

b. Oil and Gas

Oil and gas interests are probably the least desirable type of asset to be used in a unitrust. Because prices for these commodities are very volatile, any sort of fixed payout will be very difficult to meet. Valuation of these kinds of assets is also very difficult. And a forced sale by the trustee in a down market could prove disastrous.

c. Closely Held Business Interests

If a closely held business interest is part of the trust estate, many of the same problems

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[15]A distribution of an undivided interest, while theoretically possible, is not realistic. There are valuation issues, but, more importantly, the trustee is no longer in total control of the property.

exist as with real estate, especially if the trustee cannot control the business's dividend or distribution policy. And there may well, and probably would be restrictions on disposition of such interest by the trustee, even if there were a market.

d. Limited Partnership Interests

While a form of a closely held business interest, this type of asset has even more valuation problems and if all the trustee holds is an assignee interest, the problems are even greater. Again, since the trustee may be unable to sell the asset, and cannot even influence distributions, how can it meet a mandatory distribution standard?[16]

5. Difficulty of Administration

While the advocates of unitrusts argue that simplicity in administration is an attribute, these trusts are, in reality, somewhat difficult to administer even without hard to value assets, in that the trustee must be very careful in the valuation of the assets in a unitrust or the calculation of the annuity interest. Further, because of the inflexibility of distributions, the trustee must carefully monitor the trust and adjust investments so that the cash flow to pay the fixed distributions in a unitrust can be maintained without jeopardizing the future value of the trust. Since the distribution policy must drive the asset allocation, the trustee must consistently monitor the investments to assure the ability to meet the fixed requirements of a unitrust or annuity trust.[17] And this, in turn, may impair the ability of the trustee to invest for overall return.

VI. SOME BASIC FALLACIES IN THE RUSH TO FIXED RETURN UNITRUSTS

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[16]And, if the unitrust is used as the main default drafting technique, what happens if the FLP is formed after the Will is executed, but the terms of the Will are not reconsidered?

[17]Collins, at 269.

A. The Theory is Untested

All of the *sturm und drang* surrounding the use of the unitrust has arisen over the last few years. Thus, the unitrusts created are largely non-operational, and, if operational, have been in existence for only a short period of time. Thus, it is far too early to say with any certainty how these trusts will operate over a long period of time. I realize that this argument is advanced against any new or different technique, and that, if new techniques were not tried, there could be no progress. However, I believe that the analysis has been basically in the economic area and has been based upon economic projections which may prove overly optimistic in the medium term. More importantly, the analyses have been done with little or no regard to the human component of trust distributions.

B. Trusts That Are Invested the Same Way Produce the Same Result

Almost all the illustrations which are used to demonstrate the superiority of investment performance of the TRU assume that the unitrust (because there is no need to invest to produce income) will be a largely equity based portfolio, while the "all income" trust (because of the "need" to produce income) will be invested at least one half in fixed income which will not increase in value, and thus the unitrust will outperform the all income trust. This is only true if the trust provides for no principal distributions (and some relief such as UPAIA §104) is not available. If the trustee has discretion to distribute principal to the income beneficiary, then the trustee is free to invest for overall return. **No matter what the distribution standard, two trusts invested in the same manner will produce the same *investment* results.** The two trusts will not perform identically over the long term because the distributions will be different, but there is no way to compare such performance, and it should vary from trust to trust in any event

because of differences in the goals of the trust and the situations of the beneficiaries.

C. Ignores Human Nature

One of the arguments for the unitrust, as noted above, is that all classes of beneficiaries prosper or suffer together and thereby peace and harmony will reign, the income beneficiary lion will lie down with the remainderman lamb, and all beneficiaries will beat their swords into plowshares and their spears into pruning hooks. Of course, this ignores a basic tenet of human behavior – greed is a stronger force than gravity. Or, put another way, envy of what someone else is getting is often more important than what the recipient is getting.

D. <u>Even in Bull Markets the Unitrust May Not Hum</u>.

Advocates of the unitrust say that while there may be some difficulties in a down market,[18] there is no doubt that a bull market will produce only happy beneficiaries as the distributions and the value of the trust both rise. I submit that the following scenario is not only reasonably possible, but reasonably probable: Assume bull markets such as the last 5 years of the 20th Century, and that in that time span the value of a $3,000,000 portfolio increased in year one to $3,750,000, while the 4% beneficiary's distribution increased from $120,000 to $150,000. And in year two, the portfolio increased from $3,750,000 to $4,5000,00, again producing a $30,000 increase in annual distributions. Now, the beneficiary looks around and says to the trustee, "In the last two years the portfolio has increased by $1.5 million, and I got a lousy $60,000 increase in distributions. I'm not going to live forever you know, so I want more of the gravy now." (Never mind that the beneficiary got 4% of the increase in value.) The flip side, of course, is that in a bear market the current beneficiary is likely to ask, "Just because the value

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[18]Q.E.D.

of the trust went down, why should I suffer?" Somehow, I doubt that the trustee's explanation that it is following the trust design will suffice, any more than the explanation that the trustee cannot distribute more than the HEMS standard in a trust employing that standard satisfies the income beneficiary.

VII. THE ECONOMICS OF THE UNITRUST

There are several potential designs for total return trusts, as set forth below in the drafting examples. Each of these designs, of course, has its own economic effects, but there are some general propositions which can be applied to all. This section seeks to examine the general types of total return trusts, along with certain economic effects.

A. Types of Trusts

The total return trusts fall generally into five categories.

1. <u>Unitrusts</u>

The distribution, or payout, is tied to the market value of this type of trust, usually at annual intervals. In order to avoid extreme short term swings, it is generally suggested by the proponents of this trust that some average over a period of time be used to create a "smoothing" effect. Generally, such terms are three to five years.

2. <u>Fixed Payout Trusts not Tied to Value or Market Averages</u>

The annuity trust has the advantage of predictability and does not tie distributions to the current value of the trust. As noted earlier, distributions from this type of trust are almost always counter-cyclical, and, in a prolonged downturn, could impair the viability of the trust.

3. <u>Trusts With a Discretionary Distribution Standard</u>.

These types of trust divide into basically four types: (i) purely discretionary, (ii)

mandatory income with pure discretion as to principal, (iii) mandatory income with discretionary principal distributions limited to a standard such as HEMS, and (iv) discretionary income and principal limited to an ascertainable standard. In each of these cases, the trustee can invest for overall return because it has the flexibility to make discretionary distributions. A discretionary payout with a cap based on value might have some of the best (or perhaps the worst) attributes of the variations on fixed payout trusts.

4. Fixed Payout Based on Market Averages[19]

James P. Garland, while purporting to argue against unitrusts, is really only opposed to the fixed percentage of market value unitrusts. He actually favors the unitrust approach, but with a formula tied to market performance. He argues that spending tied to value places the ability to provide for the income beneficiary beyond control of the trustee, since it cannot control market fluctuations. In fact, two bad results will accrue if the fixed percent of value unitrust is used because of the desire of a trustee to avoid substantial swings in trust distributions: (i) practical considerations will force a trustee away from more equities, and (ii) the trustees will engage in market timing, a proven failure under modern investing standards. Finally, although troughs have been of relatively short durations in recent years, the market has historically experienced troughs as long as 10 years, and even longer if adjusted for inflation. (And we could be in one of those now.) Therefore, Garland champions a payout based upon some percentage of earnings on the S&P 500 plus the real bond yield (perhaps averaged over some short period) of mid-term

[19] This idea is vigorously supported by James P. Garland, who has set out his position clearly and eloquently in Garland, "The Problems with Unitrusts," The Journal of Private Portfolio Management, Vol. I, No. 4, Spring, 1999. A helpful source of references is included at the end of the article for those interested in delving more deeply into this morass. Note, however, that Mr. Garland works primarily in the not-for-profit market, where predictability is a greater virtue than instant gratification.

treasury bonds. "Real bond yield" is the stated interest rate on the bond less inflation; *e.g.,* If the stated interest is 5%, and inflation is 3%, then the real bond yield is 2%. By tying the return to earnings in the market place, fluctuations are smoothed. And that is the basic argument for this approach -- that the amount of real dollars received by the income beneficiary is predictable, even though the percent of value approach could have produced much more in bull markets such as we enjoyed in the not (yet) too distant past.

5. The "Give-Me-Five" Trust.

Jerry Horn is a staunch advocate of the "Give-Me-Five" approach to distributions in which the current beneficiary is given the right to draw down up to 5% of the value of the trust, the 5% number being based on Code §2041(b) which allows the lapse of a general power over 5% of a trust without any adverse transfer tax results. Mr. Horn bases this approach on the surmise that most clients would leave property outright if given a choice, but there are real asset protection, tax and other benefits to the use of trusts. Therefore, the trust should come as close to outright ownership as possible. He argues, as do I, that the unitrust or annuity trust approach is too inflexible, and this approach is his answer as to how to let the trustee invest for total return and still maintain the desired flexibility. The pros and cons will be discussed below in the drafting section. From an economic standpoint, this approach at least lets the beneficiary determine how much the payout from the trust should be.

B. Economic Considerations

In contemplating the efficacy of a fixed percent of market value unitrust, there are certain economic realties and problems to be considered, some of which may not be too obvious. These arguments are succinctly summarized by David Levine and are attached hereto as Appendix C.

1. History as a Predictor

A centerpiece of the arguments as to the type of unitrust, the spending policies and the efficacy of such policies is the debate as to the reliability of history as a predictor. If, for instance, dividend policies of the past could be arithmetically applied to the future, dividend yields would eventually go to zero, and price/earnings ratios would go to 300%. In that environment, a fixed percent of value unitrust would continue to work well. But remember that a fall in prices has historically produced a higher dividend yield as a percent of value. But prices have been falling for over two years now, and not only have dividend yields as a percent of value not risen, actual dividends have been reduced or eliminated.

While I believe that historical trends can be useful in certain areas, I also believe that they are valid only in the short run.

> Electing a distribution formula based primarily on successful historical results is not a good decision....When suggested distribution formulae are back tested against historical results, the methodological flaw is known as "data mining."[20]

The one certainty is that things will change. This belief that history is not an accurate predictor is the very heart and soul of the Random Walk theory.

2. Use of Averages in Projections

In the vast majority of projections I have seen of the long-term effects of the unitrust, an assumed growth rate has been used to illustrate the results of the unitrust over a long period of time. Because of this, the illustration is at best misleading, since the growth will not be steady, but, rather, it will be cyclical. Thus, to fully understand the effects of the unitrust, projections should contain some periods of higher return and some of lower than the average anticipated

[20]Collins, at 245.

long term growth. While the projections will undoubtedly not be accurate as to the timing of the cycles, it will demonstrate the distribution swings that the beneficiary can expect and the effect of such swings on the long term prospects of the trust.

Dramatic illustrations of the effects of market cycles are provided in Appendix D-1 through D-4. These Exhibits are reprinted with permission from a presentation by Robert Weiss, CFA, Director of the Wealth Management Group at Bernstein Investment Research and Management. Exhibit D-1indicates that smoothing can statistically limit the annual decline in income of 10% or more to once in only 17 years, but as noted on Exhibit D-2, it cannot reduce the effect of market cycles. And so, with one market cycle assumption, there is incredibale volatility in distributions. Exhibit D-3 illustrates the effect on distributions of a reverse assumption. Note that in either trial, the portfolio ends up in the same place (although that is clearly not an inevitable result), but the effect on the beneficiary's income is dramatically different. Exhibit D-4 is, in Mr. Weiss's words, "the ugliest chart that Bernstein has ever produced." It demonstrates multiple market cycles, and shows that distributions even in a smoothed unitrust environment can be all over the lot. And, the fact that 59% of trials experienced a decline in 30% from initial distributions is nothing short of stunning. This raises the issue as to how well yhis fixed distribution formula takes the trustee out of the middle and satisfies both classes of beneficiaries.

Projections without the cyclical calculations demonstrate a fallacy referred to as the "expected value" fallacy. That fallacy postulates that, based on historical data, bad years will be offset by good years and, therefore, wealth accumulations and portfolio distribution will remain on track.

> Consider, for example, an intoxicated person wandering down the middle of the road. As he progresses, he wanders outside of the double yellow lines (the zone of safety). Sometimes he stumbles to the left (into oncoming traffic) and sometimes to the right (also into traffic). The average position of the intoxicated person is in the safety zone. However, the average physical state of the intoxicated person...is injury or death.[21]

These principles are illustrated by the graphs attached as Appendix B-1 through Appendix B-12.[22] These graphs use a three year smoothing formula and assume that capital gains are paid from the trust and are not distributed as DNI. They are based upon two investment paradigms – an all equity fund represented by the S & P 500, and a "balanced" 60% equity (represented by the S&P 500)-40% bond (represented by the Lehman Bros. intermediate bond index) mix. There are three time periods shown, and it is particularly interesting to note the impact of the bull market of the last five years of the twentieth century, the beginning effects of the bear market of this millennium, and the difference that the time period chosen makes.

Utilizing the almost 30 year time period from 1973 through 2002, with a three year smoothing, Appendix B-1 illustrates the distributions to the beneficiary based upon actual S&P performance versus average performance.[23] For most of the period, the actual performance distributions trailed the compounded average of 10.66% (down from 12.01% for 1973 to 2001), but in 1997, after the lower years disappeared from the smoothing base, the actual returns from the bull market of that period surpassed the average. The same is true of the account balance

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[21] *Id.,* at 282-3.

[22] The illustrations use nominal rather than real returns. The author is indebted to the Kentor Company, Austin, Texas for its assistance in preparing these graphs.

[23] Appendix B-13 demonstrates theat distributions are even more volatile without the three year smoothing. Overall distributions with smoothing are about 8% less, and the distribution in an unsmoothed scenario is 30% less than with smoothing.

illustrated in Appendix B-2. The actual account balance starts to exceed the average account balance in 1994. But, note that the drop in 2000 through 2002 was steep enough to bring the actual year end value below the average again. This is an accurate predictor of what will happen to distributions when the bull market years drop out of the smoothing formula. And, even though the actual total distributions to the beneficiary over that period *total* more than the illustrated returns using the compound average by a little less than 8%, the beneficiary's actual distributions trail the average distributions by a substantial amount in many years.

The balanced portfolio follows much the same parameters, although the returns are less volatile, but ending balances are substantially less. (*See* Appendix B-3 and B-4).

The 20 year period beginning in 1983 shows, not surprisingly, the same results as the longer period, although the compounding rate of 12.71% (down from 15.24% in the 1982-2001 period, illustrating again the effect of market cycles) skews the results a little bit more. (See Appendices B-4 to B-8.)

If, however, we choose the 20 year period from 1973-1992 in which the average S&P compound rate is 11.33%, then actual distributions *always* trail the averages. This is also true in the balanced portfolio model. (*See* Appendices B-9 to B-12.)

So what do all these numbers mean other than that many of us who write in this area love to put charts together. (Truth be told, I am not really that fond of doing economic modeling, so I persuaded The Kentor Company in Austin, Texas to do the modeling for me.) The bottom line is that the period chosen and the indices chosen dramatically impact the results, and that averages almost always vary from actual. As noted by Collins, the beneficiary cannot rely on averages. He or she must live year to year with the actual results.

3. Volatility

Using a 60-40 asset allocation, there is wide fluctuation of the return to the beneficiary in real dollars. Mr. Garland, in the article cited earlier, measured the spending from a 5% market value unitrust from 1951 through 1998. In 1951 dollars, such spending ranged from $1 in 1951 to $1.84 in 1986, to $0.756 in 1981, and back to $1.938 in the bull market of 1998 (before the dip experienced in 1999). Using a market return of 125% of the earnings of the S&P 500 companies only, the volatility was from a high of $1.385 in 1966 to a low of $0.931 in 1986 and $1.136 in 1998. So, if the desire is for stability, the earnings model is much more predictable than the percent of market value.[24]

Mr. Garland's analysis demonstrates even more volatility as the portfolio tends toward a greater percent of equities. The return is always higher in the 80% to 100% equity mode, but a good deal more volatile. Volatility can be better tolerated so long as everything goes up, especially in nominal terms which would produce even more dramatic results. However, in a sustained drop involving a fixed return unitrust based upon a percentage of value, problems will invariably develop.

> Indeed,...the formula fails to fulfill the grantor's objectives with respect to the remainderman in approximately 18% of the trials. On average, the formula works. However, the remainder beneficiary cannot rely on the average result and must accept the actual result.[25]

4. Inability to Protect the Real Value

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[24]This illustration was developed in connection with expenditures by non-profits from endowments and thus ignores the effect of income taxes. There is a greater virtue in predictability in the non-profit arena, but it is achieved by failing to take advantage of upswings in the market to increase distributions. In the private sector, the beneficiary likes the increase in an up market.

[25]Collins, at 251.

In addition to volatility in distributions, using the 60%-40% model and taking into account administrative costs, taxes and inflation, a requirement to distribute all the income will cause a real long term loss in value in the income stream and in the value of the trust estate. In real terms, two economists calculated that the value of $1,000,000 invested in 1960 would be worth only $677,000 in 1995, and the real income in 1960 dollars from that amount would have dropped from $25,000 to $22,000.[26] Using the greater of all income or a 4% mandatory payout[27] may cause the trust to lose enough value that it will expire during its term and prior to the termination date stated in the instrument, depending upon its net after tax return. Thus, the all income or mandatory fixed percent unitrust may not protect either the remainderman or the income beneficiary, and putting the two standards together only exacerbates the problem.

> **AUTHOR'S NOTE:** Messrs. Hertog's and Levine's study concluded in 1995 and thus does not include the phenomenal upward spiral of the market in the succeeding five years. However, as we have learned since the spring of 2000, and, as the Random Walk theory would confirm, past price trends are not necessarily a predictor of future price trends. Thus, while the Hertog-Levine study results would clearly have been different in the 1995-2000 period, that period may not be reflective of the future.

5. <u>"Excess" Distributions of Bond Interest</u>

Some economists argue that bond interest reflects not only real return but in part a payback on inflation. Bonds are valuable in a portfolio in that they decrease volatility and provide a more stable return than do stocks. So long as the stated rate of bond interest is higher

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[26]Hertog and Levine, "Income versus Wealth: Making the Trade Off," *5-1 The Journal of Investing 1*, (Spring 1996)

[27]This formula was often advocated to meet QTIP requirements. The Proposed Regulations under §643(b) will allow a fixed return unitrust to meet the "all income" requirement in states which adopt a unitrust statute. *See* discussion of the Proposed Regulations below.

than the unitrust amount, the excess of the stated rate over the unitrust amount is "automatically" plowed back into principal or capital. However, this proposition only holds true if the value of the bond is at par or below. If, because of lower interest rates on newer bonds the value is in excess of par, then more than the stated interest rate would be paid out as the unitrust amount. Assume a 4% unitrust rate and a $10,000 municipal bond with a rate of 5%. The unitrust amount would be $100 less than the trust received, therefore allowing that $100 to be reinvested. However, if the bond were valued at a 25% premium ($12,500) or higher, the payout would be equal to or greater than the amount received. This might force the trustee to sell the bond to realize the premium and reinvest at a lower rate, which might again force the unitrust payout to be greater than the stated rate.

6. <u>A Summary of the Effects of the Various Policies</u>

Mr. Levine has prepared a summary showing the effects of the various types of distribution formulae. While Mr. Wolf disagrees with the formulation, it is an interesting exercise. The analysis is part of Appendix C-1, including the Unstressed and Stressed scenarios.[28] Both illustrations are expressed in real (*i.e.,* inflation adjusted) dollars. "Modified Garland" is the Garland approach wherein interest returns are adjusted for inflation. The calculation as to when the trust goes broke, assumes that the trustee has the power to invade in excess of the fixed distribution, and exercises that discretion to maintain the spending power of the dollar. None of these will reduce to zero without that consideration.

In analyzing the Unstressed scenario, a 60-40 mix of equities and fixed income closely

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[28]The boxes on the Unstressed illustration indicates corrections made from previously distributed projections.

approximates the Modified Garland +1% results. Obviously in the 100% equities scenario, the all income beneficiary fares substantially worse, and the Modified Garland +2% approximates the 2½% unitrust.

The stressed scenario postulates a first year bear market with a 70% loss in value,[29] a first year rise in interest rates of 4% and a rise in inflation of 3% from 2.4% to 5.4%. (We can all agree that this is a great deal of "stress"). The important part of this analysis is that the value of the trust decreases dramatically using the 4% unitrust. Note that while the decline in value is occurring today (although not quite at 70% in one year) the accompanying rise in inflation and interest rates has not occurred. This also represents a new phenomenon.

VIII. ACCOMPLISHMENT OF CLIENT'S OBJECTIVE AND SOME SURPRISING THINGS YOU MAY NOT HAVE THOUGHT ABOUT

As stated earlier, and the proposition cannot be restated too often, the primary consideration in drafting a trust is to meet the client's objectives. The corollary to that, of course, is that the client must understand the effect of the trust design chosen. The advocates of total return unitrusts point out that all income formulations are almost certain not to meet client objectives and to create tension between the income beneficiary and the remainder beneficiary. Further, they argue, all income formulations (i) practically assure that the trustee's investment philosophy will focus more on increasing current return than on overall return and (ii) put the trustee at a disadvantage in maximizing return. The discretionary trust, while allowing investment for overall return, still creates tension between the temporal and permanent interests.

A. Focus Should Be on the "Real" Beneficiary

[29] Not so long ago, this magnitude of drop in value would have seemed not only improbable, but even impossible. Once again, history has not proved to be a reliable predictor.

Remember that the underlying philosophy of the unitrust is to assure certain benefits to the current beneficiary <u>and</u> have some left over for the remainderman. So, the first step in designing the trust is to determine whether that assumption accurately reflect's the testator's wishes. In many cases, the testator may desire to benefit the current beneficiary without regard to the interests of later beneficiaries; *e.g.*, the first spouse to die may wish to provide lavishly for the survivor, and whatever is left for the children, they are welcome to. In other instances, it may be the desire of the testator to prefer preservation of corpus for the next generation, while providing for the current beneficiary only to the extent that the primary objective is not impaired; *e.g.,* one spouse may wish to provide assistance for a surviving second spouse, but assure that the children of the first spouse have a substantial portion of the assets left to enjoy. It is almost impossible to extend the distribution standard beyond the beneficiary or beneficiaries for whom the trust was created because of the impossibility to predict with any degree of certainty future economic conditions, both macro and in the case of an individual beneficiary. While it may be possible to determine spending objectives through the child's generation, it certainly is not realistic to try to formulate spending to the generation beyond that.

So, even in drafting a unitrust formula for a dynasty type trust, the draftsman may still be faced with the task of determining distribution standards for future generations. There is, it appears to me, a certain logical inconsistency in advocating unitrusts because they hone in on the settlor's concrete desire to provide a specific type of benefit for the current beneficiary and then extend that specific desire to future generations whose needs may be entirely different. Thus, in a dynasty trust, at least two different spending formulae may need to be considered.

1. <u>Understanding the Difference Between Distributions, Spending and Return</u>

"Return" is the amount earned by the trust, and total return includes both income and realized and unrealized capital gains. "Distributions" are the amount distributed to the beneficiary. "Spending" is the actual amount available to be spent after taxes and costs, and may be applied at both the trust and beneficiary level, depending upon allocation of expenses and taxes. For example, if the grantor or the trustee allocates capital gains to the trust, and if a portion of the 4% distribution is capital gains, the spending by the beneficiary is increased because a portion is free from tax. Likewise, the spending by the trust has increased beyond 4%. The converse is true if the capital gains are included in distributable net income. Although the beneficiary receives the same amount of dollars, he or she has less available to spend because of the allocation of taxes. This is an extremely important concept in drafting fixed percent unitrust provisions.

2. Understanding Whether the Client's Desires Can be Met

Once the spending desires are determined, the next point in the analysis is whether the client's expectations can be met. This involves projecting whether the trust can reasonably sustain the spending desired by the settlor. It is possible, if these projections are not carefully done, that the trust will not be able to sustain the spending even during the life expectancy of the current beneficiary. If under the plan ultimately adopted, the trustee is expected to exercise its discretion in such a manner as to substantially diminish the trust during the life of the current beneficiary, that should be specifically noted in the trust instrument so that the trustee can feel comfortable in so doing. A general provision to prefer the current beneficiary may not be sufficient. A suggested provision might be as follows:

> I have given consideration as to the benefits to be conferred under this

> trust, and my desire is to benefit my children in the manner stated without regard to the interest of more remote beneficiaries. In fact, I recognize that the distribution directions may well deplete the trust in its entirety, and I direct the trustee to invest with a view to being able to maintain such distributions during the life of my child without regard to the preservation of assets beyond the life of my child. The trustee shall have no liability to more remote beneficiaries for following such direction.

3. Real Returns

The formula must take into account that the client probably desires to maintain the spending in terms of real dollars -- dollars that take inflation (or deflation) into account. The total return trust clauses below do make such adjustments for inflation in an annuity context, but rely on valuation to automatically adjust returns in percentage of value unitrust formulae.

4. Costs

It is very easy to ignore the effect of costs on the anticipated return. Taking into account the effect of compounding, such very real and expensive factors cannot be ignored. In fact, their effect on the overall return can be staggering.

> During the period 1926-1997, the compound mean annual return of large capitalization U.S. stocks as represented by the S&P 500 stocks, after inflation (which ran at a compound annual rate of 3.1%), was 7.9% and for smaller companies 9.6%. A 1% annual management fee that was not offset by at least some increase in investment return would have reduced this average large capitalization equity return (after inflation) by about 12% and the average smaller capitalization equity return by something on the order of 10%.
>
> Over the last 25 years, a 10%-12% lower compound annual return reduced ending real wealth by about 20%.[30]

As noted above, whether taxes (a very real cost) are allocated to the current beneficiary or to the trust can also dramatically affect returns.

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[30]William L. Hoisington, *Modern Trust Designs,*© 1999 which was an update and expansion of his article for the Heckerling Institute, cited *supra*.

B. The One Thing the Beneficiary of a 4% Unitrust Never Gets is 4%.

One of the principal things the client must understand is that the distribution from the unitrust after the initial period will never be the stated percent if smoothing is used, if capital gains taxes are allocated to the beneficiary or, in some cases, if distributions are made in kind. This phenomenon is relatively easily understood upon a small amount of reflection.

1. Effect of Smoothing

If the unitrust percentage is applied to an average (three or five years being the most commonly used), then by definition the beneficiary will *not* receive 4% of the present value of the trust. When the value of the trust is increasing, the growth in the beneficiary's distribution lags behind the growth in the value of the trust. Conversely, as the value of the trust trends downward, the beneficiary's distribution will not decrease as rapidly as the value of the trust is declining. Depending upon the length and steepness of the decline, the trust may be dissipated at a very rapid rate, thereby causing a diminution in value which will impair future distributions and the remaining value of the trust. See ¶VII.B.2, above, "Use of Averages in Projections," and the accompanying graphs.

2. Effect of Tax Allocation.

If capital gains taxes are allocated to DNI, then the value of the trust is increased, increasing the annual distributions. However, the real effect may be to reduce the spending by the beneficiary, because while the beneficiary is receiving more funds, he or she will have to pay more taxes. If the taxes are paid by the trust, then over a long period of time, even assuming a very low turnover, the payment of taxes can substantially affect the ending value of the trust. (*See* Appendix B-14 and B-15.)

IX. LEGISLATIVE APPROACHES IN GENERAL

As of the date of this writing 38 states have adopted UPIA, so that it is clear that the Prudent Investor Rule in Restatement of the Law of Trusts, Third, is the law in most jurisdictions. However, the adoption of UPIA will not solve the problems with existing trusts in light of modern portfolio theory. It also will not deal with the multitude of trusts which will be drafted after its passage either because the tax laws will still require all income formulations, or just because of inertia in changing forms. Remember that the proposed regulations under §643(b) only expand the definition of income. They do not change the statutory all income requirement, and they are not effective until final.[31]

In order to deal with existing trusts and provide flexibility for trusts in the future, there are two basic and non-exclusive legislative approaches being taken, an opt-in unitrust[32] and UPAIA's §104[33] creating a trustee's right to reallocate between income and principal. These approaches are not mutually exclusive. The application of UPAIA §104 allowing the trustee to reallocate what would be characterized as principal receipts to income, and *vice versa,* ***concerns only trusts which mandate distributions in terms of income, and have a trustee other than the beneficiary making such reallocations.*** If a trustee wants to opt into the statutory unitrust, a

[31]As of the date of this writing, the Regulations have not been finalized even though that was expected prior to the end of 2002.

[32]As of the date of this writing, 13 states have passed statutes dealing with opt-in unitrusts, and 3 states have unitrust "safe harbors". 3 other states are considering unitrust and §104 legislation together.

[33]As of the date of this writing, UPAIA §104 has been adopted in 30 states, and is being considered for adoption in 2 other jurisdictions. In some jurisdictions, UPAIA has been adopted without §104, and in others, such as Alabama, §104 has been made applicable only to trusts created after the effective date.

trustee must, ***as a practical matter***, seek approval from the beneficiaries or the Court. (Many statutes give the trustee the ability to opt in or out in its discretion, but I believe that would take a very brave trustee.)

X. UPAIA

UPAIA deals with the mandatory income trust with no invasion power (or a limited invasion power) by allowing the trustee to reallocate receipts between income and principal. While it is easy in this environment to assume that receipts normally a part of principal will be reallocated to income, in other times receipts that are normally income could be reallocated to principal.

A. The Power to Reallocate

Section 104 is the answer of the National Conference of Commissioners on Uniform State Laws to the problem of how the trustee can be impartial and invest for overall return while being mandated to pay all the income of the trust to the income beneficiary. ***Remember that this power to reallocate is not a panacea for existing trusts since it is not available if the trustee is the beneficiary.***

1. Trustee's Power to Reallocate -- UPAIA §104

The proposed statute would give a trustee the power to "adjust between principal and income to the extent the trustee considers advisable to enable the trustee to make *appropriate present and future distributions*...." (The italicized language is the standard under the Uniform Prudent Investor Act.) To invoke this power, (i) the prudent investor rule must apply to the trust, (ii) the trust must describe distributions in terms of income, (iii) the trustee must determine that such adjustment would be fair and reasonable, and (iv) such reallocation must give the income

beneficiary use consistent with preservation of the property. The Act also lists factors that the Trustee is to consider in making such reallocation:

a. the nature, purpose and duration of the trust;

b. the intent of the creator of the trust;

c. the identity and circumstances of the beneficiary;

d. the need for liquidity, regularity of payment, and preservation and appreciation of capital;

e. the assets held in the trust and their uses by the beneficiary;

f. the net amount allocated to income under the other sections of UPAIA and the increase or decrease in the value of the principal assets;

g. whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

h. the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

i. the anticipated tax consequences of an adjustment.

2. <u>Exception to Trustee's Power to Reallocate</u>

The trustee may not make an adjustment:

a. that diminishes the income interest for which the marital deduction would be allowed if the trustee did not have the power to make such adjustment;

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

c. that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the assets;

d. from any amount that is permanently set aside for charitable purposes, unless income and principal are so set aside;

e. if the holding or exercise of the power would cause the trust to be a grantor trust;

f. if possessing the power would cause estate tax inclusion in the estate of a person possessing the power to remove and replace the trustee;

g. ***if the trustee is a beneficiary*** (emphasis added); or

h. if the beneficiary is not the trustee, but the trustee would benefit directly or indirectly.

A trustee may release the power to reallocate if continuing to hold the power would produce a detrimental tax effect.

Note that the emphasized phrase is very important in limiting the applicability of this section since spouses are often the trustee of QTIP trusts.

3. Application to Existing Trusts

Since UPAIA applies to existing trusts from the date of its enactment, if the trust is governed by that Act and provides for distributions based upon income, the reallocation provisions will *not* be negated by a prohibition against invasion of principal or a bar against equitable adjustments. UPAIA is applicable to all trusts whether created on or after the effective date, unless specifically made inapplicable by the terms of the instrument or court decree.

4. Judicial Control of Discretionary Powers -- New UPAIA §105

A new §105 of UPAIA was adopted by the National Conference of Commissioners on Uniform State Laws at their August, 2000, meeting in order to make it clear, as the commentary

to that section states, that the discretionary powers in UPAIA (and specifically the power under §104) "are subject to the normal rules that govern a fiduciary's exercise of discretion." The rule referred to is that a court should review the exercise of discretion by the trustee on the basis of whether such exercise constitutes an abuse of discretion, and not whether the court might have exercised the discretion differently. The comments also make clear that the trustee must demonstrate that it exercised discretion after consideration of relevant factors. Mere inaction is failure to exercise discretion, not abuse of discretion, and therefore is not subject to the rule, citing Comment *b*, §50 of the Restatement of the Law of Trusts, Third.

The remedies prescribed are first to make adjustments within the trust among the beneficiaries, and if it is not possible to do this, the trustee may be required to pay the beneficiaries and/or the trust to make everyone whole.

The trustee has the authority to apply to the court <u>prior to</u> taking any action to determine whether its action would be an abuse of discretion; *i.e.,* to seek an advisory opinion. If the petition makes sufficient disclosure, the burden of proving an abuse of discretion is on the beneficiary asserting the abuse, an almost impossible burden.

There is some thought that this section was promulgated to stop the adoption of "notice" provisions, first adopted in California and now adopted by reputedly as many as eight other states. *See* California Probate Code §16337. These notice provisions are even worse than UPAIA §105, in that they provide that if none of the beneficiaries objects to the reallocation, the reallocation cannot be an abuse of discretion. (Note that no funds are delivered to the beneficiary to obtain counsel, and the trustee gets to pay for this protection with trust funds.)

In justifying UPAIA §105 and/or the notice provision, corporate trustees argue that §104

creates a new kind of discretion with inherent dangers for trustees in exercising these powers with no protection. I would submit that the Act simply provides an additional way for a trustee to exercise a standard form of discretion, but hardly a new one. In discretionary trusts, trustees exercise this discretion all the time. And even in income trusts, trustees exercise the same kind of discretion, albeit in the investments selected rather than in the amount of distributions. The purpose of §104 was to find a way for the prudent investor rule to apply to all income trusts, not to create a whole new area of discretion.

5. Will Trustees Exercise This Discretion?

Proponents of the power of reallocation argue that this power is no different than the other discretionary powers trustees exercise in invading principal or in determining income distributions in a discretionary environment. The trustee's willingness to exercise is obviously influenced by its perception of the purposes of the trust.

a. Trust Is Silent

Perhaps, the most obvious situation is that in which the trust is simply silent as to invasion of principal. There, it would seem the trustee has a real basis for exercising this discretion. Absent language in the trust to the contrary, it is reasonable to believe that the creator of the trust would have wanted a sufficient amount of income to pass to the beneficiary and at the same time preserve the principal. The ability to invest for total return and still provide for the income beneficiary would seem almost to demand the exercise of this discretion. After all, the alternative is to invest to produce a sufficient amount of income at the expense of overall return.

b. Trust Prohibits Invasion of Principal

While on the surface it may seem that the trustee should not exercise discretion in this type of trust, the same reasons appertain as in the trust that is silent; *i.e.,* absent a contrary indication in the instrument, the trustee must, in the exercise of its duty of impartiality, invest to produce a sufficient return for the income beneficiary, thereby potentially sacrificing a better overall return. An exercise of the ability to reallocate solves this problem and should not be seen as a prohibited invasion of principal.

c. Trust Provides for HEMS Standard

If the trust provides for principal invasion subject to a standard, and if the income beneficiary does not need such principal distributions, then should the trustee reallocate? Again, absent some guidance in the instrument, the trustee may choose to exercise the §104 power to satisfy its duty of impartiality. Once again, the issue is whether it is better to invest for overall return, and that has been decided by the adoption of UPIA, a prerequisite to the application of §104.

Analyzed in this manner, the choice is not how much the income beneficiary gets, but whether the trust should be invested for overall return in accordance with the law of the state. The inclusion of §104 has met with resistance in some states considering the adoption of UPAIA, and §105 is obviously designed to ease the passage of §104 in those states in which corporate trustees can persuade the legislature that they should be protected in exercising discretion which they are compensated to exercise.

6. How Will the Trustee Exercise This Discretion?

If the trustee is willing to exercise the discretion under UPAIA §104, how will the trustee exercise the discretion? One option is for the trustee to wait until the end of the year, see what

the actual income is and then adjust to what it deems to be a fair return for the beneficiary in whose favor the adjustment is made. However, that is a little cumbersome, but quarterly adjustments might not work a lot better. Another approach is to project the income and overall return for the year, and make adjustments off the projections. That might be a little risky in a volatile or downward trending market.

The approach most likely to be adopted by the trustee is a unitrust approach, with the percentage determined at or near the beginning of the year based on closing values for the preceding year as determined by the trustee. This is certainly easier than the mandated unitrust because the flexibility is so much greater since the trustee is not bound by a mandated formula. However, will the trustee, having once determined a unitrust percentage for one year, carefully review that percentage every year? Or will the trustee in effect use the reallocation power simply to convert the trust to a unitrust? This approach (as with the more formal unitrust) will not work very well with trusts containing non-financial assets.

XI. STATE UNITRUST CONVERSION STATUTES

As noted above, 13 states have adopted statutes which allow the conversion of an all income trust to a unitrust either upon action by the trustee or requests by the beneficiary. This approach is thought to solve the problem when UPAIA §104 is not available, and, also, arguably, provides all of the benefits as if the grantor had been far sighted enough to draft a unitrust in the first place. The proposed §643(b) Regulations, and their expected promulgation as final regulations, has added impetus to this rush by several states to enact unitrust conversion

statutes.[31]

A. New York's Initial Attempt

New York, while not the first state to adopt a unitrust conversion statute, was the first state to seriously consider so doing, and clearly provided the basis for the present wave of statutes. In connection with New York's desire to adopt the prudent investor rule, a statute was proposed that would establish a 4% fixed income unitrust ***as a default*** rule; *i.e.,* if the trust provided that the trustee was to distribute all the income to the beneficiary, that would be interpreted to mean that the trustee was required to distribute 4% of the value of the trust. This could only be overridden by specific direction in the instrument. After that initial recommendation met with some serious opposition, the statute was changed in several key aspects, the most important of which is that the unitrust would become an opt-in rather than a default; *i.e.,* the unitrust approach would operate only if chosen by the trustee or directed by the court. The New York experience would lead me to believe that it would be very difficult in any jurisdiction to get the unitrust legislated in as a default provision.

B. The Variations Among States

A detailed analysis of the statutes of the various jurisdictions is beyond the scope of this paper, but there are clearly differences in approach and quality. For example, the New York statute is extremely detailed in both the terms of the trust and the procedures to be followed in converting. The Missouri statute is almost skeletal in comparison, and the Pennsylvania statute is somewhere in between. New Jersey has a "safe harbor" approach and Delaware allows a

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[31]Texas will probably take a different approach and enact a statute that will allow a unitrust, drafted as such, to qualify for the marital deduction upon the issuance of final regulations, but would not allow for conversion to a unitrust without following the trust modification procedures under existing law.

fluctuating amount. What all of these statutes (other than New York and possibly Pennsylvania) have in common is that they were cobbled together very quickly, there is not even an attempt at any kind of uniformity, and there certainly was not time between concept and enactment for a great deal of reflection. It will be interesting to see how, or if, these statutes are utilized and what the long term effect will be.[32]

C. Considerations Prior to Converting

The considerations as to whether to convert to a unitrust under the statute are much the same as those to be considered in deciding whether to use a unitrust originally.

1. Desire of the Beneficiaries

It would take a very bold trustee to decide to opt into a unitrust if at least the vast majority of most classes of beneficiaries do not agree. As discussed below, accurate projections of the effect of the conversion is of ultimate importance. And if the performance of the trust varies widely from the projections, the trustee can be almost certain that some beneficiaries are going to feel (allege?) that they were not given complete and accurate information.

2. Availability of UPAIA §104

If UPAIA §104 is available under state law, I believe that it is almost always better to use that approach rather than the conversion to a unitrust. As indicated above, the trustee will probably do the §104 reallocation so that the payout is essentially a unitrust payout, with the

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[32]As of the date of this writing, the following states have adopted unitrust conversion statutes: Delaware, Florida, Illinois, Indiana, Iowa, Maine, Maryland, Missouri, New Hampshire, New York, Pennsylvania, South Dakota, and Washington. New Jersey and Louisiana have adopted unitrust safe harbor statutes. Legislation (in conjunction with UPAIA) is pending in three other states. Note that the pace of adoption of unitrust conversion statutes has dropped dramatically. *See* Appendix E for a list of states which have adopted unitrust statutes (and §104 of UPAIA). This chart was prepared for ACTEC by Robert Wolf, an attorney in Pittsburgh, Pa.

major difference being that the trustee has the flexibility to change the percentage and even the approach to the reallocation or to stop the reallocation entirely if situations change.

3. Composition of the Trust

Oddly enough, the trust in which it may be most difficult to produce income is a trust which contains non-financial assets, and it is exactly those assets which are the most difficult to deal with in a unitrust context.

4. Projections

The trustee should run projections under several different scenarios. (We are now much wiser than to believe that the only scenario is always and consistently up.) It is very important that such projections be based on different returns for different periods rather than an average consistent growth rate. Even though the timing will not be accurate, the benefit of such variances is to show the beneficiary and the trustee the possible effects of different markets and that averages do not apply in the real world when distributions are made on an annual basis.

XII. THE IRS RESPONSE TO MODERN PORTFOLIO THEORY AND THE "ALL INCOME" TRUST

One of the major issues in the drafting of total return trusts is whether such trusts would meet the all income requirement for marital deduction trusts. This same issue surrounds the application of UPAIA §104. On February 15, 2001, the Service published Proposed Rules on Trust Income Definition.[33] These proposed regulations, according to the Summary, revise "the definition of income under section 643(b)...to take into account changes in the definition of trust accounting income under state laws." The proposed regulations also deal with capital gains as

[33]REG-106513-00, amending primarily Treas. Regs. §1.643(b)-1, but also making conforming amendments to other regulations.

a part of distributable net income ("DNI"), charitable issues, marital deduction issues, and generation skipping issues. The proposed regulations become effective on publication of final regulations in the Federal Register.

A. Amendment to Definition of Income.

The proposed regulations revising §1.643(b)-1 maintain the old position that trust provisions defining income which depart from accepted accounting procedures will not be recognized. The proposed regulations go on to provide:

> However, amounts allocated between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and the remainder beneficiaries of the total return trust for the year, including ordinary income, capital gains, and appreciation.

The proposed regulations then give the specific example of a 3%-5% unitrust[34] or "equitable adjustments" under state law. There are other requirements for the application of equitable adjustments:

(1) the trust is managed under the prudent investor rule;

(2) the trust describes distributions in terms of the income of the trust; and,

(3) the trustee, after applying the statutory rules regarding allocation of principal and income is unable to administer the trust impartially.

An allocation of capital gains to income is recognized if made pursuant to the terms of the governing instrument or local law, <u>or</u> "pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary." There is an interesting question as to how the

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[34]Although the proposed regulation refers specifically to a 3%-5% unitrust, this would also presumably apply to an annuity approach with an inflation adjustment provision. It should, logically, also apply to the Give-Me Five approach.

exercise can be "consistent" at least the first time it is exercised. Perhaps some statement of the intent to do so in the trust's records would be sufficient.

B. Capital Gains allocated to DNI and Capital Losses.

In addition to those situations in which capital gains are included in DNI under the existing regulations, the proposed regulation §1.643(a)-(3) permits capital gains to be included in DNI if so allocated by the fiduciary pursuant to a reasonable and consistent exercise of discretion in the following situations:

(1) allocated to income;

(2) allocated to corpus but treated as part of a distribution to a beneficiary; or

(3) allocated to corpus but used in determining the amount distributed or required to be distributed to a beneficiary.

Note that, in a unitrust, either the governing instrument must deal with the allocation of capital gains or the state statute must if there is a statutory opt in.

Capital losses are netted against capital gains at the trust level except for those used under (3) in determining the amount to be distributed to a particular beneficiary.

C. Distributions in Kind

Treas. Regs. §1.651(a)-2 is amended by adding a new subsection (d) which treats distributions in kind from an all income trust as a sale by the trust on the date of distribution, but permits a §651 deduction if no more than the amount of DNI is distributed. Treas. Regs. §1.661(a)-2(f) is substantially revised to provide that gain or loss is recognized by the trust or estate if property is distributed in kind in satisfaction of a requirement to distribute income currently.

D. Charitable Remainder Unitrust

There is a unique problem with Charitable Remainder Unitrusts ("CRUT") which use income as the measure of the unitrust amount. Federal law requires that the CRUT unitrust amount be not less than 5%. If a unitrust provides for payment of the lesser of the income of the CRUT or a defined unitrust amount, and if there is a state statute defining income as a unitrust amount of 4%, then the CRUT will fail to meet the 5% test since net income (as defined by statute) will always be less than the designated unitrust amount. The proposed regulations deal with this by requiring that the instrument contain its own definition of income which is consistent with the CRUT rules. Additionally, capital gains attributable to appreciation after its contribution to the trust may be allocated to income pursuant to the terms of the governing instrument and state law, but not in the discretion of the trustee.

E. Marital Deduction Provisions

Language is added in the proposed amendments to Treas. Regs. §20.2056(b)-5(f)(1) so that the all income requirement is met: "In addition,...if the spouse is entitled to income as defined by a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of section 1.643(b)-1 of this chapter."

Although comments on the Proposed Regulations have noted that a unitrust formula or an equitable allocation clause should be available to meet the all income test even if the state has not adopted a unitrust statute or UPAIA §104, the Service has indicated that is not the result under the proposed regulations, and probably will not be under the final regulations. Because of the specificity of the Proposed Regulations, will they override the more general test

concerning the all income requirement contained above in the Regulations? Remember, the Proposed Regulations say "in addition" to the other definitions of income.[35]

The prohibition against appointing QTIP property to a third party is not violated by a power conferred by state law to allocate between income and principal to meet the duty of impartiality by adding a sentence to the end of Treas. Regs. §20.2056(b)-7(d)(1).

Similar amendments are made with respect to gift tax marital deduction regulations.

F. GST Regulations

The GST regulations are amended to provide that the use of a unitrust or power to

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[35]In an earlier version of this paper, I analyzed the existing marital deduction regulations as follows:

If the definition is other than the long standing common law approach, will that satisfy the federal requirements? The only way to answer that question is to analyze the exact language of the Treasury Regulations. In determining whether a beneficiary has the "right to income" Treas. Regs. §20.2056(b)-5(f)(1) provides that such test is met:

> ...[I]f the effect of the trust is to give her [*sic*] substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts afford to a person who is unqualifiedly designated as the life beneficiary of a trust. Such degree of enjoyment is given only if it was the decedent's intention, as manifested by the terms of the trust instrument and surrounding circumstances, that the trust should produce for the surviving spouse during her life such an income, or that the spouse should have such use of the trust property as is consistent with the trust corpus and with its preservation.

Treas. Regs. §20.2056-5(b)(f)(2) makes it clear that the right to enjoyment may be given under the instrument as well as under state law. Almost seeming to anticipate section 104 of the UPAIA, Treas. Regs. §20.2056(b)-5(f)(4) state that the trustee's power to allocate between income and principal will not run afoul of the right to income requirement if the powers are such that local courts would require the reasonable exercise thereof.

From a review of the language of the existing regulations, it would be relatively easy to conclude that all of the formulae set forth below for unitrusts would meet the all income test. However, prudence dictates that one would not use them without either a private letter ruling or some published authority. And in this respect, the proposed regulations may actually narrow the ability to apply the all income trusts to unitrusts.

reallocate will not be considered to be a shift of a beneficial interest.

G. Qualified Domestic Trust

Under existing law, it is possible that the regulations would permit a unitrust (and perhaps even a trust permitting reallocation of principal under UPAIA §104) to qualify for QTIP treatment), but the QDT had additional problems because the §2056A regulations further provide as follows:

> In addition, income does not include any other item that would be allocated to corpus under applicable local law governing the administrations of trusts irrespective of any specific trust provision to the contrary. In cases where there is no specific statutory or case law regarding the allocation of such items under the law governing the administration of the QDOT, the allocation under this paragraph (c)(2) will be governed by general principles of law (including but not limited to any uniform state acts, such as the Uniform Principal and Income Act, or any Restatements of applicable law).

Under this language, coupled with the specific reference to capital gains, it is doubtful that distributions from a unitrust in excess of the accounting income of the trust would be treated as income, at least absent a state law to the contrary. However, the proposed regulations make it clear that the rules regarding §104 allocations or a unitrust permitted by state law apply to QDTs as well as QTIPs.

XIII. NON-UNITRUST ALTERNATIVES TO DEALING WITH ALL INCOME FORMULATIONS

In the real world, many trusts measure distributions in term of income, whether such trusts were drafted because of a statutory requirement, because that was the wish of the testator or grantor, or because that was the way the draftsman always drafted them. While it will require legislation to deal with existing all income trusts, there are ways to allow the trustee to invest for total return either through the use of unitrusts, annuity trusts, "Give-Me-Five" trusts, or more

conventional techniques. Remember that the soapbox I am on is that the draftsman needs to spend more time helping the client focus on what he really wants, and then developing a distribution plan which allows the client to meet those desires. And as always, flexibility is the key.

Thus, the issue at the private level is not whether an attorney ought to be drafting total return unitrusts as a principal drafting approach. It is the overriding thesis of this paper that the most productive result of the unitrust debate will be to refocus attorneys on the need to better emphasize client desires in developing distribution provisions, and **not** the ascendancy of the TRU as the first drafting preference.

A. Solutions to the Statutorily Mandated All Income Trusts

In those situations in which the settlor or testator is restricted by statute from designing the trust so that it precisely carries out his wishes, the amount of income can be controlled somewhat by the investment blend, and if there is a supplementary standard, the beneficiary can still enjoy distributions sufficient to provide for his or her needs. I do believe that an attempt to obliterate the distinction between income and principal will fail, as that concept is too deeply imbedded throughout the statutory and common law of trusts. In fact, UPAIA maintains this dichotomy, as will be discussed in greater detail below.

1. Discretionary Principal Distribution

The trustee can be authorized to exercise discretion over principal for the benefit of the income beneficiary, and thereby protect the beneficiary while allowing the trustee to invest for total return.

a. Total Discretion

The discretion granted can be total discretion allowing the trustee to distribute "such amounts of principal as my trustee determines in its sole discretion." The total discretion standard can also be used in a spray or sprinkle trust. Consideration should be given to a provision which would unequivocally state that the creator of the trust intends for the discretion to be absolute, and that no beneficiary may require a distribution. Should the trust contain factors for the trustee to consider in exercising its discretion? Some believe that this only creates problems, and that totally discretionary trusts should be totally discretionary. However, if the trust is drafted so that it is clear that the factors are only an expression of the settlor's intent, and cannot be used as a basis for compelling distributions, then such expression may help the trustee in exercising its discretion. Obviously, the trustee cannot be a beneficiary of the trust under this standard. Equally obvious is that the trustee must exercise the discretion given, including a decision to make no distributions. Regardless of how broad the language of the trust is, the trustee must still exercise its discretion in a reasonable manner. *Thorman v. Carr,* 408 S.W.2d 259 (Tex. Civ App. [San Antonio] 1966).

b. Best Interest Standard

The discretion given the trustee may be a "best interest" standard; *i.e.*, "the trustee may distribute such amounts of principal as it determines to be in the best interest of the beneficiary." Again, this standard will work with a spray or sprinkle trust, but the trustee cannot be a beneficiary. If the best interest standard is to be used, the draftsman should specify whether a beneficiary can compel a distribution. If any guidance is given as to what the settlor envisioned would be in the best interest of the beneficiary, again the trust should be clear as to whether such guidelines can be used as a basis to compel a distribution. Since a fiduciary is always required

to act in the best interest of the beneficiary, it is hard to see how this standard improves upon total discretion. For that reason, I have determined that I will never use this standard in drafting.

c. Subjective Standard

As a middle ground, the trustee could be given discretion, with general guidelines that the trustee must consider. The beneficiary could use such standards in trying to convince a court that the trustee had abused its discretion and to compel a distribution. Again, the key is clarity in drafting.

d. Objective Standard

The discretion given the trustee may be an objective standard, such as "health, education, maintenance and support." This standard is normally used when a beneficiary is a trustee. If there are multiple permissible distributees, then clear directions must be given as to preferences. In practice, these standards are seldom as objective as they seem, and almost always raise interpretation issues.

2. <u>Formula Distributions</u>

Principal distributions can be made according to a preset formula, which could take into account the size of the income distribution by providing a fixed amount, so that the standard really becomes a "greater of" formula. The formula could also permit distributions in excess of the formula subject to a standard, or the formula could operate as a cap on distributions. A discussion of the various formulae is set out below in the unitrust drafting section.

3. <u>Redefine Income</u>

State law may, of course, define income in any way the legislative body of the state chooses. For example, Texas Trust Code §113.101(a)(1) mandates the trustee to administer the

trust with respect to the allocation of income and principal "in accordance with the terms of the instrument," and in states which have adopted UPAIA there is even greater flexibility. Texas Trust Code §113.101(a)(2) provides that the Trust Code controls "in the absence of any contrary terms of the trust instrument." Therefore, the creator of the trust is able to define what is income and what is principal. Of course, even under the proposed §643(b) regulations, if the instrument deviates from state law, it may run afoul of the federal tax rules.

4. Powers of Appointment

The beneficiary can be given a power of appointment over principal.

a. Special Power of Appointment

The beneficiary could be given a special power of appointment which could be limited as to (i) time of exercise (*i.e.,* either during life or at death, or both), (ii) amount, either by amount or percentage of the trust, and/or (iii) permissible appointees. In the latter case, the power could be as broad as possible (*i.e.,* to anyone other than the beneficiary, the beneficiary's creditors, the beneficiary's estate or the creditors of the beneficiary's estate) or as narrow as desired (*i.e.,* limited to one or more persons or classes such as descendants, charities, *etc.*). In any event, such a power would prevent inclusion in the estate for tax purposes. While such a power, whether exercised or not, would avoid inclusion of the trust in the beneficiary's estate,[36] an inter-vivos exercise of the power could create a gift of the income interest at the date of and to the extent of the exercise.[37] Thus, an inter-vivos exercise of the power so as to appoint 10%

[36]Code §2041(b)(1) limits a general power of appointment to one which can be exercised in favor of the decedent, his estate, his creditors or the creditors of his estate.

[37]See Treas. Regs. §25.2511-1(e).

of the principal may carry with it a gift of 10% of the income, which may or may not be subject to the annual exclusion depending upon the manner of exercise. A special testamentary power will still allow the trust to qualify for QTIP treatment if it meets the other tests under Code §2056(b)(7).[38]

b. General Power of Appointment

The beneficiary may be given a general power of appointment which may also be limited as to time of exercise and the amount of the trust over which it may be exercised. This power will cause inclusion in the decedent's estate of the property over which it may be exercised and will always constitute a gift of the entire interest transferred upon its inter-vivos exercise in favor of anyone other than the holder of the power or upon the lapse or release of the power in excess of 5% of the value of the trust. This type of power cannot be used in connection with a QTIP trust since the general power would cause the trust to be treated under Code §2056(b)(5). The general power may of course be limited to 5% of the value of the trust without its lapse or release causing a gift[39], but there will still be inclusion in the estate to the extent the power was exercisable at death. The 5% power will be discussed more fully below in dealing with the so called Give-Me-Five trust.

B. Conventional Solutions Where All Income is Not Mandated

Even in cases in which all income is not mandated, there may be better solutions than the unitrust to allow the trustee to invest for total return. Again, the choice of this approach is based

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[38]Exercise of an inter-vivos power in a QTIP trust carries with it its own gift tax problems. *See* Code §2519.

[39]Code §2514(e). Note that this section specifically provides that a "lapse" of a power "shall be considered a release of such power."

on the twin ideals of flexibility and drafting clarity.

1. Total Discretion Trusts

The Trustee can be given total discretion as to income and principal. The considerations in drafting are the same as noted above.

2. Distributions According to Standard

Distributions of principal and income could both be according to some standard. Once again, the considerations as to the use of standards for both income and principal are as set out above.

3. Formula Distributions

______It would seem obvious to me that where the law permits greater flexibility by not dictating the distribution of income, the draftsman should not create inflexibility by going to a unitrust approach. Therefore, any formula approach should be thought of as a minimum amount and be accompanied with some discretion in the trustee. In most cases, my approach would be to use no formula at all.

4. Powers of Appointment

a. Special Powers of Appointment

Special powers of appointment may be used as with all income trusts, but with no adverse gift tax implications. Since the beneficiary is not entitled to the income, an exercise of the special power will not result in a gift.

b. General Power of Appointment

The use of a general power of appointment is subject to the same considerations as with an all income trust.

C. The Give-Me-Five Approach[40]

While under Mr. Horn's own classification, the Give-Me-Five approach is a unitrust approach, and while it fits the definition of a unitrust posited in this article, I have chosen to present it separately from the other unitrust provisions since the Give-Me-Five approach is anything but a fixed distribution approach to drafting. What this approach does is give the beneficiary an annually lapsing general power of appointment to withdraw up to 5% of the value of the trust. It is presumed, although not required, that this power will be exercised by the donee in favor of the donee. To the extent the power is not exercised, the theory goes, the property stays within the trust, safe from transfer taxes and creditors. The efficacy of those theories is examined below.

1. Underlying Theories

Mr. Horn has developed the Give-Me-Five approach based upon his belief that clients would always (or at least almost always) favor outright gifts, and it is the lawyer who injects the use of trusts for tax reasons, to provide asset and divorce protection, or control the ultimate devolution of the property. The latter reason is somewhat in conflict with the Give-Me-Five approach. Since the client, under this theory, would have preferred just an outright gift, this technique is designed to approximate that as closely as possible in the trust context.

2. Use with All Income Trusts, *et al.*

While this technique may be used as a stand alone standard for a non-marital trust, it may

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[40]The comments and forms are taken from a presentation made by Jerold I. Horn at the Southwestern Legal Foundation 40th Annual Institute on Wills and Probate in May, 2001. Mr. Horn's paper was entitled *Total Return Trusts: Trusts That Do Not Distinguish Between Income and Principal. See also,* Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Under the "Give-Me-Five" Unitrust,* 33 REAL PROP. PROB. & TR. J. 26 (1998).

also be used as to principal in connection with an all income trust or a trust which distributes income according to a standard. Any exercise of the power in favor of a third party will result in a taxable gift.

3. Use as Marital Trust.

Although the marital deduction all income requirement is usually couched in terms of distribution to the spouse, it is sufficient that the spouse have the right, exercisable at least annually, "to require distribution to herself of the trust income, and otherwise the trust income is to be accumulated and added to corpus."[41] Since the proposed regulations under §643(b) permit a 3%-5% unitrust to satisfy the all income requirement, it would seem that a 5% withdrawal right by the surviving spouse should meet the proposed regulatory all income test for both the testamentary general power of appointment trust under Code §2056(b)(5) and the QTIP provisions of Code §2056(b)(7) in those states which have a statute allowing the creation of unitrusts.

4. Flexibility and Easing of Tensions

Give-Me-Five also provides tremendous flexibility (at least up to 5% of the value of the trust). Unlike mandated distribution trusts, there is no requirement that any of the property subject to the 5% power be distributed. And, unlike discretionary trusts, the determination as to whether to withdraw anything lies with the beneficiary and not the trustee. Thus, the trustee is not in conflict with the remainder interest since only the beneficiary holding the power can decide what to draw down. The conflict still exists where the trustee also can make discretionary distributions as in the clause below.

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[41]Treas. Regs. §20.2056(b)-5(f)(8).

5. A Sample Clause

Following is a clause taken from the Southwestern Legal Foundation paper cited above. I have not changed the language utilized by the original draftsman as I did with Mr. Hoisington's clauses below. This is the "omnibus" version the of the Give-Me-Five drafting approach in that it permits distribution in excess of 5% subject to a standard by a beneficiary/trustee and totally discretionary distributions by an independent trustee, even to the extent of terminating the trust. Obviously, the clause can be pared back by eliminating any of those additional powers. The clause is a fractional share clause, but a pecuniary clause could be used. Following the sample clause is a listing of the issues raised by this approach.

a. Give-Me-Five. If, after attaining thirty years of age, the descendant is living immediately before the end of a calendar year, the Trustee shall pay to the descendant so much, if any, of the trust estate, not to exceed in value five percent of the value of the trust estate as of the end of the year, as the descendant last directs in writing before the end of the year.

b. Additional Distributions. The Trustee shall pay to the descendant so much or all, if any, of the trust estate as the Trustee determines to be advisable from time to time, considering resources otherwise available, to provide for the descendant's health, education and support in the manner of living to which accustomed. Additionally, The Trustee shall pay to the descendant so much or all, if any, of the balance of the trust estate as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including termination of the trust.[42]

6. Creditor Protection

One of the stated purposes of the Give-Me-Five trust is creditor protection. Yet the law in many states, is unclear as to the effect this provision has with respect to creditors. For

[42] If the Trustee making the HEMS decisions is other than beneficiary, then how will the trustee know what to distribute if he has no idea what the beneficiary is going to withdraw until the end of the year? Even with respect to distributions under the total discretion standard, how much the beneficiary is going to withdraw still might affect the trustee's decision.

instance, prior to the lapse of the power, could a judge order a beneficiary to exercise this power for the benefit of creditors? As a corollary issue, in most states, spendthrift trust protection is not available for self-settled trusts. Does the lapse of the power cause the beneficiary to become the grantor of the trust to the extent of the lapse?[43]

7. Transfer Tax Avoidance

The property subject to a general power of appointment will be included in the donee's estate. Thus, one problem may be the inclusion of 5% of the trust in the gross estate of the donee. Mr. Horn would argue that the fact that the descendant must be alive at the end of the year would avoid inclusion in the estate. This, of course, presents some problems in the Trustee exercising its discretion since it has no way of knowing, in advance, how much the beneficiary will draw down, and obviously cannot make distribution of that amount prior to immediately before the end of the year.

8. Income Tax and Grantor Trust Issues

Code §678(a) treats the holder of the lapsed power as the grantor to the extent of the lapse. Further, it is the IRS position that the grantor status is cumulative, so that the donee of the power becomes the grantor of a greater portion of the trust each year.[44] A detailed discussion of the income tax issues is beyond the scope of this paper, but suffice it to say that while Mr. Horn believes the problems are "solvable," I remain less sure. That issue has never been raised by the IRS, but until it is resolved, there is a certain amount of risk in the Give-Me-Five formulation.

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[43]Some states have dealt with that issue by statute. *See* Texas Trust Code §112.035, which defines spendthrift trusts, and provides that the holder of a lapsed general power does not become a grantor as a result of the lapse.

[44]See Priv. Ltr. Ruls. 200022035, 9034004, and 8701007.

Another issue that must be dealt with is who may choose the assets to be distributed if the Give-Me-Five power is exercised, the trustee or the beneficiary?

9. Assumes Financial Corpus

As with the fixed return unitrust, the valuation issues are difficult to deal with if the assets of the trust are not primarily financial assets.

XIV. SOME UNITRUST PROVISIONS

A. Hoisington Provisions (as Modified by Golden)[45]

Following are some suggested clauses for implementing the unitrust design. Note that none of the provisions are the "greater of x% or all the income." Note also that some of these clauses are designed to be used to create supplemental benefits in addition to the primary benefits. These well thought out clauses are taken in large part from Mr. Hoisington's article for the Heckerling Institute, cited above, with some modifications by the author.[46] Most of these provisions employ averages rather than the current value in an attempt to reduce volatility in the amount distributed. Keep in mind that a discretionary trust, as noted earlier, is a form of unitrust. See the discussion above as to the various types of discretionary formulae.

1. Discretionary Distributions Not to Exceed Certain Percentage of Value

Mr. Hoisington suggests that the following provision can be used as a supplement to a

[45]Much of the material concerning the use of the total return unitrust and its variations are based upon William L. Hoisington, *Modern Trust Designs,*© 1999 which was an update and expansion of his article for the Heckerling Institute, cited *supra.*

[46]The essence of our specialty is selective plagiarism with, of course, some modification to make such purloined material our own. While the type of formula is from Mr. Hoisington's work, the author has taken the liberty, in some cases, of making substantial stylistic changes, which may even affect the substance.

foregoing distribution formula such as all income or a fixed percentage. With slight modifications, such as raising the 2% cap to a larger number, it could also be used as a primary formula. Note that the beneficiary cannot be the trustee of this trust (at least as to distributions to himself or herself) and the spray or sprinkle provision must be removed if this provision is to be used in a QTIP trust.

> **Additional Distributions May Be Made To Or For The Benefit Of The Beneficiary And/Or The Descendants Of The Beneficiary In The Discretion Of The Special Trustee, But Not In Excess Of 2% Of The Preceding 5 Year End Average Fair Market Value Of The Trust Property.** In addition to the required distributions set out above, after the end of the first full calendar year during which the trust is funded (in whole or in part), the Trustee may, in its discretion, distribute to, or for the benefit of the Beneficiary and/or any of the then living descendants of the Beneficiary as much (if any) of the property in the Trust and in such manner, as the Trustee[47], may at any time determine and direct. The exercise of the trustee's discretion, however, is limited as follows:
>
> (1) The Trustee shall not make any discretionary distribution of trust property directly or indirectly to, or for the benefit of, the Trustee or in any circumstance in which such discretionary distribution would constitute a taxable gift by such Trustee; and,
>
> (2) The aggregate amount of any distributions made pursuant to this subparagraph during any one calendar year shall not exceed two percent of the average net fair market value of the trust property at the close of the last business day of each of the immediately preceding five calendar years or lesser number of years of the trust's existence (*excluding, in each case, any amounts that were required to be distributed during any preceding calendar year of the trust,* but were not actually distributed prior to the end of the calendar year, and any residential real or tangible personal property held in the trust that was occupied by, or was within the possession or control of, the Beneficiary or any descendant of the Beneficiary at any time during the immediately preceding calendar year).
>
> Except to the extent that the Trustee may direct otherwise, distributions from the Trust to, or for the direct benefit of, any descendant of the Beneficiary

[47]Mr. Hoisington suggests that a special trustee may be used to make such distributions so that the trustee with investment and other distribution powers could be a beneficiary.

shall be charged against the trust estate of the Trust as a whole and not against the ultimate distributive share (if any) of such descendant.

Note that this provision does not provide the kind of certainty of distribution that the supporters of unitrusts advocate in that there is still a potential for disputes between the current beneficiaries and remaindermen, but it has the attribute of giving flexibility while still ostensibly preserving principal. Note, also, that this provision may require an allocation of GST exemption to the trust. The exclusions, which have been italicized, are extremely important. Note that there may be undistributed income in the trust on the valuation date which should not be included in determining value for the purpose of applying the unitrust percent.

2. <u>Discretionary Distributions Not to Exceed Fixed (Inflation Adjusted) Amount</u>

This provision is also designed to be used as a supplement to a primary distribution formula. Used as a primary formula, it would be the annuity unitrust described below except for the discretionary feature. Because of the ascertainable standard, a beneficiary could also be the trustee.

> **Additional Amounts Are Required To Be Distributed For the Beneficiary's Support If All Financial Resources Available For The Beneficiary's Support Are Insufficient, But Not In Excess Of $50,000/Year Adjusted For Inflation.** If, at any time after the end of the first full calendar year during which the trust is in existence, the Trustee, in his good faith judgment, determines that the sum of (i) the amounts required to be distributed pursuant to subparagraphs [x.x.1] and [x.x.2] during the current calendar year and (ii) all other financial resources then available for the support of the Beneficiary that are reasonably quantifiable by the Trustee (such sum being referred to as the "Available Resources") are insufficient in the aggregate to provide adequately for the Beneficiary's reasonable support, the Trustee shall distribute to, or directly for the support of, the Beneficiary as much of the property then held in the Trust as, when added to the Available Resources of the Beneficiary, will, in the good faith judgment of the Trustee, provide adequately for the reasonable support of the Beneficiary; provided however that the aggregate amount of all distributions made pursuant to this subparagraph during any one calendar year of the trust (or

portion thereof) shall not exceed the following described total amount (the Dollar Limit): The Dollar Limit for the first calendar year shall be Fifty Thousand Dollars ($50,000) increased or decreased by a percentage of such dollar amount as is equal to any percentage increase or decrease in consumer prices between January 1, 2000, and January 1 of the first calendar year during which the trust is funded (in whole or part); and the Dollar Limit for the next and each succeeding calendar year during which the trust is in existence shall be the Dollar Limit for the immediately preceding calendar year increased or decreased by a percentage of such dollar amount that is equal to the annual rate of change in consumer prices during the preceding calendar year determined as of the end of such preceding calendar year (year-over-year). For purposes of the foregoing changes in consumer prices shall be determined by reference to the Consumer Price Index for All Urban Consumers (CPI-U), not seasonally adjusted, or any other independently maintained cost of living index that the Trustee determines in good faith more accurately reflects the costs of living of the Beneficiary during such preceding calendar year.

This provision could also be accompanied with a cap on total distributions from principal based upon the amount of income received by the beneficiary. Provisions of this nature dealing with "Available Resources" are difficult to draft. While I believe this one is relatively clear in that includes capital as well as income, does this mean that the beneficiary must sell his or her home or ranch before getting anything from the trust? I think not, but a court may see things differently.

3. The Fixed Percent of Market Value

This formula is designed to be used as a primary formula, and the beneficiary can serve as trustee. This is nothing more than the charitable unitrust formula without a congressionally mandated amount. Some of the practical problems in the use of this formula can be seen in the clause below and in the New York statute.

4% Of The Value Of Trust Is Distributed To Or For The Support Of The Beneficiary Annually. The Trustee shall distribute to, or as directed by, or directly for the support of, the Beneficiary, at convenient intervals, but at least

> annually, amounts in the aggregate equal to four percent of the net fair market value of all property held in the Trust at the close of the last business day of the year[48] during which the Trust was first established and, thereafter, four percent of the average net fair market value of all property held in the Beneficiary's Family Trust on the last business day of each of the immediately preceding five calendar years or lesser number of years of the trust's existence; provided however that, in the case of a short year, the Trustee shall prorate the aggregate annual amount on a daily basis. Within a reasonable time after the end of each calendar year, the Trustee shall pay to the Beneficiary (in the case of an underpayment) or receive from the Beneficiary (in the case of an overpayment), without interest (in either case), the difference between any amounts actually paid during the preceding calendar year and the aggregate amount required to be paid during that year. Solely for purposes of determining the annual amount that is required to be distributed to the Beneficiary pursuant to this subparagraph [x.x.1], "net fair market value of all property held in the Beneficiary's Family Trust" shall exclude any amounts that were required to be distributed during any preceding calendar year of the trust, but were not actually distributed prior to the end of the calendar year, and shall not include the fair market value of any residential real or tangible personal property held in the trust that was occupied or possessed by, or the occupancy or possession of which was within the control of, the Beneficiary (other than merely in their capacity as the Trustee of the trust) at any time during the calendar year of the trust.

Studies by David Levine and Roger Hertog indicate that the real value of the trust can probably be sustained, but barely, with a 3% distribution requirement, and that a 5% distribution requirement would result in a substantial reduction in real value of the portfolio and resultant reduction in real value of the income distributions.

Even today, there is no agreement as to whether 4% (the New York amount) is too high. So long as the growth rate exceeds the inflation rate, everyone ought to be relatively happy campers. However, if the inflation rate suddenly outpaces growth and the unitrust rate, then the real value of the income beneficiary's distributions will drop. A large drop well into the term

[48]Note that Mr. Hoisington uses a five year rolling average as opposed to the three year rolling average utilized by Mr. Wolf. Studies would indicate that the five year period adds little additional smoothing, and the three year period would seem preferable.

of the trust, after the beneficiary has established a lifestyle based on the distributions could prove disastrous. It is of course possible that the distributions would drop in nominal terms also.

4. Indexed Annuity

This is the charitable annuity trust formula, but indexed for inflation. It is designed to assure that the beneficiary always has a fixed amount in terms of inflation adjusted dollars. One of the more interesting features is that the trust is designed to substantially increase its distributions after reaching a certain age. This may answer the concern often expressed by clients today that they do not want their children to receive so much from the trust that the incentive to be productive is diminished. Note the inflexibility of this, and the fixed percent of value formulae, if there are no discretionary distributions in addition to these amounts. Also note that this is a cap based on the value of the trust , in case the distributions deplete the value of the trust. The beneficiary can be the trustee under this formula.

> **$48,000 Is Distributed To Or For The Support Of The Beneficiary Annually As Long As The Beneficiary Is Living And Under The Age of 60 and $96,000 After 60.** The Trustee shall distribute to, or as directed by, or directly for the support of, the Beneficiary, at convenient intervals, but at least annually, amounts in the aggregate equal to the Annuity Amount as hereinafter determined. The Annuity Amount for the first calendar year during which the Trustee is satisfied that the trust is substantially fully funded shall be $48,000 if and while the Beneficiary is living and under the age of 60 years and $96,000 if and while the Beneficiary is living and over the age of 60 years, in either case, increased by a percentage of such dollar amount that is equal to any percentage increase in consumer prices between January 1, 2000, and January 1 of the first calendar year during which the trust is funded (in whole or part). The Annuity Amount for the next and each succeeding calendar year during which the trust is in existence shall be the Annuity Amount for the immediately preceding calendar year increased or decreased by a percentage of such dollar amount that is equal to the average annual rate of change in consumer prices during the preceding five calendar years determined as of the end of each such preceding calendar year. For purposes of the foregoing, changes in consumer prices shall be determined by reference to the Consumer Price Index for All Urban Consumers (CPI-U), not

seasonally adjusted, or any other independently maintained cost of living index that the Trustee determines in good faith more accurately reflects the costs of living of the Beneficiary during such preceding calendar year.

Notwithstanding anything in the foregoing to the contrary, in no event shall the Annuity Amount exceed five percent of the net fair market value of all property held in this trust at the close of the last business day of each of the immediately preceding five calendar years or lesser number of years of the trust's existence, excluding, in each case, any amounts that were required to be distributed during any preceding calendar year of the trust, but were not actually distributed prior to the end of the calendar year, and further excluding the fair market value of any residential real or tangible personal property held in the trust that was occupied or possessed by, or the occupancy or possession of which was within the control of, the Beneficiary (other than merely in their capacity as the Trustee of the trust) at any time during the calendar year of the trust..

5. Market Performance Unitrust

This type of unitrust formula was developed by James P. Garland. The theory behind this is that tying distributions to *value* is a very artificial measurement, and that distributions should be tied to market returns. The beneficiary can be the trustee under this provision.

Distributions Are Sum of 125% of Dividends Plus Bond Yields and 4% of Other Assets held for Investment. While Beneficiary is living, the Trustee shall, each calendar year, distribute to Beneficiary an amount or amounts in the aggregate equal to the following:

(a) The product of [i] 125% of the average dividend yield on the S&P 500 Stock Index for the immediately preceding 5 calendar years and [ii] the average fair market value on the last business day of each of the immediately preceding 5 calendar years (or lesser number of years of the trust's existence) of that portion of the trust investments that consists of publicly traded equity securities, plus

(b) the actual yield on the portion of the trust property that is invested in bonds or other debt instruments, less any percentage increase (or plus any percentage decrease) in consumer prices during the immediately preceding calendar year (year-over-year), as reflected in any change in the Consumer Price Index for All Urban Consumers (CPI-U), not seasonally adjusted, plus

(c) 4% of the market value at the end of the preceding calendar year of all other trust property that is held primarily for investment, which shall not include

> the fair market value of any residential real or tangible personal property held in the trust that was occupied or possessed by, or the occupancy or possession of which was within the control of, the Beneficiary (other than merely in their capacity as the Trustee of the trust) at any time during the calendar year of the trust.

Mr. Hoisington suggests, although Mr. Garland would probably not agree, that the formula was developed at a time when dividends were a good deal higher in relation to value, and that clause (a) should be permanently modified to something such as 150% of the average earnings on S&P 500 stocks. Of course, this assumes that dividend policies will remain constant. This assumption may or may not be valid. In fact, as Mr. Garland points out, if stock values decline, then, in all probability, the amount of dividends will increase in relation to the value of the stock and therefore in relation to earnings also (although this is not happening now).

Clause (c) causes some valuation problems also in that if the assets held for investment are neither publicly traded securities nor bonds. If you use this type of formula, there must be some provision made, either here or in the administrative provisions as to how the valuation of these difficult to value assets is to be done. This is, of course, a problem in any percentage of value distribution formula.

B. The Northern Trust Forms

Northern Trust Co. has prepared forms creating a fixed payout unitrust and an annuity type trust. I believe that these forms are exceptionally well thought out, and deal with the issues of hard to value assets much better than the New York statute. Northern Trust notes in its comments that a unitrust (whether fixed percent or annuity type) should not be used where the trust has large non-financial and difficult to value assets. A copy of the proposed Northern Trust forms are attached hereto as Appendix A-1 and Appendix A-2

XV. CONCLUSION

Drawing a conclusion about the various approaches and the multi-faceted and complex arguments is very difficult and goes to the heart of what an estate planner does.

A. The Economic Conclusions

The economic arguments center largely around belief in future performance and whether the past is indeed prologue to the future. The arguments certainly prove that statistics can be used to prove almost any proposition. Almost all agree that higher returns in the present inevitably produce lower returns in the future, and *vice-versa.* David Levine argues that, "[Fixed percentage of value] Unitrusts represent the classic error of 'fighting the last war.'" I am not persuaded by the advocates of the fixed percent of value unitrust, primarily because of the lack of flexibility. Additionally, this type of trust spends a great deal of appreciation in the early years and discriminates heavily in favor of the income beneficiary.

B. Fixing Existing Trusts

Each of the statutory solutions to adapting existing trusts to the prudent investor standard is flawed. The unitrust model is simply too inflexible. Even if all beneficiaries agree, a beneficiary could potentially claim that all of the facts were not explained. UPAIA §104 cannot be used with a beneficiary/trustee. In some situations, perhaps, a modification could be sought to allow the appointment of an independent trustee to make the §104 allocations.

C. The Drafting Conclusions

One of the more interesting aspects of this discussion is that the lawyers involved believe passionately in unitrusts, one economist (Garland) also believe in unitrusts, but only those related to returns, not value. And Messrs. Levine, Collins, *et al.*, the economists, believes that the all

income trust works just fine.

So what is the estate planner to do with all these decisions?

- First, remember that the problem as to distributions from a trust is not new.
- Second, the main goal is still to accomplish the client's objectives, particularly with respect to current beneficiaries. While the generation skipping transfer tax causes many people to set up dynasty trusts, there are also strong non-tax reasons that apply only to spouse and children. Most of my clients are not really concerned beyond that. (And special powers of appointment allow children to deal with their descendants or others.)
- Third, depending upon the trustee, a totally discretionary trust or a trust with standards that apply to both income and principal allow the trustee to invest for overall return. Even an all income trust that allows principal invasion should not limit the trustee's investment power. And if there is any doubt, the draftsman can clearly state that the trustee can invest for overall return in accordance with modern portfolio theory, and then gild the lily by incorporating the prudent investor rule as the investment standard. If an ascertainable standard is used, the draftsman must make it clear as to how the income beneficiary is to be treated and whether the trustee is to be relieved of the duty of impartiality.
- Fourth, the choice of trustee is critical. In a long term "happy" marriage, the choice of the surviving spouse probably will get the testator where he or she wants to be -- leave all the money at the disposal of the spouse. This may also be true with a trust for a responsible child where the child is the trustee. In

situations of a second marriage, perhaps the only way to get the proper spending result is an independent trustee or a fixed return unitrust.

- Fifth, if the testator desires to prefer one beneficiary, then that should be spelled out also.
- Sixth, if the testator desires to assure a real fixed level of spending, then an annuity approach may work, but a choice of the level must be carefully considered since a sharp and prolonged downturn could substantially deplete the trust.

D. The Bottom Line

When I first started reading in this area, I was convinced that the fixed percentage of value unitrust was the wave of the future and the way future trusts should be drafted. However, after much consideration, I am convinced that more attention to the client's spending desires and more careful statements in the trust as to intent produce a better result. The question I could not escape is, "If the 'experts' cannot agree on the proper formula, how can I lead a client into this morass?" In other words, the discussion surrounding the use of TRUs has exposed some things on which we, as estate planners, should focus more carefully.